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BEYOND THE CENTER: DECENTRALIZING THE STATE

Shahid Javed Burki
Guillermo E. Perry
William R. Dillinger

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Shahid Javed Burki is vice president and Guillermo E. Perry is chief economist of the World Bank's Latin America and the Caribbean Regional Office.

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Acronyms and Abbreviations

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ACE	Community Education Association (El Salvador)
ARS	Administradora del Regimen Subsidiado (Colombia)
BANOBRAS	Banco Nacional de Obras Publicas (Mexico)
CEPAL	Centro Estudios para America Latina
CONAFE	National Board for Educational Improvement (Consejo Nacional de Fomento Educativo)
CREMA	Contrato de Recuperaciucat Mantenimiento
CVF	Consejo de Vialidad Federal (Federal Road Council, Argentina)
DNV	Direcci de Vialidad Federal (Federal Road Council, Argentina)
DRG	Diagnostic Related Group
EDUCO	Educación con la participación de la Comunidad (Education with the Participation of the Community)
FINDETER	Financera de Desarrollo Territorial S.A. (Colombia)
GDP	Gross domestic product
GNP	Gross national product
INEP	Instituto Nacional de Estudos e Pesquisas Educacionais
IMSS	Social Security Institute (Mexico)
LAC	Latin America and the Caribbean
NGO	Non-governmental organization
OECD	Organization for Economic Cooperation and Development
OPD	Decentralized public organism (Mexico)
PRI	Partido Revolucionario Institucional
PSF	Programa de Saude de Familia (Brazil)
SIMCE	Sistema de Medicion de la Calidad de la Ensenanza
SN	Subnational
SSA	Ministry of Health (Mexico)
SUS	Single health system (Brazil)
TVAAS	Tennessee Value-Added Assessment System
UNESCO	United Nations Educational, Scientific and Cultural Organization
VAT	Value-added tax

PROLOGUE

Matching Authority and Accountability

Decentralization is transforming the structure of governance in Latin America. Since 1983, all but one of the largest countries in the region have seen a transfer of power, resources, and responsibilities to subnational units of government. In much of the region this began as a shift from appointed to elected governors and mayors (see Table P.1). In some countries this occurred in the course of a reversion from military to civilian rule (as in Argentina in 1983, Brazil in 1985, and Chile in 1992). In other countries it represented the introduction of local elections for the first time in decades (as in Colombia in 1986 [mayors] and 1991 [governors], and Venezuela in 1989 [governors]). In Mexico the expansion of local democracy has been more subtle. After decades of one-party dominance in state and local elections throughout the country, opposition parties now constitute serious competition.

Decentralization has also appeared in the form of a devolution of major functional responsibilities. In Colombia and Argentina primary education has been decentralized to the intermediate levels of government. In Chile it has been transferred, in part, to the municipal level. Parts of the highway network have been decentralized to state governments in Brazil. Major increases in fiscal transfers to subnational governments have also occurred, particularly in Brazil, Mexico, and Colombia.

What is at Stake

Political Stability and the Deepening of Democracy

The dominant force behind decentralization is, in the final analysis, political. It is part of a broader trend toward democracy in the region. As shown in Table P.1, of the 14 countries in the region with populations over 5 million, only three were multiparty democracies in 1960. (Mexico may be best classified as a single-party democracy from 1929 to 1988, but can now be considered a multiparty democracy.) As of 1999, all 14 countries fall into this category. At the national level, this has meant a dispersion of formal political power to elected presidents and congressmen. At the subnational level, it has meant a dispersion of power to governors, mayors, and subnational legislatures.

This dispersion of power is a global trend (see *World Development Report* [1999–2000]). Political scientists have proposed various explanations for it. In broad terms, they have suggested that it is an outcome of the declining credibility of the centralized state. Groups that have historically been denied power now demand it, and central governments are increasingly reluctant to combat this demand with force. The state's declining credibility, in turn, has been attributed to economic failure (with the consequent alienation of important business and labor support), to the relative absence of war and civil unrest (with the consequent decline in the acceptance of strong authoritarian government), and to the emergence of educated urban middle classes (with the consequent decline of traditional patron-client relationships between the government and the gov-

TABLE P.1

Summary of Decentralization Measures

		FIRST YEAR OF ELECTIONS BY LEVEL OF GOVERNMENT*			ADDED LOCAL ELECTIONS[5]	DEVOLVED FUNCTIONS	DEVOLVED REVENUE
COUNTRIES WITH POPULATION ≥5 MILLION	POPULATION (IN MILLIONS)	NATIONAL	PROVINCIAL	MUNICIPAL			
Brazil	164	1985	1982	1985		X	X
Mexico	95	1917	1917	1917	X[1]	X	X
Colombia	38	1958	1992	1986	X	X	X
Argentina	36	1983	1983	1983		X	X
Peru	25	1980	--	1981			
Venezuela	23	1961	1989	1989[2]	X	X	X
Chile	15	1990	[4]	1992	X	X	X
Ecuador[3]	12	1978	1978	1978	X		
Guatemala	11	1985	[4]	1985	X		
Bolivia	8	1985	[4]	1987	X	X	X
Dominican Republic	8	1966	--	1966	X		
Honduras	6	1982	--	1982	X		
Nicaragua	5	1986–90	--	1990	X		
Paraguay	5	1991	1994	1991	X		

*Following military rule, where applicable.
-- = Countries with no provincial level of government.
[1] Victories by opposition parties at the municipal level began in 1982 and at the state level in 1989.
[2] Open list replaces closed, blocked party list.
[3] Provincial executives and councils have traditionally been elected—except during military regimes—but have limited powers. Parallel provincial governments, headed by a centrally appointed governor, are responsible for the field administration of central government functions.
[4] Although Chile, Guatemala, and Bolivia do not have elected governments at the regional level, these countries have assigned major planning and investment responsibilities to regional governments, with significant revenues and expenditure autonomy.
[5] Compares current regime to previous civilian regime. (Local elections are generally absent during periods of military rule.)
Source: Willis, Garman, and Haggard 1997.

erned) (O'Donnell, Schmitter, and Whitehead 1986; Potter 1993). In a fundamental sense, democratization, and with it, decentralization, can be seen as a strategy to maintain political stability—to provide an institutional mechanism for bringing opposition groups into a formal, ritualized bargaining process. As such, it constitutes an alternative to civil war or other forms of violent opposition.

Specific cases, of course, do not lend themselves to such global generalizations. In Latin America the motivations for decentralization are complex. In Brazil, for example, decentralization accompanied the transition from military to civilian rule. By shifting political and fiscal resources to the municipal level, the negotiators of Brazil's transition were able to accommodate popular dissatisfaction with military centralism and allow the military to withdraw in good order (Hagopian and Mainwaring 1987). In Guatemala, decentralization was one of the key tenets of the peace accords (1996) and raised the expectation of greater self-government for indigenous communities. In Colombia, the institution of elected mayors, and later provincial governors, was in part motivated by the desire of central party leaders to gain grass roots support in areas under rebel control. But it also reflected a concession to long-standing demands from the established parties for regional autonomy. The decentralization of education and health in Colombia also reflected concerns with efficiency and quality in those sectors. In Mexico, the decentralization had its origins in a long-running series of political reforms that began with the decision to allocate 25 percent of the seats in congress to opposition parties. A subsequent financial crisis caused the government party to lose control of congress and several key governorships and mayoralties. Opposition parties have therefore tended to favor decentralization, and their increasing influence—particularly in congress—has permitted them to demand further measures as a price for their support on key government legislation.

More Efficient, Responsive Public Services

Political stability and democratic government are worthwhile ends in themselves. But there is more at stake. On the positive side, it is argued that decentralization can increase the efficiency and responsiveness of government (Oates 1972). According to this argument, devolving resource allocation decisions to locally elected leaders can improve the match between the mix of services produced by the public sector and the preferences of the local population. Because local officials have better knowledge of local conditions and are more accessible to their constituents, they have the means and the incentive to be responsive. Decentralization, according to this argument, may also improve the management of public services since, through sheer proximity, local officials can be held more accountable for their performance (Ostrom, Schroeder, and Wynne 1993). Where the population is mobile and citizens can "vote with their feet," decentralization may also result in local governments competing with each other to better satisfy the wishes of citizens (Tiebout 1956; Inman and Rubenfeld 1997).

There are downside risks to decentralization. First, of course, is the risk that service delivery could decline. Granting political autonomy to local governments does not guarantee an improvement in public services. There is, to start with, a risk of capture by local political elites. Transferring decisionmaking power from central government administrators to local elites may worsen the quality of services, at least for the majority of constituents. Questions have also been raised about the technical capabilities of local government staff.

While the evidence to date does not point definitively in either direction, it is clear that there has been an increase in the variance of public service performance. Centralized ministries were capable of delivering a fairly standardized level of services nationwide. Decentralization has improved services in some jurisdictions and worsened it in others.

Concern with these risks has prompted some Latin American and Caribbean countries to favor slow, incremental, or partial decentralization. This has taken the form of micromonitored earmarking (as for example, in the Mexican approach to sector decentralization or the Colombian government's requirement that provincial and local governments be "certified" before assuming responsibility for education or health). Programs geared to strengthening subnational government technical capacity have been implemented in practically every country in the region, although this has been more successful when organized as information sharing among peers than as top-down technical assistance directed at recalcitrant mayors.

BOXP.1

What is Decentralization?

Decentralization, as the term is used here, refers to the process of devolving political, fiscal, and administrative powers to subnational units of government. Although there are many entry points and strategies for decentralization, for purposes of this report a country is not considered to have decentralized unless it has a locally elected subnational government. Decentralization may consist of bringing such governments into existence, restoring them after a period of authoritarian rule, or expanding the resources or responsibilities of existing elected subnational governments.

There are, of course, other ways to disperse the power of central government ministries. One is deconcentration, in which the central government increases the autonomy of its regional offices. This has been widely used in Latin America, often as a precursor to the transformation of regional governments into independent political entities. Another is privatization, through the sale of assets, the granting of concessions, and through public-private alliances.

This report focuses on elected subnational government for two reasons. First, it is the most ambitious—and perhaps most risky—of the three forms of structural reform going on in the region. Second, it is unique in its behavioral implications. Decentralization shifts the structure of local accountability from central government to local constituents. Deconcentration, in contrast, preserves the hierarchical relationship between central government and field staff. Privatization introduces the profit motive as an influence on behavior. Although in practice the three can be employed simultaneously, their political, fiscal, and administrative implications are quite different. Decentralization must be considered unique.

Widening Disparities

In theory, decentralization may also widen regional disparities in the provision of public services. Such disparities, per se, are not undesirable. As with private goods, effective demand for local public services is likely to vary with income. But disparities matter when they have distributional implications. Thus disparities in spending on primary education or primary health may be cause for concern. If the financing of education or health is decentralized, spending levels will reflect variations in local tax bases, rather than the allocations of centralized government ministries.

Macro Risks

Decentralization may also pose macroeconomic risks in the form of recurring central government deficits, an overexpanded public sector, or the inability to use fiscal policy to adjust to economic shocks.

Central government deficits may arise if governments are unable to reduce expenditures or increase taxes to match the increasing cost of intergovernmental transfers. Brazil's 1988 constitution, for example, required a major increase in federal tax sharing without providing for any devolution of federal spending responsibilities. This threatened to provoke recurrent deficits at the federal level (see Chapter 3.) In other cases, central governments have decentralized both revenues and expenditures, but have been unable to reduce existing levels of central government spending after the functions have been decentralized. Colombia, for instance, maintained and sometimes increased central government spending on education and health several years after these functions were transferred to subnational government. Mexico substantially increased transfers to municipalities in 1998 and 1999 without a reciprocal reduction in spending at the federal level. As a result, both countries have been forced—at least temporarily—to maintain existing levels of spending while funding an expanding volume of intergovernmental transfers. In some cases this has resulted in significant central government deficits.

Attempts to eliminate such deficits by raising taxes can raise another macroeconomic problem: an overexpansion of the public sector. Brazil's mismatch between revenues and expenditures, for example, was ultimately resolved not by reducing federal government expenditures, but by increasing federal taxes. (Other ways of reducing deficits can have equally adverse microeconomic consequences. Central governments may reduce deficits by cutting spending in the sectors that remain under their responsibility. This can distort the sectoral allocation of spending in the public sector as a whole.)

Decentralization can also hamper a government's ability to respond to economic shocks. Fiscal decentralization—whether in the form of tax reassignment or mandatory revenue sharing—reduces central control over aggregate public sector revenues and expenditures. Governments, such as Brazil's and Colombia's, which must share nearly half their tax revenues with subnational governments, may find it difficult to raise tax rates sufficiently to compensate for economic downturns (Tanzi 1996).

But it is not merely the technical issues—transfers, expenditure assignments, and tax levels—that are a source of macroeconomic risks. There is a more subtle risk that newly empowered local governments may use their political muscle to undermine the national interest for the benefit of their individual constituencies.

Mayors or governors, for example, may borrow excessively in the expectation of central government debt relief. While central governments are generally under no obligation to provide such relief, decentralization can change politics at the national level. The emergence of powerful regional voting blocs can weaken the government's resolve. This was the case, for example, in Brazil, where the Federal Senate permitted states to accumulate unsustainable levels of bond debt. This ultimately required a federal assumption of the state debt, at massive cost to the government (see Chapter 3).

* * *

In this report we examine these claims in the light of empirical evidence from both Latin America and the long-standing multitier democracies of Europe and North America. This report finds that the impact of decentralization—its effect on the efficiency of public services, on equity, and on macroeconomic stability—depends very much on the specifics of the case. One has to look beyond the question of whether a country has elections at the local level, whether a nominal transfer of functional responsibilities has taken place, or whether intergovernmental transfers have grown, to the whole range of factors that affect the behavior of the people who are involved in public policymaking and service provision. Who are these people? They are the newly elected mayors and governors, of course. But not only them. They are also the teachers, doctors, and road engineers who are involved in delivering public services. We find that the microeconomic impacts of decentralization—the impacts on the efficiency and responsiveness of services—depend not merely on decisions made in provincial or municipal governments, but also in individual schools, health clinics, and road departments.

Mayors and governors, moreover, are not the only politicians who matter. It is the politicians at the national level—the congressmen, the president, the national party leadership—who write the rules and decide which ones will be enforced. Rules decided at the national level have an overriding impact on the behavior of politicians at lower tiers of government. To understand how these rules are made and enforced, one has to understand how decentralization affects national as well as local politics.

If there is one common theme that runs through the six chapters that follow, it is the importance of ***accountability:*** the need to clearly demarcate who is responsible for what. But accountability is not enough. Those who are accountable must also have the ***authority*** to deliver results. This means not merely the legal authority to make decisions, but also the financial and human resources to carry them out.

This lesson emerges, first, in the chapter on macroeconomic stability. Chapter 3 describes how four countries have responded to pressure for excessive borrowing by subnational governments. Two factors appear to determine success. The first is a hard budget constraint imposed by the central government. Where a central government maintains a credible policy against bailouts, it forces subnational governments and their lenders to live with the consequences of their decisions. They become ***accountable*** for their borrowing and lending. Under these circumstances, lenders tend to refrain from lending to uncreditworthy subnational governments. Where responsibility for debt is ambiguous—as it is when there is reason to expect national bailouts of failing subnational entities—subnational governments and their lenders have a greater incentive to take risks at the expense of national taxpayers.

The second factor is subnational management autonomy, that is, the ability to adjust to macroeconomic shocks in a way that forestalls default. Where subnational governments have the ***authority*** to cut personnel costs or raise tax rates, they can respond to adverse economic circumstances without reneging on their debt obligations. This in turn makes it easier for central governments to maintain a policy against bailouts.

A similar pattern emerges in the chapters that examine the impact of decentralization on the quality of public services. To examine this issue, the report looks at three specific sectors: education, health, and roads. Each is a major expenditure item of government. Each has been the object of decentralization in Latin America. Here again we find that success lies in (a) clearly establishing responsibility for performance ***(accountability)*** while (b) allocating sufficient ***authority*** to deliver results. In the case of roads, for example, some success has been achieved by allocating responsibility for different parts of the road network to the level of government that best represents the roads' users. Thus rural roads are assigned to rural local governments, urban streets to urban local governments, secondary highways to provincial governments, and the major intercity highways to the national government. But such functional decentralization has failed where it has not been accompanied by sufficient authority. As Chapter 6 details, Peru's attempt at road decentralization ran aground when the central government failed to establish a financing mechanism for the roads it had decentralized.

The education and health chapters tell a similar story, but at a more micro level. Decentralization in these sectors can improve performance but only if it extends to the level of the individual schools and health units. Where the school director is made ***accountable*** to the parents (through a school board) and has the ***authority*** to make key management decisions (including who gets hired and how the curriculum is adapted to meet the particular needs of the student body), improvements can be expected. By the same token, in the health sector, the benefits of decentralization do not appear until responsibility and authority are extended beyond the level of the municipality. In fact, one of the most effective forms of health care decentralization is to shift power to the patient by changing the focus of government funding from inputs (salaries of health workers in government hospitals) to outputs (reimbursements to providers, whether public or private) thus allowing patients to choose where they will go for treatment.

Does this mean that subnational governments should be organized as a collection of sectoral autarkies, with each sector organized as an independent unit of government responsible to its particular clientele? No. As Chapter 2 describes, there are important constraints to this approach.

First, the beneficiaries of a service are not easily defined. While there may be a general consensus that the benefits of national defense are national and the benefits of local street lighting are local, this simple prescription is of little use in allocating responsibility for the "big ticket" items that are now the object of decentralization. Parents may be the primary beneficiaries of public education, but there are national interests in primary education as well. (Education, for example, may be a key element in a poverty reduction strategy.)

What we find as a solution in both Organization for Economic Cooperation and Development (OECD) and some Latin American countries is a structure of government that consists of a complex set of principal-agent relationships, in which subnational governments act both as agents of higher levels of government and as principals (or more precisely as agents of their constituents) in the delivery of local services. Services, such as education, health, or roads, are "unbundled," with central and subnational units dividing up aspects of service delivery according to interest and comparative advantage. This arrangement often finds central governments playing a financial and regulatory role—providing financing to maintain at least a minimal level of social services in all jurisdictions, for example, but leaving detailed management decisions to lower tiers of government.

What is important is that the role of each tier is fixed—that the division of roles among tiers of government is clear—and that subnational units of government have sufficient authority to perform the roles assigned to them. The most striking problems in the decentralizing countries in Latin American and the Caribbean occur where these conditions are not met. Chapter 4 recounts the problems in education decentralization in Colombia, for example, where responsibility was nominally transferred to the provincial (department) level, but where key controls over teacher salaries and working conditions were retained by the Ministry of Education. Chapter 5 critiques the case of health care in Bolivia, where physical facilities are the responsibility of local governments, personnel is the responsibility of departments (deconcentrated units of central government), and medicine is the responsibility of the central Ministry of Health.

This report also addresses the issue of politics. We have learned that even the best set of intergovernmental rules has little effect if it is not consistent with political culture. Successful decentralization requires more than good rules. Rules must be compatible with incentives. Politicians at both the local and national levels have their political careers to protect. Interest groups have their axes to grind. Ordinary citizens have their lives to worry about. A system cannot depend on altruistic politicians or a constantly alert citizenry poised to intervene whenever its interests are threatened.

This report, therefore, looks at the broader set of rules that affect political behavior, focusing particularly on electoral systems and political parties. What we observe is that weaknesses in the formal rules can be offset by strengths in the political system. In examining the case of subnational debt, for example, Chapter 3 finds that there are several different institutional setups that can produce a hard budget constraint on subnational borrowing. One is a credible policy against central government bailouts, demonstrated over the course of many years and many economic circumstances. This tends to discourage lenders from increasing their exposure to shaky subnational governments. But another institutional setup is a hegemonic and internally disciplined political party with the power to suppress any defiant behavior on the part of subnational politicians. As long as the national party continues to pursue a conservative fiscal policy, such a system can force mayors and governors to refrain from excessive borrowing.

But hegemonic political parties are becoming rare in Latin America. This report therefore examines ways in which electoral rules can be revised at the national level to enable governments to maintain a firm policy against bailouts—an examination that calls into question the widespread use of proportional representation in the region. The report also attempts to address the issue of voter apathy and the risk that subnational politics will be captured by local elites. This again involves changes in electoral rules and internal party practices.

Decentralization in Latin America is clearly driven by national political imperatives. Progress on the rest of the agenda—improving public service delivery, forestalling macroeconomic risks—depends very much on astute political timing. What is right for a given country will depend on its particular historical conditions and the other imperatives it faces.

In most of the region, national and federal government policies and institutions have been the focus of previous reform and modernization efforts. Though by no means completed at that level, the reform agenda must increasingly focus on subnational and intergovernmental institutions and policies. The strong drive toward decentralization that is taking place throughout the region, and that we expect to continue, means that already today some of the public services that matter most for citizens and the overall economy and society—such as basic education and health, subnational roads, water supply and sanitation—are in the hands of semiautonomous subnational governments. It also means that adequate rules are essential to avoid fiscal and macroeconomic threats that this process may entail. Finally, it means that progressively good governance at the subnational level is becoming essential for the quality of democracy in the region. We hope that this report will help in the required refocusing of the reforms and modernization agendas toward subnational government and intergovernmental institutions and policies, and that it will provide some useful guidance to countries that—willingly or not—are in the throes of the process.

Shahid Javed Burki
Guillermo Perry
William Dillinger

CHAPTER 1

Decentralization: Politics in Command

Latin America has a long tradition of centralized government. To understand the causes of decentralization, it is necessary to understand the causes of the centralism that preceded it. Some observers have traced centralization back to the colonial era. Spain's legacy to Latin America was a tradition of extreme centralization in governmental decisionmaking. This autocratic control reflected the crown's long-standing solutions to conflicts with local elites in Spain (similar measures were also adopted into law for Latin America) and the crown's fear of losing control to the *antecedentes*—the early explorers who established their own fiefdoms in Latin America (Nickson 1995).

The Roots of Centralism

Historians also see cultural and economic roots of centralism in (a) the acceptance of authority fostered by the particular form of Catholicism practiced in the region (authoritarian and allied with conservative groups), (b) the deep inequality in social relations, (c) the high concentration of land ownership (which in turn fixed the economic boundaries between owner and peon), (d) the low prevailing levels of education, and (e) the marginalization of indigenous people from national politics (Dominguez 1994).

Centralism was also a reaction to the civil wars that occurred throughout Spanish-speaking Latin America in the nineteenth century (Germani and Silvert 1994). After Latin Americans gained their independence from Spain, they established fledgling "democracies" on the U.S. model, but these failed quickly. Political competition degenerated into open civil war between competing caudillos (war lords) in most of the countries of the region. Peace was achieved only through the victory of centralizing dictators (Reyes in Colombia, Gomez in Venezuela, Porfirio Diaz in Mexico). In this respect, centralization was a key condition for consolidating the nation-state. (Brazil, which remained a monarchy throughout the nineteenth century, is the only continental Latin American country that survived the century in relative peace.)

Industrialization and urbanization, beginning in the early twentieth century, changed the political context somewhat. Theoretically, these trends generate demand for the decentralization of power. Because of its inherent requirements, a modern economy distributes political resources and political skills to a wide variety of individuals, groups, and organizations. Business groups, labor unions, and other economic interests all demand a voice in government (Haggard 1995; Przeworski 1977). Peasants, once under the control of landlords, move to the cities and become an urban underclass, better organized and better positioned to pressure the existing power structure (Lipset 1983).

Interludes of democratic government did in fact follow in some Latin American countries in the early twentieth century. Political participation—which was initially confined to traditional elites—was broadened in an attempt to cope with the rise of the middle class and industrial workers. In some countries elites attempted to co-opt the middle class while leaving industrial workers disenfranchised. In other countries political leaders recognized the potential political base of organized workers and co-opted them (Skidmore and Smith 1997). But these governments were unstable. Because the government itself was a source of economic power, political groups fought among themselves to get control of it (Kling 1994). Military interventions during this period were common, with the military entering as an agent of civilian forces to topple the existing president and replace him with someone more to their liking.

The 1960s saw the emergence of a new kind of military intervention. Justifying their actions as a response to leftist threats, military governments took power with no fixed deadline for return to civilian rule. By 1980, 9 of the 14 largest countries in the region had military governments. Mexico, although civilian, was firmly under the control of the Partido Revolucionario Institucional (PRI). In Colombia and Venezuela, multiparty democracies were politically centralized: In Colombia, all political offices below the national government were appointive rather than elective; in Venezuela, state governors were appointed and mayors were elected from closed, blocked party lists. (See Box 2.1 for a glossary of political terms.)

This era also saw an increase in the role of the central government. Rapid urbanization laid bare the inability of local governments to meet growing demands for urban infrastructure. Virtually every government in the region reacted not by strengthening municipal government, but by creating new central government bodies that stripped municipalities of their formal role as service providers at the local level. As a result, in the 1950s and 1960s a widespread process of demunicipalization took place throughout the subcontinent. Responsibility for the delivery of such important services as the urban water supply, transportation, public housing, primary health care, and education were transferred to the central government (Nickson 1995).

The Wind Changes

As the 1970s wore on, it became apparent that the state faced a growing crisis of legitimacy in many countries of the region. In part this was due to the declining threat from the left. In Argentina and Chile, political groups on the center and right had tacitly condoned military intervention in the expectation that once the crisis had subsided, they would be restored to office. When it became clear that the military had other plans, they withdrew their covert support, helping to isolate the regime (Little 1997).

The legitimacy of the military regimes also depended on successful economic performance. Military failings in this arena further eroded their standing. Even in those cases where there had been some initial success (Brazil 1968–73, Argentina 1977–79, and Chile 1977–82), the military found that sustained improvement was beyond them. Not only did this prevent the military from reaching out to civil society to "buy" support, but it also led to disenchantment with their rule by their natural allies among the property-owning classes. Although in aggregate terms Latin America did develop during the period in which military regimes were common, the perception of politically influential classes was that authoritarian economic policies were no more successful than democratic policies (Little 1997).

One final element that seems to have been widely present in the move toward democratization was the perception in military circles that holding power inevitably meant the politicization of military institutions as different factions split over policy issues. Since military power and autonomy rested above all on institutional unity, the longer the military stayed in power, the greater became institutional pressures to withdraw.

Crises of legitimacy have occurred not only in the military-ruled countries, but also in the nominally civilian democracies. In Colombia, the government's decentralization efforts since 1983 have been linked to the challenge to political stability posed by the growing guerrilla movement. Although previous administrations had responded with force, the new (Betancur) administration initiated a peace process based on a democratic opening of the political system. The new administration argued that a strong connection existed between political and functional decentralization: Without increased autonomy and resources at the local level, political autonomy would be meaningless (Haggard 1998).

Eight Cases

The specific form in which power has been dispersed from central governments varies considerably in Latin America. In some countries, the most striking change has been political: the first-time introduction of elected governors in Venezuela, for example, or the emergence of genuinely competitive multiparty elections for subnational offices in Mexico. In other cases, it is functional decentralization that is more striking, as in the decentralization of education to the departments in Colombia and to the municipalities in Chile. Radical changes in the distribution of revenues have also occurred, as in the doubling of revenue sharing to municipalities in Brazil and Colombia.

Countries also vary in the amount of change they have experienced. Argentina is arguably one of the most decentralized countries in the region but has essentially the same political and fiscal structure it had before the military intervened in 1976. In contrast, Colombia has radically increased the powers and responsibilities of subnational units of government.

Any understanding of decentralization in the region requires some examination of individual cases. The eight Latin American countries discussed below appear to be in the forefront of decentralization, but they represent eight distinct decentralization stories.

Federal Countries Reverting to Type

For descriptive purposes, the eight countries can be divided into two groups: the federal (or three-tier) countries and the unitary (or two-tier) countries. The three-tier countries can be further divided between those in which political decentralization largely consisted of a reversion to type after a period of authoritarian rule and those that have opened subnational offices to electoral competition for the first time.

Argentina is the least radical of the group. Expressed in terms of shares of total public expenditures, it appears to be one of the most decentralized countries in Latin America: Provincial spending accounts for nearly half the total. But in arriving at this condition, Argentina has traveled only a small distance during the last 30 years.

Argentina's federal structure dates from 1853. From the outset, provinces have had elected governors and legislatures. Despite a history of coups beginning in the 1930s (and extended periods of dictatorship during 1946–55, 1966–73, and 1976–83), Argentina has functioned as a multiparty federal democracy for much of its history.

With the departure of the military in 1983, Argentina reverted to its former federal structure. Decentralization efforts under the subsequent civilian regimes have been relatively limited. Under the Menem administration, control of federal hospitals and secondary schools was transferred to the provinces (which already operated all primary schools and the majority of secondary schools). The Federal District was granted the status of a state, with an elected governor and legislature. At the same time, the federal government increased its control over the provinces—particularly the smaller ones—by encouraging the closure of provincial banks and federalizing provincial pension funds. Changes in electoral laws also eliminated the power of provincial legislatures to elect their representatives in the federal senate. (Senators are now directly elected.) Below the provincial level, Argentina remains highly centralized. While municipal mayors and councils are elected, their functional responsibilities are limited and their independent revenue-raising powers virtually nonexistent.

Brazil is another case of a long-standing federal country reverting to type after a period of military rule. Since the founding of the republic (in 1891) Brazil has been constitutionally organized as a federation, with elected state governors and legislatures. Centralized government has existed only during the Vargas dictatorship (1937–50) and the recent military period (1964–85). With the departure of the military, Brazil reverted to its former federal structure.

Brazil's postmilitary constitution (1988) is far more decentralist than the former civilian constitution, however. This is due to changes in its treatment of the municipal tier of government. The 1988 constitution recognizes municipalities as a third, independent tier of government (rather than as creatures of their respective states, as formerly.) It radically increased municipal revenues by doubling the proportion of federal taxes that must be shared with the municipalities and by requiring the states to transfer an increasing share of state-collected taxes to the municipalities within their jurisdictions.[1] The new constitution made no attempt to redefine the distribution of functions between tiers of government, despite its reallocation of revenues. After an aborted effort to legislate a systematic devolution of functional responsibilities, the federal government fell back on case-by-case negotiations, which are still in process.

Civilian Regimes Unleashing Local Electoral Competition

Colombia, Venezuela, and Mexico have relatively long-standing democratic regimes. In political terms, decentralization in Colombia and Venezuela meant the replacement of appointed governors by elected ones. In Mexico, it meant the emergence of genuine political competition at the subnational level.

Except for a military intervention in the early 1950s and a 16-year period of joint administration by the two major parties (1958–74), Colombia has functioned as a multiparty democracy since 1886. The country has, nevertheless, been politically centralized. Prior to the recent reforms, the president appointed the provincial governors, who in turn appointed municipal mayors. In functional terms, Colombia was also highly centralized. Education and health were either directly provided by the central government or deconcentrated to the provincial level. Except in large cities, the water supply, sanitation, and roads were also responsibilities of the central government.

Colombia's decentralization began in 1983 with the decision to strengthen subnational sources of revenue and to grant subnational governments more discretionary authority on tax rates and overall tax administration. This path was reinforced in 1986 with the decision to permit the direct election of mayors and the transfer of significant revenues and responsibilities to municipalities. Responsibilities transferred to the municipal level included oversight of education, health, water supply, and local road construction and maintenance. Although the electoral and revenue transfer reforms were implemented, municipalities were slow in assuming—and the central government in effectively transferring—the new responsibilities. A new constitution in 1991 and the 1993 law on the distribution of resources and responsibilities called for a phased transfer of education and health, first to departments, then to municipalities (through a certification process). In addition, the constitution of 1991 authorized the direct election of provincial governors. The new constitution also raised the 1986 level of transfers to subnational governments to almost 50 percent of current revenues and made them predominantly formula based. The increase was particularly large for municipalities, though their responsibilities were not increased and remain ill defined. All three measures have since been implemented.

Venezuela, like Colombia, has no recent history of authoritarian government (since 1958) but has a long tradition of political centralism. Until 1989, state governors were appointed by the president. Mayors were elected, but on a closed, blocked, party list system, which effectively gave national party leaders control over local politics. States functioned as administrative agencies of the central government. Although municipalities were constitutionally assigned responsibility for water supply, sanitation, and urban roads, in practice these functions were performed by agencies of the federal government.

Venezuelan decentralization began in 1989 with legislation authorizing the direct election of state governors. Municipal legislation enacted in the same year replaced the closed, blocked, party list system with an open, unblocked system in which voters could express their preferences for individual candidates. New legislation also established a process for decentralizing federal government responsibilities to the states. This specified a list of functions—including education, health, and "public works of state interest"—that could be transferred to the states at the initiative of individual state governors. The legislation thus permitted each state to choose which functions it would assume and which it would leave in the hands of the federal government. Implementation has, however, been thwarted by a lack of agreement on how the decentralized functions would be financed. Since the states themselves have virtually no taxing powers, they are entirely dependent on federal transfers. Although the legislation established general guidelines on how states would be compensated, the process of federal-state negotiations was cumbersome and left wide discretionary margins to federal budget authorities. As a result, although many functional transfers are under study, few functions have been effectively transferred to any states. The only functions that have in fact been transferred have been those that generate their own revenues—toll roads and bridges, for example.

Although nominally a multiparty democracy with a three-tier federal structure, Mexico has historically had neither of these characteristics. Mexican politics have been dominated by a single party—the PRI—since the party's founding in 1929. The PRI has in turn functioned as a highly disciplined party under the direct control of the president, who is "designated" by his predecessor and serves a single six-year term. As head of the PRI the president has customarily designated the candidates for state governorships. At the municipal level the president has also exercised final control over the choice of PRI candidates for political office.[2] PRI gubernatorial and mayoral candidates have then been "elected" in political contests with only token political opposition. In his capacity as chief executive, the president has had the power to remove sitting governors and replace them with provisional governors (with senate approval). In functional terms, Mexico has traditionally been highly centralized, with the federal government responsible for education and health and the most infrastructure investment. Municipalities, in particular, have exercised a minor and ill-defined role, and have been largely dependent on ad hoc grants from their respective state governments.

Mexico's decentralization began in 1977 with the passage of legislation setting aside one-quarter of all seats in the lower house of the legislature for members of opposition parties. While tentative, this marked the beginning of multiparty politics. Further reforms (and increasing disenchantment with the PRI) led to opposition victories in five municipal capitals in 1982 and in four states during 1989–95.

Changes were also made in the division of functions and resources between levels of government. In 1984, the constitution was amended to regularize revenue sharing to municipalities, devolve the property tax from states to municipalities, and specifically define the functions of municipal government. These include urban water supply, street paving, and public security. While the fiscal reforms have been implemented, smaller municipalities have been unable to assume all the infrastructure responsibilities assigned to them, and continue to rely on state agencies. In 1992 the government embarked on a more radical transfer of functions from the federal government to the states, effective in 1993. The federal government transferred responsibility for all primary, lower secondary, and teacher training institutes to the states. A new intergovernmental transfer system was created to finance the corresponding costs. However, human resource policies and negotiations with the powerful federal teachers' union remain at the federal level. Government health services were also transferred to the states, and a corresponding financing mechanism set up. A growing number of sector-matching grant programs now complements earmarked transfers and general revenue sharing for the states.

Two-tier States

The three remaining cases are all two-tier countries. Two have reverted to local democracy after a period of military rule. The third has introduced municipal elections for the first time in decades.

Prior to the recent military regime (1970–90), Chile had a two-tier structure of government—central and municipal—but with a high degree of central control. The mayors of the four largest cities were directly appointed by the president. Smaller municipalities elected their own mayors, but these operated under the close prefectoral supervision of presidentially appointed officers. Municipal responsibilities were extremely limited, with the central government directly responsible for education, health, welfare, and most infrastructure services.

Although the military regime abolished all traces of local democracy, it greatly increased the functional responsibilities of local government. Primary education was transferred to the municipal level (where the newly municipalized schools were required to compete with private schools for central government education funding). Municipalities also assumed responsibility for the administration of the national income support program and for primary health care. With the departure of the military in 1990, the incoming civilian administration kept intact the functional assignments imposed by the military. Political autonomy was not only restored but expanded. Mayors and councils were elected in even the largest cities. Thus, through the intervention of an authoritarian regime, Chile became one of the continent's more functionally decentralized nations.

Bolivia has traditionally been highly centralized. Bolivian municipalities have historically not been geographical subdivisions of the national territory. Instead, their boundaries have been limited to urban areas. Much of Bolivia's territory thus had no local government, but instead fell directly under the control of the central government. Municipal political autonomy has been a sometime thing. From 1878 to 1942, mayors were appointed directly by the president (from candidates nominated by directly elected councilors). In 1942 a new municipal code authorized direct elections, but it was in force only five years. From 1949 to 1987, no local government elections took place, municipal councils were abolished altogether, and mayors were once again appointed by the central government.

Bolivian decentralization began with municipal elections held—for the first time in decades—in 1987. A comprehensive package of decentralization legislation was then passed in 1994. This had three major components. First, it redefined the boundaries of municipalities to cover both rural and urban areas. In effect, this extended the jurisdiction of municipalities to the entire national territory. Second, it increased municipal revenues by doubling the scale of revenue sharing (from 10 to 20 percent of central national sharable taxes) and by giving municipalities exclusive (rather than concurrent) authority to impose vehicle and property taxes. Third, it transferred a wide range of physical assets—along with responsibility for maintenance and new construction—to the municipal level. Notable among these assets were primary and secondary schools, health posts, hospitals of the second and third level, and neighborhood roads. (Note that staff employed in these facilities—including teachers and health workers—continued to be paid by the central government.)

More than decentralization in any other country in Latin America and the Caribbean, Bolivia's reform efforts put the emphasis on the organization of civil society for participation in allocation decisions and control actions at the local level. As a result, participatory organizations grew dramatically during the initial years of implementation of the Law of Popular Participation (1994), and citizens have demonstrated an active interest in local investment planning and monitoring of municipal governments.

Municipal elections were reestablished in Guatemala soon after the transition from military to civilian rule. The 1985 constitution also established a transfer of 8 percent (now 10 percent) of national current revenues to municipalities. Transfers to municipalities were again strengthened during the Peace Accords of 1996 when a 1 percentage point surcharge on the value-added tax (VAT) was transferred to municipalities. Eighty percent of the constitutional transfer and 90 percent of the VAT are now broadly earmarked for capital investment. These formula-driven, revenue-sharing transfers are complemented by a variety of planning (Consejos de Desarrollo), grant (social investment funds), and credit mechanisms—some of them similar to matching grants—that partially preserve the influence of the central government on allocation of resources at the local level. Although Guatemalan municipalities have a wide range of responsibilities of their own, local revenues are extremely limited. Indeed, the national level manages most local tax and fee policies and the central government administers the property tax for most municipalities.

Table 1.1, below, summarizes the decentralization experience of the eight countries, distinguishing decentralization among its political, functional, and fiscal dimensions.

Table 1.2 attempts to rank these eight countries according to their current degree of decentralization as of 1999. The four variables in the table are intended to measure the extent to which power is held by "autonomous elected sub-

TABLE 1.1

Summary of Decentralization Measures in Selected Countries

COUNTRY	POLITICAL	FUNCTIONAL	FISCAL
Federal (or multitier) countries			
Argentina	Federal country reverts to type	Secondary education and health transferred to provinces	Minor adjustments in revenue sharing
Brazil	Federal country reverts to type, with new constitutional guarantees for municipalities	No explicit reallocation of functions	Increase in revenue sharing to municipalities
Colombia	Introduces election of mayors and governors	Transfers primary education, health to provinces	Increases earmarked transfers for social service expenditures in provinces, general revenue sharing to municipalities
Venezuela	Introduces election of governors, direct election of mayors	Introduces optional decentralization of social services, infrastructure to states	Increase in funding is to follow decentralization of functions
Mexico	Concedes opposition victories in states, municipalities	Transfers education and health to states; water supply, paving, public security to municipalities	Increases earmarked transfers for social services in states
Unitary or single-tier countries			
Chile	Reverts to elected mayors in small municipalities, introduces election of mayors in cities	Transfers primary education, health to municipalities	Increases earmarked transfers for social services to municipalities
Bolivia	Introduces election of mayors	Transfers primary schools, clinics (physical assets only) to municipalities	Increases general revenue sharing to municipalities
Guatemala	Reverts to elected mayors		Increases general revenue sharing

TABLE 1.2
Indicators of Decentralization

	ELECTORAL AUTONOMY	INDEPENDENCE OF SUBNATIONAL PARTY ORGANIZATION	SUBNATIONAL SHARE OF TOTAL SPENDING[1] %	FUNCTIONAL RESPONSIBILITIES IN MAJOR SECTORS
Brazil	Both levels elected	Strong	37	Education, health, police, most highways
Argentina	Both levels elected	Weak	45	Education, health, some highways
Colombia	Both levels elected	Strong	47	Education, health, some highways
Venezuela	Both levels elected	Weak	19	
Mexico	Both levels elected	Weak	30	Education, health
Chile	Local level elected	Strong	82	Education, health
Bolivia	Local level elected	n.a.	10	
Guatemala	Local level elected	n.a.	11	

1 Excludes social security from central government expenditures.
2 Excludes expenditures financed through central government transfers to municipal schools and health posts.
n.a. = not available
Sources: GFS, country data.

national governments capable of taking binding decisions in at least some policy areas."[3] The first variable, electoral autonomy, measures the extent to which subnational offices are filled through elections, rather than by appointment. The second, independence of subnational party organizations, conveys the degree to which central political party organizations control the choice of candidates for subnational office and can influence their subsequent careers. The third, subnational share of total spending, indicates the degree of expenditures accounted for by subnational governments. The fourth variable, functional responsibilities in major sectors, shows the degree of management autonomy held by subnational governments over major sectors.

These are obviously crude indicators. The existence of local elections does not imply complete political autonomy. (Nor does the absence of local elections imply that central government decisions are immune from local influence.) Party control may be strong in some areas and weak in others. A large subnational share of total public spending does not imply that these expenditures are made independently of central government control. Even nominal functional responsibility does not imply management control, as illustrated by the case of Mexico. Despite many similarities in the decentralization experience of Latin America, precise comparisons continue to be elusive.

Notes

1. The new constitution also mandated an increase in federal tax sharing to states. As a group, the states nevertheless made little net gain from the transfer reforms, because the increase in federal tax sharing was offset by the federally mandated increases in state tax sharing with municipalities.

2. As with other appointments to the highest state position, these decisions were made concurrently by the president, high-ranking party officials, and the state governors.

3. This is the classic definition of decentralization, used by Smith (1996).

CHAPTER 2

Getting the Rules Right: A Framework for Subnational Government

Given the magnitude of changes in these Latin American countries, it would be useful to have a normative framework for decentralization—a set of guidelines that would help countries that are under pressure to decentralize to not only maintain political stability, but also improve the efficiency and responsiveness of public service delivery while preserving macroeconomic stability and equity in the delivery of social services.

The academic disciplines of public finance, political science, and organization theory have all attempted to produce such guidelines. Public finance sees this as an assignment issue—a question of dividing functional responsibilities among levels of government and allocating corresponding revenue sources. Local politics, in this model, serve to "clear the market" in local public goods and services: Citizens are confronted with a menu of alternative combinations of services and tax levels and can express their preferences through the ballot box. But this model assumes that all citizens have equal access to the political process and that politicians act simply as the agents of voters.

Political science takes a more jaundiced view of the political process. It sees politics as a device for mediating conflict among interest groups, and it takes a more complex view of the motivations of politicians. It explains the behavior of politicians as the pursuit of political power and emphasizes the role of key constituencies and party leadership in determining the rate of advancement in a political career.

Organization theory calls attention to the problem of incentives and the difficulties that arise when one group—say, local taxpayers—must rely on another—say, local politicians—to act on their behalf. Conflicts can arise because the interests of the taxpayers, the "principals," differ from those of their "agents," the politicians. When agents have privileged information and are difficult to monitor, the interests of the principals can be thwarted. Organization theory attempts to overcome this problem, by proposing ways in which the interests of principals and agents can be made compatible.

None of these conceptual approaches alone is adequate. This report takes the view that the most useful way to see decentralization is as a management reorganization of the public sector, in which the rules of hierarchical bureaucracy are replaced by a much more limited set of constraints on the behavior of subnational political actors. The difference can be understood by contrasting a stylized authoritarian system with one that is politically decentralized. In an authoritarian system, policy is made at the top and executed through a hierarchy. Each level is accountable to the one above. Detailed instructions emanate from central government ministries. Local administrators are motivated by a career path that leads upward through the ministerial hierarchy. Advancement depends on the favorable opinion of immediate superiors.[1] With decentralization, this hierarchical relationship is cut—or more accurately, attenuated. Because local politicians now owe their office to the local electorate, they become increasingly motivated by a political career that requires the favorable opinion of local interest groups and party leaders. As a result, subnational politicians may find it in their interest to act counter to the wishes of the central government. But not entirely. In a country (as opposed to a voluntary association of states) subnational units are not sovereign. As long as a country remains intact, rules will constrain the behavior of subnational politicians. Decentralization thus implies not subnational sovereignty, but a new set of rules that define the relationship between national and subnational governments and replace the rules of hierarchical bureaucracy. (In practice, this contrast between authoritarian and decentralized regimes is somewhat exaggerated. Few authoritarian regimes in Latin America have managed to govern without conceding some important autonomy and influence to subnational interest groups.)

The rest of this chapter deals with these rules. Such rules come in a variety of forms, not all of them legislation. Party nominating practices, for example, can have a strong influence on whether central government interests prevail over local ones. For example, the traditional Mexican practice in which the president designates party candidates for gubernatorial office reinforces the authority of the national government. In Brazil, these decisions are made at the state level, thus weakening the authority of the national government. Rules also take the form of customs and expectations. No law prohibits the U.S. government from bailing out defaulting states; no Brazilian law requires the federal government to do so. Yet in both cases these are well-established practices that profoundly influence the expectations of banks and politicians.

Explicit legislation is nevertheless a key element of successful decentralization. Explicit rules reduce uncertainty and provide a common set of ground rules for the political process. They provide a focal point to coordinate subnational governments' reaction against an abusive central government, while restricting the subnational government's scope for bargaining. "Superlaws" can be used to strengthen the credibility of the most important rules. These superlaws can take the form of constitutional provisions or other forms of legislation that can be altered only by exceptional majorities or complicated amendment procedures (Linz 1997; Elster 1988). It is important to note that even superlaws are made and enforced by self-interested human beings. The discussion that follows is therefore intended to be relevant to the second-best world of political decisionmaking, rather than to an ideal world of theory.

Dividing Up National Political Power

It is the national government that makes the rules under which subnational governments operate. The power of subnational interests in the national government, therefore, has a key bearing on how the intergovernmental rules are revised and enforced. For Latin America the risks involved are exemplified by Brazil's recent state debt crisis. There, strong regional interests in the national legislature acquiesced to the accumulation of massive state debts, ultimately requiring a federal bailout of equally massive proportions. The obverse case is Argentina, where a more centralized system of governance—both in the formal structure of government and in the working rules of the political parties—permitted the national government to force spendthrift provinces to adjust.

Democracies have long struggled with the question of how to represent regional interests in the national government. Over three decades ago, Riker (1964) noted that in any federal system (defined as a system with multiple tiers of elected government), the constituent units have an incentive to undermine federalism by trying to get a free ride—that is, trying to get benefits without paying for them.

Are there ways to guard against this? Political science suggests several. One strategy is to strengthen the office of the presidency in relation to the legislature.[2] Constitutions vary in terms of the powers granted to presidents. These include the power to rule by decree (that is, to promulgate laws without legislative approval), and the size of the majority required to overturn a presidential veto. In Brazil, for example, a veto can be overridden with a mere 50 percent majority plus 1. In Argentina, it requires two-thirds. In principle, presidents with broad powers to rule by decree and an unassailable veto are better positioned to defend the national interest against the parochial interests of individual legislators.

Electoral rules that discourage party fragmentation can also help. Party fragmentation makes policymaking, in general, more difficult and weakens the position of the president, in particular. In a country with numerous parties, a presidential candidate typically has to run as the head of a coalition. He is thus forced to promise key offices or key policies to other parties. Once victorious, he is constantly faced with the prospect of abandonment by coalition members (Carey 1997). Coalition partners may have enough power to block change, but not enough leverage to effect positive change on their own (Roubini and Sachs 1989; Alesina and Perotti 1995).

Many Latin American democracies are subject to this difficulty. As shown in Table 2.1, all the listed countries, except Argentina, Colombia, and Mexico, have at least five parties represented in the lower house of the legislature.[3]

One way to reduce party fragmentation is to change electoral rules. The proliferation of parties in Latin America is traceable in part to the widespread use of proportional representation as a means of electing candidates (see Box 2.1). This encourages the proliferation of parties, because it allows any party to scour an entire electoral district in search of enough votes to win a single seat. (If a district has 10 seats, a party can win representation with just 10 percent of the vote.) Single-seat districts, in contrast, encourage party consolidation, since a party has to win a majority (or plurality) in order to gain any representation at all. In principle this would argue for a shift to the single-seat approach. Mexico and Guatemala have, in fact, opted for a mixed system, in which half the seats in the lower house are elected from single-seat districts (60 percent in Mexico), with the rest elected on a proportional basis. The Brazilian Congress is currently considering a similar plan. The rule is not infallible, however. As shown in Table 2.2, France, which uses the single-seat approach, has nine parties represented in the national assembly.

Rules that affect party discipline also can strengthen central control over subnational governments. Consider the procedure used to nominate candidates. The Mexican practice, in which the president ultimately approves the selection of all Partido Revolucionario Institucional candidates for public office, fosters considerably stronger party disci-

TABLE 2.1

Electoral Rules, Selected Latin American Countries

	EXECUTIVE	NO. OF PARTIES*	LOWER HOUSE	UPPER HOUSE
Argentina	President directly elected	3	Directly elected by multiseat provincewide electoral districts	Directly elected by province, equal seats per province
Brazil	President directly elected	7	Directly elected by multiseat statewide electoral districts	Directly elected by state, equal seats per state
Bolivia	President directly elected	7	50% by single-seat electoral districts; 50% by multiseat districts	Directly elected by department, equal seats per department
Chile	President directly elected	6	Directly elected by electoral districts (not specified in Constitution whether single seat)	Directly elected by region with equal seats, 7 regions having 2 seats each, the remaining 6 being divided into 2 electoral districts, each with 2 seats
Colombia	President directly elected	2	Directly elected by multiseat departmentwide electoral districts	Directly elected by party list from nationwide electoral district
Guatemala	President directly elected	5	80% elected by multiseat departmental districts; 20% by single-seat districts	None
Mexico	President directly elected	3	40% elected by large multiseat districts; 60% by single-seat districts	Directly elected by state, equal seats per state (with one seat in each state reserved for the runner-up party)
Nicaragua	President directly elected	6**	Directly elected by multiseat “regional” districts	None
Peru	President directly elected	6	Directly elected by single national multiseat district	None
Venezuela	President directly elected	5	Directly elected by multiseat statewide electoral districts	Directly elected, equal seats per state, plus ex oficio seats for ex-presidents

*Number of parties represented in lower house of congress, excluding parties with less than 3 percent of seats.
**Including four parties in government coalition.

BOX 2.1

A Glossary of Political Terms

Proportional representation is by far the most common system for choosing congressional candidates in Latin America. As shown in Table 2.2, it is also used in Italy and Spain. Under a proportional representation system, the country is divided into relatively large districts—usually corresponding to the boundaries of existing states or provinces. Each district is assigned several seats. Candidates or parties compete at large throughout the district. The number of seats won by each party in the district is based on its percentage of the total vote. If the party list is *closed*, the party leadership chooses which of its candidates actually takes office. If the party list is *open*, voters can choose among individual candidates within a party list, with the candidates' winning the most votes occupying the seats won by the party. Party lists may also be *blocked*, in which case voters are not allowed to cast votes for candidates of different parties. Unblocked systems permit voters to divide their votes among different parties.

The alternative is a *single-seat* electoral district system in which the national territory is divided into small electoral districts, each of which is assigned only one seat. Under this system, a single winner is elected either by plurality or—through a runoff—by an absolute majority. The single-seat system is used in the U.S., the U.K., and France. No Latin American country relies exclusively on it. Mexico and Guatemala, however, use a mixed system, in which some seats are elected from single-seat districts and others by proportional representation.

pline than its U.S. counterpart, in which this task is performed by local branches of the national parties. By the same token, the closed voting system used in Venezuela fosters greater party control than the open system used in Brazil. Brazil, in fact, has a uniquely open system of candidate selection.[4] Anyone meeting age and residence qualifications can run for office under the party banner of his or her choice. Voters vote for a single candidate by name. Although the number of seats is awarded to each party on the basis of proportional representation, parties are obliged to assign seats to the candidates on the party's list who win the largest number of votes. As a result, parties may find themselves represented in congress by members who have no links to the party leadership.

TABLE 2.2

Electoral Rules, Selected OECD Countries

	EXECUTIVE	NO. OF PARTIES	LOWER HOUSE	UPPER HOUSE
France	President directly elected; prime minister elected by lower house	9	Directly elected by small (577) single-seat electoral districts	Indirectly elected by electoral college, no specific regional representation
Germany	Prime minister elected by lower house (figurehead president)	7	1/2 elected from nationwide multiseat party list; 1/2 elected by single-seat subprovincial districts	Ex oficio 3–5 seats per state
Italy	Prime minister elected by lower house	6	Directly elected by multiseat subprovincial districts (32)	Directly elected by regions; number of seats proportional to population
Spain	Prime minister elected from lower house (constitutional monarch)	4	Directly elected by multiseat provincial districts by proportional representation	By province equal seats per province, 81% directly elected; 19% appointed by provincial legislatures
U.K.	Prime minister elected by lower house (figurehead monarch)	3	Directly elected from small single-seat electoral districts	Hereditary and appointed
U.S.	President directly elected (pro forma electoral college)	2	Directly elected from small (435) single-seat electoral districts	Directly elected by state; equal seats per state

Assigning Functions, Structures, and Revenues

In principle, the rules governing the structure, functions, and revenues of subnational government should have an important bearing on the impact of decentralization. The "right" design should produce a more efficient and responsive public sector, while guarding against macroeconomic instability or growing disparities in the provision of social services. Unfortunately, the empirical basis for recommendations in this area is weak. While rules have been derived from first principles from such fields as organization theory and public finance (as discussed below), the empirical evidence to support any particular approach is limited. The Organization for Economic Cooperation and Development (OECD) models are of some use. The OECD countries—with relatively long histories of multitier democratic government—might be expected to have converged upon a single-best-practice approach. But in fact the differences among them are as pronounced as the similarities. The combination of first principles, evidence from OECD countries, and the ongoing experience of Latin American countries in the process of decentralization nevertheless provide some basis for normative statements.

Functions

Traditionally, the Latin American *municipio* has performed a relatively minor role in the production of public goods and services. The nineteenth century municipality provided services fitted to the small scale of urbanization at the time—the regulation of public nuisances, street repair, public lighting, and garbage collection. In the large cities that had emerged by the end of the century, private (often foreign-owned) concessionaires normally provided public utilities—water supply, electric power, and mass transit (streetcars).

In response to the large-scale urbanization of the 1950s to 1970s, national governments reacted not by strengthening the role of municipal governments, but by expanding the role of the central government. In Brazil, the private water and power companies were nationalized and consolidated into state-level companies under the control of federally owned holding companies. Similarly, in Chile, Mexico, Peru, and Venezuela, national water companies assumed the responsibility for the water supply. The expansion of education and health services was also usually a central government initiative. Thus primary education, once it passed from the domain of the church, became a central government responsibility in all the unitary states in the region, and in Mexico and Argentina. In Brazil it became a mixed responsibility of the states and the municipalities.

What should be the functional role of subnational governments? The literature on fiscal federalism provides a useful framework for thinking about this question. Fiscal federalism assigns three roles to the public sector as a whole: macroeconomic stabilization, income redistribution, and resource allocation (in the case of market failure) (Oates 1972; Inman and Rubenfeld 1998). The model assigns the first two roles to the central government. The central government is assigned responsibility for stabilization on the grounds that local economies have no access to an independent monetary policy and are too open for effective countercyclical measures. The income redistribution function is also assigned to the central government, on the grounds that local attempts to address income disparities are likely to provoke higher-income groups to move to low-tax areas and low-income groups to move to high-benefit areas.

Subnational governments enter the picture only with respect to the third function: resource allocation. The theory argues that if the benefits of particular services are largely confined to local jurisdictions, welfare gains can be achieved by permitting the level and mix of such services to vary according to local preferences. Local consumers, confronted with the costs of alternative levels of service (according to this viewpoint), will reveal their preferences by voting for rival political candidates or moving to other jurisdictions. In this respect, local politics can approximate the efficiencies of a market in the allocation of local public services by "pricing" municipal services and relying on the local political process and household mobility to clear the market.

There are a number of limitations to this approach, however.[5] As a practical matter, it is often difficult to define the scope of benefits of a specific service and match it to a specific jurisdiction. Although the benefits of defense may be unambiguously national and the benefits of public lighting unambiguously local, the largest sectoral expenditures of government—education, health, and transportation—fall somewhere in between. Education, for example, can be considered to have extremely localized benefits, reflecting the impact of education on the future income of pupils. But it also has national benefits as a vehicle for poverty alleviation and political acculturation. Spending on education, for example, is often the largest form of income transfer to low-income populations. A common curriculum is often one of the few effective means of weaving diverse ethnic interests into a functioning society. It is, therefore, difficult to imagine that a central government would be content to permit a subnational government to abolish all public education within its jurisdiction. But neither is it necessary for central government to manage every detail of public education to ensure that its interests are addressed.

There are also administrative constraints to the theoretical model. Public services are subject to economies of scale, particularly in the use of technical staff. Not every village can use a full-time homicide detective, even if the benefits of his services are entirely local. Nor can a town with 200 students afford to offer 12 years of grade-differentiated education. Local governments may, therefore, find it advantageous to contract with larger, higher-level authorities to produce specialized services. By the same token, central governments may find it advantageous to contract with local governments to act on their behalf. Even programs that are unambiguously central have to be administered on the ground. A program of direct income transfers to the poor, for example, requires field offices to determine who is eligible. Creating a separate unit of field administration in each municipality would result in unnecessarily high administrative costs.

What in fact characterizes the division of functional responsibilities—in the long-standing multitier democracies and many countries in Latin America and the Carribean—is a complicated set of principal-agent relationships, in which subnational governments act both as agents of higher levels of government and as principals (or more precisely as agents of their constituents) in the delivery of local services. This typically involves at least two tiers of subnational government. It may also involve the private sector in various roles as concessionaires or operators of public utilities.

BOX 2.2

How Far to Decentralize?

One of the vaunted benefits of decentralization is its ability to improve the efficiency and responsiveness of government. According to this argument, local officials have better knowledge of local conditions than central government officials and are thus better positioned to respond to local tastes and preferences. And because they are more accessible to their constituents, they can more easily be held accountable for results. But the evidence in Chapters 4, 5, and 6 of this report raises some interesting questions: How much decentralization is enough? And is it always necessary?

Chapter 4 suggests that transferring management responsibility for primary education to local governments may not be sufficient. It is only when management is decentralized to community school boards and school directors that the positive impacts of decentralization appear. As described in Chapter 4, improvement in school quality is positively correlated with (a) community influence over the hiring and dismissal of school directors, and (b) the influence of school directors over the recruitment, promotion, and dismissal of teachers. Decentralizing education to state governments per se—as in Colombia or Mexico—is therefore unlikely to improve quality. On the other hand, efforts in El Salvador, Nicaragua, and the state of Minas Gerais, Brazil, to shift management power to community groups and school directors are likely to show results.

In addition, decentralization may not be the most important structural reform governments can take. For example, in the health sector (Chapter 5), the most important structural reform has not been the decentralization of public hospitals to local governments. Instead, it has been a more fundamental shift in the public sector role as a whole from that of a producer of health services to that of an insurer of health care provided by the private sector. The discussion of road decentralization (Chapter 6) suggests that privatization—particularly in road maintenance—has had a more marked impact on road performance than the efforts to decentralize parts of the highway network to subnational governments. While decentralization from one tier of government to another may improve efficiency and responsiveness in some sectors, it may not be sufficient in itself, or even the highest priority for structural reform, in all cases.

Individual services are often unbundled, with each level performing a role that reflects its interest or comparative advantage. In Northern Europe and North America, for example, primary education is de facto a concurrent responsibility of central or state governments and local governments. But the role of the higher level of government is largely confined to financing, rather than day-to-day operations. Because education is seen, in part, as a tool to alleviate poverty, central governments seek to ensure a minimum level of education funding in all jurisdictions, regardless of their local tax bases. Local governments or school boards, however, are assigned responsibility for day-to-day management decisions. Thus schools boards are often given responsibility for personnel management (decisions on the hiring and dismissal of staff, salary schedules, conditions of work, and career structure) and the allocation of the budget (for teaching and administrative personnel, teaching materials and supplies, maintenance of school buildings, and other programs). The central government role may also consist of establishing the rules under which local decisions are made. In England (United Kingdom), for example, primary education is nominally the responsibility of counties and metropolitan districts and boroughs. The 1988 education reform act, however, requires local governments to adopt a nationally standardized curriculum and a mixed public-private governing board for each school district, and requires central approval of the formula to be used to distribute funding among individual schools.

In some sectors, local governments may also operate strictly as agents of the national government. In Germany, for example, *Lander* (states) act explicitly as agents of the federal government in the construction and maintenance of federal highways, but act as principals in the provision of police services. In France, the departments are paymasters in the administration of national social assistance, but act on their own in providing local roads and regulating urban transport. The principal-agent relationship can work in other ways. Small *gemeinden* (municipalities) in Germany contract with county governments to provide primary and secondary schools. In France, small communes contract with private international water companies, and contiguous municipalities often create a metropolitan association to manage services such as transit or waste disposal.

While these relationships are complex, they are characterized by a high degree of stability and clarity in the link between each tier of government. The responsibilities of each tier are well defined. Revenue assignment is fixed. Intergovernmental transfers are allocated on the basis of formulas, rather than through negotiations.

The absence of these characteristics has complicated government operations in countries that have decentralized in Latin America. In Brazil, for example, there is no explicit division of functional responsibilities between state and municipal governments. Under the constitution, states are authorized to legislate about “any subject not otherwise assigned to the federal government.” Municipal governments are authorized to “legislate over any matter of local interest.” As a result, crises tend to be met with conflict and finger pointing among politicians at different levels, rather than by the concerted action of one tier of government.

Another problem is that central governments appear to delegate management responsibility but then fail to relinquish enough management control for the recipient government to exercise it. In Brazil, for example, state and municipal governments were (until recently) constitutionally prohibited from dismissing staff or reducing nominal salaries.[6] This hamstrung subnational governments in their efforts to adjust to falling revenues and abrupt increases in nonpersonnel costs, resulting in a massive accumulation of debt. Similarly in Colombia, the central government—while nominally decentralizing education to the provinces—maintained its authority to determine teacher salaries. The government then granted a major salary increase to the teachers. As the provinces lacked the resources to pay the increase, the central government was ultimately required to create a separate transfer program to enable them to meet their payrolls.

In other cases, the central government takes responsibility for financing but then fails to follow through. Chile’s system of education financing, for example, went through a period of crisis in the 1980s when the central government dramatically reduced per-pupil capitation grants in an attempt to reduce its deficit. Peru, similarly, attempted to decentralize much of its road network to provincial and municipal governments but then failed to provide financing. (This resulted in widespread deterioration of the network and, ultimately, a recentralization [see Chapter 6].)

The form and content of the rules governing intergovernmental relationships involve a delicate balance between the central government’s interest in subnational performance, on the one hand, and the demands of local autonomy on the other.

BOX 2.3

Are Local Governments Incompetent?

One of the classic objections to decentralization is that local governments are incompetent. Citing statistics on illiterate mayors, crude accounting systems, and widespread nepotism, critics argue that local governments are incapable of taking on expanded functions.

This argument is not as compelling as it may first appear. As a practical matter, when a major service is decentralized, existing field staff are normally decentralized with it. Thus when primary education was decentralized to the departments and states in Colombia and Mexico (respectively), existing central government teachers were decentralized at the same time. They became no less (or more) competent than they had been when they were employed by the central government.

Technical competence has emerged as a problem when central government employees have refused to be decentralized. In Peru, for example, many central government highway engineers chose to retire rather than accept employment in local government. Local staff proved incapable of assuming the task on its own (a problem exacerbated by the absence of central government financing for the newly decentralized roads). This eventually led to the collapse of the decentralization effort, which was followed by recentralization. Governments can facilitate the transfer of central government staff by requiring local governments to offer them the same wages and benefits they received as central government employees. But this is a two-edged sword. While it makes it easier to decentralize staff, it can make it difficult for local government to adapt wages and benefits to local conditions or to introduce management and personnel reform.

While transferring staff can address the immediate issue raised by decentralization, the overall management weakness of local government remains a cause for concern. Low salaries, low prestige, and the high turnover that results from extensive political interference in personnel decisions can make it difficult to attract and retain competent staff, particularly in very small jurisdictions.

Reform has proven difficult. The management of public spending is at once a highly technical and an intensely political process. The challenge for local governments is to put into practice methods that are both technically sound and politically and bureaucratically feasible (Nellis 1991). Human resource management is also a challenge. Local governments' ability to introduce personnel reforms—including performance evaluation mechanisms, training, pay linked to productivity, and incentives to attract and retain competent, skilled personnel—is often constrained by powerful public employee unions. These problems are not unique to local governments, however. They are the same factors that affect the competence of staff in central government.

Detailed regulation is more appropriate in some situations than in others. Where subnational governments act as agents of the central government, central regulation is required to ensure that they in fact do so. In even the most decentralized country, the central government will require centrally financed welfare payments to be distributed according to federal criteria. Regulation is required to ensure the validity of the local electoral process and to address conflicts between units of subnational government. The spread of political autonomy at the local level, nevertheless, should allow for less reliance on central regulation and more reliance on interest groups to monitor the performance of local government.

Structure

The structure of subnational governments—the number of tiers, the number of units in each tier, and any legal distinctions among units within a given tier—can affect the performance of subnational governments. A structure that fails to distinguish between major metropolitan areas and small villages makes it difficult to clearly define the functional responsibilities of local government. A structure with too many tiers or too many units of government at each level can exhaust its resources on administrative costs. Latin America suffers from both problems.

Almost all the major Latin American countries have a common structure of subnational government. Subnational governments are territorial subdivisions of the nation. In countries with two tiers of national government, the national territory is first divided into states (or provinces or departments). Each state is then divided into *municipios*. (Countries with a single tier of subnational government forego the first step.) In rural parts of the country, a *municipio* may be largely rural, with only a few villages within it. In urban areas, a municipio may be an entire city, or part of one. No legal distinction is made between rural or urban municipios or among municipios of different size. Instead, within each tier, subnational governments have the same enabling legislation. Thus the legislation for municipios in Brazil applies equally to the municipio of São Paulo (with a population over 11.2 million) and the municipio of Pirapora de Bom Jesus, with only 4,585.

This degree of uniformity can make it difficult to define the roles of subnational governments with any degree of specificity. Under such a system, the only roles that can be specifically assigned to the biggest unit are those that can be performed by the smallest. In a situation where the smallest municipio may have a population of only a few hundred, this is extremely limiting. In practice, the use of uniform structure for municipal government results in an ad hoc division of labor between tiers of government, in which large municipalities carve out a large role for themselves, while smaller jurisdictions remain dependent on central (or state) government intervention. Under these circumstances, responsibility is ambiguous.

The alternative is a system that recognizes the differences among local jurisdictions and assigns different responsibilities according to needs and capabilities. British local government legislation, for example, has traditionally distinguished between services that must be provided throughout the national territory (such as education) and those that are strictly urban (such as solid waste collection and public housing). Counties have traditionally been assigned the former, while urban districts have been assigned the latter. The German structure of subnational government distinguishes among governments of different sizes, granting broader responsibilities to three "city-states" (Berlin, Bremen, and Hamburg) and allowing other large municipalities to assume the responsibilities of counties. Similarly, Japan grants provincial status to Tokyo, Kyoto, and Osaka; Russia grants Moscow and St. Petersburg the status of *oblasts* (provinces).The United States illustrates local government specialization at its most extreme. State laws permit not only distinctions among different classes of municipal government, but also the formation of single-purpose local units to provide such services as education, fire protection, water supply, and mosquito abatement.

Some degree of distinction among local governments (though perhaps not to the degree practiced in the United States) has much to recommend it. Such distinctions allow functional assignments to be customized to the capacity and requirements of different jurisdictions, and they reduce the need for bargaining and negotiation among tiers of government. Ironically, the trend in Latin America is in the opposite direction. Until 1994 Bolivia was unique in having municipalities whose jurisdiction was confined to urban areas. The law was later changed to place Bolivia in conformance with its neighbors.

Are there *too many* municipal governments in Latin America? Proliferation can be a problem for two reasons. First, there are overhead costs to government, distinct from the costs of delivering services. Increasing the number of municipalities presumably increases these costs in the aggregate. Second, proliferation implies a reduction in the average size of local governments. This can lead to losses in economies of scale (as, for example, a case where a municipality does not have enough work to support a full-time homicide detective).

By the standards of the OECD countries, Latin America would not appear to have too many local governments. As shown in Table 2.3, the average population of a municipality in the larger Latin American countries is in the tens of thousands, exceeding 20,000 in all cited cases except Peru. In continental Europe, on the other hand, average populations are an order of magnitude smaller, ranging from 1,600 to 7,000. Large average sizes are found only in Japan and the United Kingdom. The statistically large average populations in Latin America are deceptive, however. In every Latin American country (except Costa Rica) they mask enormous disparities in population size. The vast majority of municipalities in the region have fewer than 15,000 inhabitants. Sixty percent of the municipios in both Chile and Guatemala have fewer than 20,000 inhabitants. Population size can be as small as Rosario Tasna in Bolivia (population 185) and Santiago Tepetlapa in the state of Oaxaca, Mexico (population 149), (Nickson 1995). Moreover, Europe is not necessarily a model in all respects. The large number of local governments in Europe reflects the same political pressures for local control that exist in Latin America.

Where OECD governments have attempted reform, the direction of reform has been toward reducing the number of municipal governments. This is usually justified on grounds of efficiency and cost. There was a massive decrease in the number of school districts in the United States in the 1950s as jurisdictions tried to combine enough students in a single jurisdiction to run grade-differentiated primary schools. Germany has reduced the number of *gemeinden* by half. The United Kingdom has eliminated a tier of subnational government in Scotland, Wales, and metropolitan areas of England. In contrast, the tendency in some Latin American countries has been to increase the number of municipalities. The number of municipios in Brazil increased from 3,000 to nearly 5,000 in the 15 years following the return of democracy. In Venezuela, the number of municipios increased from 202 in 1985 to 330 a decade later. The criteria used to allocate the transfers of resources to subnational governments in many Latin American countries favor the further subdivision of municipalities.

Revenues: Taxes and Transfers

A third important element of the relationship between central and subnational governments is the assignment of and control over sources of revenues. Money is power. The degree to which subnational governments have independent control over broad tax bases influences their ability to act contrary to the wishes of the central government. The fiscal relationships between tiers of government are fraught with subtleties. Central governments may assign broad-based taxes to subnational governments but limit their revenues through controls over rates. A central government may ostensibly refrain from guaranteeing subnational borrowing,

TABLE 2.3

Structure of Subnational Governments: Selected OECD and Latin American Countries

OECD	INTERMEDIATE	LOCAL	AVERAGE POPULATION
Canada	10 provinces, 2 territories	4,507 municipalities	6,700
France	22 regions, 96 departments	36,772 communes	1,600
Germany	13 states, 3 city-states	329 counties, 115 county-free cities; 14,915 municipalities	5,500
Italy	22 regions, 93 provinces	8,100 municipalities	7,000
Japan	47 prefectures	655 cities, 2,586 towns	38,800
Spain	17 autonomous communities, 50 provinces	8,097 municipalities	4,800
United Kingdom*	49 counties	540 rural districts, metropolitan districts, and London boroughs	92,600
United States	50 states	39,000 counties and municipalities**	
LATIN AMERICA			
Argentina	23 provinces	1,617 municipios	21,600
Bolivia		296 municipios	27,000
Brazil	27 states, 1 Federal District	4,974 municipios	32,400
Colombia	32 departments, 1 Federal District	1,068 municipios	34,600
Chile		325 municipios	43,000
Ecuador	20 provinces	176 municipios	68,200
Mexico	31 states, 1 Federal District	2,412 municipios	38,600
Peru	194 provincial councils	1,624 municipios	14,778
Venezuela	23 states, 1 Federal District	282 municipios	78,000

*England only. ** Excludes special districts.
Sources: U.S. CIA 1997; OECD 1997; country-specific sources.

TABLE 2.4

Principal Revenue Sources of Subnational Governments

	THREE-TIER COUNTRIES	
	PROVINCIAL GOVERNMENT	MUNICIPAL GOVERNMENT
Argentina	Fixed shares of total central government taxes; taxes on gross receipts, property, motor vehicles	Varying shares of provincial taxes and transfer revenues, fees
Brazil	Origin-based VAT, fixed shares of central government income and excise taxes	Fixed shares of state VAT and central income and excise taxes, property and services taxes
Colombia	Fixed shares of total central government taxes; minor taxes on alcohol and tobacco	Fixed shares of total central government taxes; property tax, industry and commerce tax, gasoline surcharges
Mexico	Fixed shares of total federal taxes; earmarked transfers for education and health, minor payroll and motor vehicle taxes	Fixed shares of federal taxes (passed through states), property tax, business licenses
Peru	Fixed shares of national sales tax, taxes on vehicle purchases and business licenses	Shares of central government revenues, property tax
Venezuela	Fixed shares of total central government taxes	Fixed shares of state revenue-sharing receipts, taxes on property, vehicle tax

	TWO-TIER COUNTRIES
	MUNICIPAL GOVERNMENT
Chile	Earmarked capitation grants for education, health, property tax
Ecuador	Fixed shares of central government oil revenue; taxes on property, business assets, vehicles, business registration
Guatemala	Fixed shares of total central government revenue, miscellaneous local taxes
Bolivia	Fixed shares of total central government revenues; taxes on vehicles and property

but find itself forced to come to the relief of overindebted borrowers to prevent tumult in financial markets.

In the abstract, the principles of revenue assignment are straightforward. Finance follows function. The appropriate structure of subnational finance—the mix of user charges, taxes, transfers—depends on the functions that have been assigned to each tier of government. This is because different sources of revenue have different effects on behavior and different patterns of incidence. User charges, for example, impose costs directly on individual consumers and can ration consumption by price. Therefore, there is an argument for assigning user charges to finance services whose benefits are confined largely to individual consumers, such as water supply and bus transportation. Certain forms of direct taxation are appropriate for financing services whose benefits cannot be confined to individual consumers but do not extend beyond the boundaries of individual subnational jurisdictions. A property tax, for example, can be an appropriate way to finance local police services. In the same way that user charges allow individuals to express their demand for services whose benefits are largely private, such taxes enable taxpayers to express their demand for local services that are consumed collectively.

What should be the role of transfers? In the traditional fiscal federalism formulation, intergovernmental transfers have a very limited role. They exist to "correct" the decision-making process of local governments. Left to their own devices, local governments would be expected to base their budget decisions only on the benefits captured by their constituents. This would cause them to "underprovide" services that confer benefits on neighboring jurisdictions. Transfers, in this view of the world, can be used to improve allocative efficiency by inducing local governments to take these wider benefits into account. To perform in this role, transfers have to be earmarked—to ensure they are spent on the service in question—and must be subject to matching requirements to ensure that local governments do not reduce their own expenditures on the service by a corresponding amount. Earmarked grants for sewage treatment plants or cost-sharing arrangements for national highways that serve urban areas are often cited as examples of such transfers.

But transfers also have a distributional role to play. This role is becoming more important as social services—particularly education and health—are decentralized to subnational governments. Transfers permit central governments to use local governments as agents of income distribution policies. As noted earlier, local governments are badly positioned to pursue such objectives on their own. Local attempts to redistribute income from the rich to the poor are likely to provoke inefficient migration. Nevertheless, many of the services that have been decentralized to local governments have important distributional implications. Primary education, for example, is often the largest redistributive expenditure that the public sector undertakes. Primary health care, similarly, tends to benefit the poor disproportionately. In some countries, Chile, for example, local governments have been recruited to act as administrators of the national income support program. Where such redistributive services have been decentralized, transfers are an appropriate means to finance them.

Transfers have also been justified on the grounds that they reduce the economic distortions or high administrative costs that would arise if subnational governments relied only on their own tax bases. The characteristics that make for a good local tax also make for high costs of administration. To function as a local tax, the incidence of a tax must be borne locally. To be cheaply administered, a tax must be imposed on a large volume of taxable activity flowing through a small number of collection points. Few taxes can meet both criteria simultaneously. Taxes that meet the test of localized incidence (such as property or business taxes) tend to involve large numbers of small-scale taxpayers. Taxes that meet the ease of administration test (such as taxes on manufacturing and imports and origin-based value-added taxes [VATs]) tend to involve large-scale inter-jurisdictional incidence shifting.[7] Local taxes also tend to be subject to arbitrary assessment and incidence patterns. Property taxes are based on the gross (rather than net) value of assets held in the particular form of real property. They are thus a poor reflection of benefits received or ability to pay. Local business taxes also tend to be arbitrarily assessed (in the absence of good record keeping among small businesses). For all these reasons, transfers can be justified as a means as a substitute for local taxes.

In practice, transfers pursue a mix of objectives. Not all of them are confined to strictly technical objectives. Politically motivated transfers, for example, remain a key part of the intergovernmental relationship. Attempts to eliminate them have simply demonstrated their resilience (Rojas 1999). In 1991 Colombia passed a constitutional reform that prohibited the traditional form of politically oriented discretionary transfers, known as *auxilios regionales*. These were central government grants to private entities—often non-governmental organizations (NGOs) controlled by parliamentarians—and were rife with corruption. Soon the

TABLE 2.5

Sources of Revenues: Percent Distribution, Selected Countries

	PROVINCES			MUNICIPALITIES		
	TAXES %	TRANSFERS %	NON-TAX REVENUE %	TAXES %	TRANSFERS %	NON-TAX REVENUE %
Argentina	36	57	7			
Australia	36	40	24	55	17	28
Brazil	67	17	9	19	67	14
Canada	67	20	14	41	44	15
France				48	34	18
Germany	68	19	13	32	32	36
Mexico	7	81	12	18	64	18
Peru	3	94	3	15	57	28
Spain	19	78	3	52	36	12
U.K.				16	72	12
U.S.	50	22	28	41	37	22

Note: Taxes collected centrally for the benefit of subnational governments are classified as subnational taxes. Data on French regions and departments is included with communes under municipalities; data on German Lander exclude inter-Lander equalization payments.
Source: GFS 1991.

BOX 2.4

Revenue Assignment in Federal Countries

Public finance theory is not particularly enlightening when it comes to financing large intermediate tiers of government. The principle of using taxes as prices does not hold up well when the jurisdiction in question has a population of several millions (as in Brazil or Mexico). In practice, countries use two approaches: They either assign a broad-based tax to intermediate governments or they finance intermediate levels through fixed shares of national taxes. Most federal OECD countries do some of both.

In the United States, states rely largely on state-administered taxes—income and retail sales—with federal transfers confined to federally sponsored programs. Canada also relies heavily on state-administered taxes—a VAT and an income tax—but makes large federal transfers directly to poorer provinces. Germany relies on a system of constitutionally defined tax sharing in which the principal taxes—personal income, corporate income, and VAT—are divided, roughly equally, between the federal government and the states. The income tax is distributed among individual states on the basis of origin. The VAT, however, is redistributed among states so as to reduce regional revenue disparities. Australia has the most centralized form of state financing. Virtually all taxes are administered by the central government. States are financed from fixed shares of federal revenues, distributed on the basis on fiscal capacity and fiscal needs.

Over the course of the twentieth century, Latin American federal countries have moved away from the U.S. model toward one that more closely resembles Australia's. This has generally coincided with attempts to reform the tax structure as a whole by replacing arbitrarily assessed provincial taxes on business with more modern VATs. Argentina replaced its system of provincial business taxes with a national tax-sharing program in the 1930s. Similarly, Mexico abolished provincial taxes and—after an aborted attempt at a state-level VAT—replaced them with revenue sharing. Brazil remains the exception. When the VAT was introduced in the 1960s, it was assigned to the states. And although the federal government transfers fixed shares of its income and excise taxes to poorer states of the federation, the state VAT remains by far the largest source of aggregate state revenue in the country.

auxilios reappeared in the form of parliamentary influence on the allocation of the rural, urban, and social special investment funds. Parliamentarians used their power over the budget and other legislation to pressure the executive to divert these funds in favor of their particular constituencies. (See Box 2.5 for a discussion of the impact of transfers on local political behavior.)

Perhaps the most important remedial measure developing countries can take is to reduce the uncertainty and bargaining that now accompanies intergovernmental fiscal relations. Fixed, formula-driven transfers have much to recommend them. The effectiveness of transfers in achieving their various objectives can, in principle, be improved through changes in design: the method used to determine the total amount to be transferred, the criteria used to divide this amount among individual jurisdictions, and the conditions attached to the use of the transfer. Where the intent is to support expenditure on primary education in jurisdictions with weak tax bases, for example, there is a case for distributing the pool on the basis of tax capacity and earmarking it for education. Such methods are used in OECD countries (although earmarking is far more common in the United States than in Europe or Japan). The ability of Latin American countries to follow suit depends on whether they possess a similar quality of information on local finances and a similar capacity to monitor spending.

Controlling Subnational Debt

Debt can play an important role in subnational financing, particularly in financing long-lived capital works in cities that are growing rapidly. Long-term borrowing enables the cost of such infrastructure to be spread out to match the duration of its benefits. It also permits a flow of savings from areas of surplus savings to areas where subnational infrastructure investments have potentially high rates of return. Access to credit is a particularly thorny aspect of

BOX 2.5

The Impact of Transfers on Local Political Behavior

Opposing these technical arguments in favor of transfers is the view that transfers have adverse behavioral impacts on their recipients; that local politicians regard transfers as "other people's money" and will be more inclined to misuse it than they would taxes raised locally. There is little evidence either way on this question. Comparisons with OECD countries nevertheless suggest that extensive reliance on transfers is not ipso facto associated with widespread corruption and mismanagement. As shown in Table 2.5, the reliance of municipalities on transfers in the United Kingdom is higher than in any Latin American country for which internationally comparable data are available. Provincial government reliance on transfers is higher in Spain than it is in Argentina or Brazil.

What would more logically appear to have an impact on the behavior of local politicians are the terms on which transfers are provided. Negotiable transfers—those that are provided in return for political support to central government politicians—may distort local spending decisions. Transfers reserved for subnational governments in fiscal crises may encourage local governments to take unwarranted financial risks. Such transfers were widespread in Latin America in the 1960s and 1970s. Since then there has been a general shift to formula-based transfers. As shown in Table 2.5, the major transfer programs in the region now take the form of fixed shares of specified central government revenues, distributed among subnational governments on the basis of predetermined formulas. While these have eliminated the most obvious incentives to perverse local fiscal behavior, the scale of intergovernmental transfers in Latin America continues to alarm some observers.

intergovernmental relationships, however. Subnational borrowing can destabilize national financial systems or lead to central government deficits. While in principle, borrowing by subnational governments can be a private transaction between subnational borrower and private lender, the national government's role in ensuring the stability of the financial system often draws it reluctantly into the transaction.

In principle, subnational governments can borrow from a variety of sources. Arrears to suppliers and personnel are probably the most widespread form of subnational debt. But this source has its limits. Suppliers and personnel will eventually withdraw their services if they go unpaid too long. Another source is the domestic private capital market, but it too has historically played only a limited role in subnational finance. Shallow domestic financial markets have limited the aggregate supply of private capital. Doubts about the credit worthiness of subnational governments have prompted private lenders to confine their government lending to the national level. Long experience with macroeconomic instability has discouraged private investors from making long-term commitments of any kind. Private lending to subnational governments has therefore been limited in scale and largely confined to short-term cash flow management.

In Latin America, it has been central governments that have mobilized much of the long-term savings that went into infrastructure during the 1960s and 1970s. Where subnational governments were responsible for these functions, the funds were often mobilized and allocated through centrally owned institutions. Much of the state-level infrastructure housing and water supply in Brazil in the 1960s and 1970s, for example, was financed from resources generated by a federally sponsored unemployment insurance plan and allocated through the national housing bank. Federal taxes on electricity, telephones, and fuels financed investment in power, telecommunications, and highways. Mexico's federal development bank, the Banco Nacional de Obras Publicas (BANOBRAS), has long served as an intermediary for donor financing for subnational governments, while federal tax revenues have been used to finance large programs of federal capital grants to states and municipalities. Colombia's Financera de Desarrollo Territorial S.A. (FINDETER) has performed a similar role. As a means of mobilizing savings, this practice has often been successful.

But the recovery record of centrally sponsored financial intermediation is mixed. The allocation of loans and enforcement of debt service have tended to become politicized, with taxpayers ultimately bearing the financial consequences of bad loans.

With domestic financial deepening and the increasing financial credibility of some subnational governments, the market for private financing of subnational debt has grown. Private banks (as well as pension and mutual funds) have entered some markets on a significant scale. In Brazil the volume of state bonds in private hands at one time exceeded US$15 billion. Private lending to provincial banks in Argentina now exceeds US$4.4 billion.

In principle, this presents a way of avoiding politicized lending. With their own capital at risk, private lenders would appear to have an incentive to make prudent loans and to insist on repayment. In practice, this is not entirely the case. When the consequences have been a pending strike by public employees over unpaid salaries or the failure of a major bank, central governments have often stepped in to assume or restructure the debt of subnational governments that have borrowed too much. This has set up a cycle of perverse expectations. It has encouraged subnational governments to overborrow and domestic banks to overlend, secure in the knowledge that the national government will come to their relief.

One common reaction to this risk is to increase regulation. The Brazilian government, for example, now prohibits the issuance of new bonds or any expansion in aggregate domestic bank lending to subnational governments. Other central governments prohibit subnational governments from undertaking certain forms of debt, as in Mexico, where subnational governments are prohibited from issuing external debt. National governments also regulate subnational borrowing through the supply side. In Colombia the national banking regulation commission has required private banks to increase their reserves for loans to subnational governments.

Recent evidence suggests that regulation alone is not sufficient. Brazil's recent state debt crisis, for example, arose despite a blanket ceiling on subnational borrowing and a web of restrictions and controls on various forms of debt. These regulations failed to withstand the pressures of regional politics.

Fortunately, in matters of debt, it takes two to tango. Subnational governments cannot borrow unless someone is willing to lend to them. This provides central governments with an important source of leverage. If lenders are convinced that central governments will not bail them out, lenders themselves will act as a source of restraint. Convincing the lenders of this requires more than a statement of intent. It requires a central government to demonstrate its commitment in practice by allowing a subnational borrower to go into default and leaving the lender and the borrower to work out a settlement between themselves. Once private lenders are persuaded that lending to subnational governments carries real risks, they are likely to restrain their lending despite the supplications of subnational politicians.

As will be discussed in Chapter 3, neither a purely regulatory nor a purely laissez-faire approach is likely to be entirely successful. Some degree of regulation—particularly over foreign borrowing—combined with a credible policy against subnational bailouts—is likely to be necessary.

Local Politics

So far this has been a story about the relationship between central government politicians and local government politicians. But what about the people? If decentralization does not increase local influence over the public sector, then the principal case for decentralization—other than political stability—vanishes. The presumption of some decentralization advocates is that decentralization automatically increases the influence of all strata of society. But there is an equal possibility that decentralization simply transfers power from national to local elites, and that improved access of local elites to public resources simply increases opportunities for corruption.

One of the key determinants of the influence of local interest groups on local officials is, of course, the formal electoral process: how governors, mayors, and members of the subnational legislatures are elected. But the existence of subnational elections, while important, is not sufficient. Incentives and mechanisms for participation need to be in place.

In principle, decentralization itself would be expected to increase local participation. Writers on institutional economics have long observed that people's willingness to participate varies according to their perception of how much impact such participation will have (Hirschman 1970; North 1990; Ostrom and others 1993). Individuals who are expected to invest resources (including their own time and labor) must believe that the benefits they receive will exceed the costs of doing so. The more interest groups perceive that they can influence political decisions, the more likely they are to mobilize (Smith 1996).

The empirical evidence is ambiguous. In countries undergoing a transition from military to civilian regimes, the initial push to throw out the *ancien regime* has sometimes mobilized mass participation. O'Donnell and Schmitter describe how trade unions, grass-roots movements, religious groups, intellectuals, and artists supported one another's efforts to hasten the exit of military governments in the 1980s (O'Donnell and Schmitter 1996). The transition to democracy in Latin America has never been revolutionary, however. (In fact, no stable democracy has ever emerged from mass actors gaining even temporary ascendancy over dominant elites in the region [Haggard and others 1995].) Instead, most Latin American cases were transitions from above, in which traditional elites remained in control and successfully used some combination of compromise and force to retain at least some of their power (Karl 1996). What followed the democratic revolutions was often a dissipation of civic energy. The broad fronts of religious, professional, student, labor, and other associations broke up once their common goal of bringing down the regime had been achieved.

This is not surprising. Political participation is limited because it requires time and effort (Dahl 1971). Thus day-to-day politics tends to be the work of a small coterie of professional politicians and party workers for whom politics is a full-time job. To paraphrase O'Donnell, Schmitter, and Whitehead (1986):

> The (traditional) theory of liberal democracy was based on the presumption that active citizens would elect and hold accountable, individual representatives who would, in turn, produce substantively superior decisions. Contemporary theories of democracy place the burden of consent on party elites and professional politicians (sporadically subject to legitimization at the polls). These agree among themselves that they will compete in such a way that those who win will exercise their temporary political superiority in such a way as not to impede those who lose from competing for office in the future, and those who lose agree, in exchange for being allowed to take office and make decisions later on, to respect the winner's authority to make binding decisions in the interim.

Members of the public become actively involved only when their vital interests are at stake (Hirschman 1980). Local democracy is not, therefore, a forum for mass decisionmaking on all issues of public policy. Rather, it provides a mechanism for interest groups to reach political decisions without resorting to open conflict.

Several measures can be taken, nevertheless, to encourage more widespread participation in local government. The first is to adopt ward- or neighborhood-based electoral districts. The election of council members by ward or neighborhood gives geographically defined interest groups an assured seat on the council and thus some prospect that their involvement in the political process will produce a tangible result. It also reduces the costs of running for office, because a candidate needs to run only in a single ward, not throughout the entire city or province. International evidence confirms this: Turnout is higher when seats on the assembly are elected by ward, rather than at large (Galeotti 1991). Ward-based elections are the exception rather than the rule in Latin America, however. Councilors typically run at large (Nickson 1995).

A second measure is to adopt open, unblocked electoral systems for local elections. As noted earlier, the closed and blocked balloting system increases national party control over elected officials. While useful in fostering party discipline among members of the national legislature, it may be less appropriate for local elections.

A third measure is to change the timing of subnational elections. In many Latin American countries, subnational elections coincide with national elections. This linkage means that local government elections are overshadowed in importance by the national elections held at the same time. This distracts voter attention from local questions and toward a consideration of national issues. It also effectively encourages clientelist considerations in the selection of party candidates for municipal office. Selection is often determined by the electoral support that potential municipal officeholders can mobilize for the party's national politicians. In exchange for this support, potential officeholders are "rewarded" with a municipal office position (Nickson 1995).

While changes in the electoral rules will help, political parties will continue to provide the critical connection between the electorate and the political system. Political parties are an essential instrument for representing political interests, aggregating demands, recruiting and socializing new candidates for office, organizing the electoral competition for power, and forming effective governments (Diamond 1997). By organizing class and other interests, parties are one of the instruments by which the poor and marginal groups can gain voice in the formal political system (Boeninger 1991; Przeworski 1995). Party members and leaders have an incentive to get out the vote, create a presence in the community, seek out voters, and respond to voters' contacts.

Strategies

Decentralization often takes place amid political and economic turmoil. The euphoria at the fall of a military regime; the economic crisis that precipitates a regime's collapse; the jockeying for power by newly emergent interest groups—all these conditions create an environment in which a careful, rational, and orderly process of decentralization is highly unlikely. Even where decentralization happens in a less dramatic context, questions of strategy and timing still arise. Experimenting, testing, adjusting, and replicating are emerging as the prevailing methods of decentralization in the region (Rojas 1999).

There is clearly no blueprint for decentralization. Much depends on the initial conditions in the country and the particular political interests that support or oppose decentralization. The recent experience of countries in the throes of decentralization nevertheless leads to two general conclusions.

Synchronizing the Elements of Reform

The most consistent lesson of recent decentralization experience is the need to synchronize the elements of reform. The political impetus behind decentralization prompts central governments to make political concessions hastily. But granting local elections is a step that can be taken rapidly. What is slow and difficult is the working through of new regulatory relationships between central and subnational governments, the transfer of central government assets (and staff), and the conversion of what had been annual budgetary transfers between units of a centralized administration to a system of tax assignment and intergovernmental transfers.

The recent history of decentralization in Latin America has been plagued by a lack of synchronization. Countries have failed to synchronize the decentralization of functions with the decentralization of revenues. In Brazil, for example, federal transfers to municipios doubled, while their expenditure responsibilities remain undefined. The added fiscal burden on the federal government was alleviated only by an increase in national taxes and a protracted series of case-by-case asset transfers (Dillinger and Webb 1999). In Colombia, the central government committed itself in 1999 to transfer 22 percent of central government revenues by 2002, without defining the responsibilities that would be correspondingly devolved. The opposite has also occurred. In Argentina, the federal government transferred its remaining secondary school and health programs to the provinces. While the federal government guaranteed a compensatory payment, the payment was financed not by the federal treasury, but from the provinces' own share of *participaciones.*

National governments have crippled local governments' ability to perform newly decentralized functions by failing to decentralize key management controls. In Brazil, as noted earlier, the postmilitary constitution imposed rigid controls on state and municipal personnel policies, forbidding the dismissal of staff or any reduction in nominal salaries, and requiring expensive pension benefits. These rigidities played a large part in Brazil's subsequent state debt crisis. Similarly, in Colombia the central government continued to set the salaries of public school teachers after the management of primary and secondary schools was ostensibly decentralized to the provinces. The central government's subsequent decision to grant a major increase in salaries prompted a fiscal deficit in some provinces, which was only resolved through the creation of a special compensation fund.

The recent decentralization of education in Mexico has followed a more balanced approach. Along with the transfer of assets and teaching staff, corresponding financing was provided in an amount equal to federal spending on these functions in the previous year.[8] Similarly, in Chile the decentralization of education and health to municipal (and private) providers was accompanied by a loosening of management controls.

Demonstrating Early Commitment to the New Rules of the Game

A second lesson that emerges from recent decentralization experience is the need to demonstrate commitment to the new rules of the intergovernmental relationship early in the game. Precedents matter. They affect expectations. The benefits of a stable set of rules can only be achieved if the rules are credible. Credibility requires demonstration.

One of the most important precedents a central government can set for newly autonomous subnational governments is the hardness of the central budget constraint. Evidence suggests that even the possibility of a central government bailout will prompt excess spending and deficit financing by subnational governments. This is shown in recent experience with government efforts to restrain the borrowing of recently redemocratized provincial governments in Brazil and Argentina. As elaborated in Chapter 3, Brazil began its current democratic era with a mass rescheduling of debts owed by state governments to foreign creditors. Three years later came a mass rescheduling of debt owed by the states to federal financial intermediaries. Together, these established the presumption that the federal government stood ready to provide debt relief to any state that required it. The following five years witnessed an explosion of state borrowing, largely through bonds and debt to state-owned banks. Ultimately, both had to be assumed by the federal government. Argentina, in contrast, has succeeded in enforcing a hard budget constraint on its provinces. From the outset the current administration has refused to provide any significant debt relief to the provincial governments. Moreover, it has taken steps to minimize its potential exposure by prohibiting direct lending from the federal treasury to the provinces and by prohibiting the central bank from discounting loans made by provincial banks to their governments. As a result, when provincial governments ran aground in the Tequila crisis of late 1994, they were forced to adjust rather than rely on federal relief.

Conclusion

Decentralization in Latin America is very much a work in progress. There are many experiments under way and little data on final outcomes. But we do know a few things. A system that is based on rules is likely to produce better results than one that is based on negotiation and clientelism. Differentiated structures of subnational governments would help governments to define the functions of different units more explicitly. A hands-off attitude toward subnational loan default is as critical to controlling subnational debt as the most comprehensive set of regulations and controls. Ward-based local politics are more likely to elicit participation than elections at large.

Finally, we know that a strategy aimed at stopping decentralization is unlikely to succeed. The pressures for decentralization are beyond the control of governments. The emergence of modern economies and an urban, literate middle class has created nearly insurmountable pressures for a broader distribution of political power. The ongoing decentralization efforts in Latin America are a response to these pressures. Rather than attempting to resist them, governments need to accommodate them in a way that maintains political stability while improving public sector performance.

Notes

1.This is not to say that each member of the bureaucracy is an automaton. Individuals within an organization will not necessarily find the interests of the organization to be congruent with their own. They can nevertheless be expected to make self-interested responses to the working rules that allocate rewards and costs within the bureaucracy (Ostrom and others 1993).

2. Note that all Latin American countries have presidential, as opposed to parliamentary, systems.

3. The importance of the minor parties varies among countries. In recent elections for the chamber of deputies in Argentina, the two largest parties garnered 73 percent of the seats. In Brazil the two largest parties garnered only 39 percent of the seats.

4. Among countries using proportional representation, the only other country with this system is Finland.

5. These limitations are in addition to its unwarranted assumptions concerning the efficacy of local democracy as a market-clearing mechanism.

6. In 1998 the Brazilian congress approved a constitutional amendment that would allow states to dismiss staff, provided their personnel spending exceeded a threshold percentage of state revenues. The congress was also considering amendments to pension legislation. If approved, these amendments would go a long way toward providing states with the means to respond to fiscal pressures without resorting to default.

7. Income and payroll taxes would appear to meet both tests to the extent they can be imposed through withholding by employers. But the coverage of such taxes is limited in most Latin American countries. A local income tax in a municipio with a population of a few thousand would probably have no more than a dozen contributors.

8. Thereafter, funding has been based on a formula that gradually shifts the distribution from its historic pattern to one that provides an equal amount per pupil across all states.

CHAPTER 3

Addressing the Macroeconomic Threat: The Quest for Hard Budget Constraints

Some decentralized democracies like Germany, Switzerland, and the United States are known for their macroeconomic stability, and some scholars even give federalism some of the credit for the stability (McKinnon 1997; Qian and Weingast 1997). Recent events in Brazil, however, show how decentralization can contribute to macroeconomic instability. Other cases in Latin America, such as Argentina, show how decentralization can complicate achieving stability, as it did in the 1980s, but also how it can be made compatible with stability, as has happened in the 1990s. Colombia is also a good example of how rapid decentralization can put substantial stress on macrofiscal stability (Dillinger and Webb 1999a, 1999b). Many other countries in the region, such as Ecuador, Guatemala, Mexico, Nicaragua, and Venezuela, have begun decentralization more recently, and it is crucial that they make institutional arrangements to prevent undesirable macroeconomic consequences.

This paper considers two questions:

- How does decentralization affect macroeconomic management and the size of the state?
- What institutional arrangements and policies account for the good and the bad macroeconomic effects of decentralization in Latin America and the Caribbean.

The standard economic dimensions for evaluating public finance policy are macroeconomic stability, equity, and efficiency (Musgrave and Musgrave 1959). In analyzing macroeconomic management in decentralized democracies, we focus mostly on the first dimension, although we also discuss some broad issues of efficiency, related to the size of the public sector and the relative supply of local and national public goods.

We recognize that decentralization is not to be judged by only its economic dimensions. Indeed, the primary reasons for decentralization in Latin America and elsewhere have been political, not economic (Rojas 1998; Willis and others 1997). Decentralization has been an integral part of programs to restore or deepen democracy in many countries. Even more, as we show below, understanding the political dimensions of decentralized states is crucial for understanding their macroeconomic outcomes.

In the macroeconomic dimension, decentralization has raised both hopes and fears. The first hope is that decentralization will improve the overall macroeconomic performance of the public sector by involving the taxpayer more closely in spending decisions. Some people think that citizens are more tightfisted with the taxes they pay to local government than with the taxes they pay to central government, with the result that when spending is decentralized, aggregate public sector spending will be lower. It is also believed that creditors will be more conservative in lending to local governments than they are to central governments.

Central governments, in contrast, seem more likely to overspend and overborrow, both because taxpayers are more remote from the beneficiaries of services, employment, and contracts, and because the banking sector is often a captive market for national debt.

The macroeconomic fears about decentralization arise precisely because the conditions outlined above are frequently not met. First, decentralization often increases the separation between spending and tax decisions, rather than bringing them closer. This happens whenever subnational expenditures are financed mainly through transfers from the central government, as is the case in most of Latin America. Subnational governments may then overspend, if they expect to get more resources from the common pool of national resources, either through additional discretionary transfers or bailouts.

Second, creditors willl be conservative only if they believe the central government will not bail out failing local governments. But, in fact, central governments often do so.[1]

Federal systems also present the danger that states' representatives to the national government will collude to extract more resources from the common pool through legislation or negotiated agreements (Alesina and Perotti 1994; Sauguinetti and Tommasi 1997). Such decentralized or concerted attacks on the "commons" might lead to different outcomes, depending on the central government's reactions. If the central government responds by cutting its own expenditures to maintain fiscal equilibrium, the result will be an inefficient composition of public expenditures: larger than optimal spending on local public goods, lower than optimal spending on national-federal types of public goods. If the central government responds by increasing taxes so as to keep fiscal equilibrium, the result will be a bloated state: larger than optimal total public expenditures and taxes. If the central government cannot or does not do any of the above, the result will be excess fiscal deficits and macroeconomic instability.

In addition, the central government's ability to carry out stabilization policy in response to shocks may be more hampered in decentralized economies. One reason is that the central government may have to share with subnational governments the more efficient tax bases or give them up completely. Then, a necessary and desired fiscal contraction may not be achieved because the central government cannot induce subnational governments to participate in the required budget cuts (Tanzi 1996; Prud'homme 1995). Alternatively, fiscal adjustment may be achieved, but through undesirable means. Central government expenditures may have to be cut drastically, or rates on taxes not subject to revenue-sharing may have to be increased excessively.

Finally, the transition from a centralized to a decentralized system may also be a source of macroeconomic problems. Central government deficits may grow if the government fails to reduce spending as it increases transfers or gives up tax bases to subnational governments. Such an outcome may develop because of a serious mismatch between the allocation of responsibilities and resources. It can also arise because the subnational governments fail to do the job with the monies transferred, leaving the center with the double cost of continued service provision plus the transfer (or forgone revenue from the devolved tax base). Finally, it may happen because the central government does not reduce its size, even after subnational governments take over its previous tasks, because it refuses to relinquish the powers of patronage or is constrained by inflexible labor codes or union power.

Thus, together with the hopes, there are legitimate concerns that decentralization will lead to excessive decentralized expenditures and to problems with macroeconomic management. As indicated above, compensating actions to avoid macroeconomic instability—excessive reductions in federal spending or excessive overall tax levels—can lead to efficiency and equity problems.[2] Decentralization can then result either in insufficient provision of federal public goods, in larger overall public expenditures and taxes, or in macroeconomic instability.

In attempting to answer the two questions presented above, this paper draws mainly on research conducted by the Chief Economist Office for Latin America and the Caribbean at the World Bank (Dillinger and Webb 1999a, 1999b; Fornasari, Webb, and Zou 1999). This chapter presents evidence on the effect of decentralization on public finances in a worldwide sample of countries; analyzes the effects of institutions on the macroeconomic outcomes of decentralization experiences in four Latin American countries (Argentina, Brazil, Colombia, and Mexico); compares these experiences schematically to see which combinations of institutional arrangements for decentralized fiscal management suffice to avert severe macroeconomic problems, and which do not; and summarizes the main conclusions of these analyses.

Evidence of Macroeconomic Problems: Econometric Results

To answer the question of whether decentralization contributes to excessive public expenditures or unsustainable fiscal deficits, an econometric study analyzed the relationships between subnational and national government fiscal indicators, using data from 32 industrial and developing countries during 1980–94 (Fornasari, Webb, and Zou 1999). The dependent variables were central government primary spending (including transfers and primary deficits).[3] The main independent variables were the subnational fiscal variables—either subnational total spending and taxes, as a pair, or lagged subnational overall deficits. Some standard control variables, such as GDP growth, inflation, urbanization, central bank independence, and major political transitions, were also used.

When the data were averaged over time to make cross-section comparisons, only two coefficients on subnational fiscal variables turned out to have t-statistics indicating a significant difference from zero: In the equation with national spending on the left side, the subnational spending variable had a positive coefficient and the subnational tax variable had a negative coefficient (see Table 3.1). The coefficient on subnational spending was close to 1.0, which implies that central government spending tends to grow in a one-to-one ratio with subnational spending. On the other hand, the coefficient for subnational taxes is below -1.0 (significantly). These results suggest that (a) decentralization of spending by transfers increases the size of total government, and (b) when subnational governments finance themselves with their own taxes, the overall public sector tends to be smaller than in a centralized setting.

The subnational deficits did not, on average, affect the national spending or the national-level deficit in the cross-section regressions, nor did the subnational spending have

TABLE 3.1

Basic Model: Cross Section; Overall Sample Estimates

(All dependent variables are net of interest payments)

DEPENDENT VARIABLE	CG DEFICIT TO GDP	CG EXP. TO GDP	CG DEFICIT TO GDP	CG EXP. TO GDP
Constant	5.404**	0.619	5.867**	–5.506
	2.250	*0.056*	*2.211*	*–0.566*
SN Tot. Expenditure to GDP			0.041	1.009**
			–0.384	*2.556*
SN Tax Revenue to GDP			0.033	–2.110**
			0.180	*–3.132*
Lag Overall SN Deficit to GDP	0.758*	–0.199		
	1.884	*–0.108*		
Lag CPI Inflation	–0.073**	–0.206	–0.068**	–0.122
	–2.691	*–1.649*	*–2.167*	*–1.060*
Percentage Urban Population	–0.029	0.160	–0.026	0.128
	–1.162	*1.398*	*–0.959*	*1.268*
1980 GDP Per Capita in US$	–0.272	2.157	–0.248	2.836**
	–0.799	*1.380*	*–0.661*	*2.065*
Real GDP Growth	–0.539**	0.586	–0.570*	0.320
	–2.096	*0.496*	*–2.012*	*0.309*
Adj. R-Squared	0.25	0.36	0.13	0.52
No. Time Observations	1	1	1	1
No. Cross Section	32	32	32	32

CG = central government. SN = subnational.
*Indicates a significance level of 10 percent. **Indicates a significance level of 5 percent.
Note: The numbers in italics represent the t–statistic associated with each coefficient.

TABLE 3.2

Panel Data, Fiscal Variables in First Differences, 1980–94

(All dependent variables are net of interest payments)

DEPENDENT VARIABLE	CG DEFICIT TO GDP	CG EXP. TO GDP	CG DEFICIT TO GDP	CG EXP. TO GDP
Constant	–0.045 *–0.092*	0.459* *1.838*	–0.413 *–0.932*	–0.069 *–0.312*
SN Tot. Expenditure to GDP			0.322** *4.007*	0.538** *8.121*
SN Tax Revenue to GDP			–0.176 *–1.004*	–0.073 *–0.571*
Lag Overall SN Deficit to GDP	0.234** *2.805*	0.261** *7.902*		
Lag CPI Inflation	–0.054** *–2.806*	–0.013 *–0.592*	–0.057** *–3.368*	–0.028 *–1.509*
Percentage Urban Population	–0.007** *–2.019*	–0.013** *–4.657*	–0.010** *–2.693*	–0.012** *–4.959*
1980 GDP Per Capita in US$	0.070 *0.985*	0.089** *2.113*	0.123* *1.878*	0.128** *3.393*
Real GDP Growth	–0.150** *–8.141*	–0.194** *–13.545*	–0.143** *–8.896*	–0.142** *–12.706*
Adj. R-Squared	0.10	0.23	0.14	0.33
Durbin-Watson Statistic	2.12	1.77	2.13	1.82
No. Time Observations	13	13	13	13
No. Cross Section	32	32	32	32

CG = central government. SN = subnational.

*Indicates a significance level of 10 percent. **Indicates a significance level of 5 percent.
Note: The only variables that are in first difference are the dependent variable and the fiscal explanatory variables; that is, total expenditure, tax revenue, and deficit.
The numbers in italics represent the t-statistic associated with each coefficient.

a statistically significant relation to the national government deficits. This implies that when countries are decentralized in a long-run steady state—which is the interpretation of these cross-country regressions on averages per country—they do not have higher national deficits on average than the less-decentralized countries. They have presumably developed institutions—and raised taxes—at least to avert the macroeconomic fears concerning deficits.

The panel regressions with changes in the national and subnational fiscal variables got very different results, however (see Table 3.2).[4] They show that increases in subnational spending and deficits lead to higher spending and deficits at the national level. The relationships are strong economically, and statistically significant.[5] The results in columns 1 and 2 have the clearest meaning—an increase in subnational deficits is associated with an almost 1-to-1 increase in central government spending and deficits in the subsequent period. This is consistent with a pattern of the central government bailing out states and cities when they have increased borrowing too much.

In interpreting these results, it is important to recognize that the use of first differences means that the results are determined mainly by the countries and periods when the levels of spending and deficits at the national and subnational levels are changing rapidly; that is, by those times and places where increased decentralization is taking place. In these times and places, we can reject the hypothesis that the transfers between central and subnational governments

TABLE 3.3

Institutional Arrangements to Set and Keep Hard Budget Constraints on States

- Hard budget constraints from the central government to subnational governments
- Rule-based transfers
- Firm allocation of spending responsibilities
- Constraints on borrowing
    - Ex ante constraints
    - Ex post consequences and resulting incentives
    - Enforcing payment by subnational governments
    - Enforcing losses on banks with bad loans to uncreditworthy subnational governments—bank regulation
    - Central bank independence
- Autonomy of subnational governments to stay within hard budget constraints
- Ability to control spending and costs
- Ability to increase revenues
- Political ability of central government to enforce hard budget constraints
- Power of the president
- Power of the governors
- Political party discipline
- Electoral rules

are usually determined exogenously by the center. The process of fiscal decentralization tends to cause problems. These results are powerful arguments against rapid decentralization without adequate safeguards.

The results in the panel data held up even with the inclusion of political-institutional variables—major national political transitions and central bank independence; and two variables that pertained directly to decentralization—election of subnational officials and a unitary-federal constitution. Whether local officials were elected had no effect on the intergovernmental fiscal relations considered here. In other words, local democracy does not seem to worsen or improve macroeconomic fiscal management on average. Being a unitary state (rather than a federation), however, significantly increased the extent to which national government spending was related to subnational spending and deficits. This might reflect the fact that the national spending figure includes some transfers to states, and one would expect budgeted transfers (rather than tax sharing or delegated taxes) to be more important in a unitary state. Being a unitary state does not significantly affect the transmission of subnational to national deficits.

To summarize, whereas in the cross-section analysis, the steady state level of subnational borrowing (implicitly sustainable) is not associated with higher central government spending and deficits, when subnational governments increase their borrowing (potentially unsustainable) the central government seems to have to spend and borrow more in the subsequent period. This implies that transitions to decentralization and fluctuations of borrowing by subnationals typically cause problems for macroeconomic management, but evidently many countries with long-standing decentralized public sectors have developed institutions to prevent these problems. Although many of these countries are outside Latin America, the experiences in the region show important positive as well as negative lessons for macroeconomic management in decentralized democracies.

The results presented thus far support some of the hypotheses of hopes and fears discussed above, but not others:

- Decentralization based on local taxes tends to reduce the size of the state over the long term (hope realized).
- Decentralization based on transfers from the center tends to increase the size of the state (fear realized).
- Decentralization is not associated with higher or lower fiscal deficits in the steady state (neither hope nor fear realized).
- Increases in subnational expenditures and deficits lead to increases in overall expenditures and deficits. Thus, fast transitions from centralized to decentralized settings tend to lead to a rapid growth of overall public expenditures and macroeconomic instability (fear realized).

Outcomes and Institutions in Major Decentralized States of Latin America

This section analyzes the macroeconomic outcomes from decentralized fiscal management in Argentina, Brazil, Colombia, and Mexico.[6] These cases give some indications of which institutional features of decentralized fiscal systems lead to excess deficits at national or subnational levels and which features help avert these problems. To guide the analysis we use the following list of 12 institutional factors, both fiscal and political, which are expected to affect the quality of fiscal management in decentralized democracies (see Table 3.3).

Hard Budget Constraints for Subnational Governments

First and foremost, a firm allocation of expenditure responsibilities is critical for establishing a hard budget constraint for subnational governments. If the central government can effectively delegate functions to subnational governments to go along with the delegation of revenue sources, central spending and deficits are more likely to be contained. If this is not the case—because, for example, the constitution or the law mandates resource transfers without allocating explicitly equivalent responsibilities—the central government may find itself with a constitutional obligation and political expectation to continue providing some services, even after revenues or tax bases have been turned over to subnational governments with the understanding that they will do the task.

Second, basing transfers on clear rules is a necessary ingredient for a hard budget constraint. Wherever there is recourse to significant discretionary transfers, including matching grants, subnational governments will have an incentive to overspend because they expect that they can get a larger transfer.

Borrowing Constraints

Although tax and spending policies create fiscal pressures, whether they cause problems for macroeconomic management depends on whether the subnational governments face hard limits on their ability to borrow or to seek other ways of increasing their resources by spending more. Unsustainable deficits are less likely if the central government effectively controls subnational borrowing ex ante. But how to enforce this in practice is not always clear when the subnational governments have considerable political autonomy. Pseudo-strict controls could make matters worse if central government approval creates the impression, and perhaps the self-fulfilling expectation, that the central government has also extended a guarantee.

To run deficits, subnational government must find a source of financing, which potentially includes contractual borrowing from private foreign or domestic banks (especially banks owned by the subnational governments), issuing of domestic or foreign bonds, and the running up of arrears to suppliers and personnel. A creditor and a subnational government would only agree to finance unsustainable deficits if both sides expect to gain, most likely through some sort of federal bailout. The bailout can take many forms, including allowing the financial system (implicitly insured by the government) to count a debt that is not being serviced as an asset. Unsustainable deficits are also less likely if the central government credibly commits not to have bailouts, prohibiting explicit bailouts and forcing subnational governments to service their debts, and if regulators force creditors to accept the losses implied by any failure to service debt by subnational governments. It is still an open question whether ex ante regulation or ex post enforcement of debt service is more effective in preventing excessive subnational government borrowing. Both can work together, but conflicts are also possible, as noted above.

Often financing from the central bank loosens the budget constraint for the subnational governments, either directly by discounting subnational debt or indirectly by easing the national government's budget constraint or allowing commercial banks to roll over bad subnational debts. Unsustainable deficits are expected to be less likely when the central bank (and the bank supervisory agency) is more autonomous and has a strong anti-inflation mandate.

As mentioned above, subnational governments may also accumulate excessive contingent liabilities. This situation is more likely to happen wherever subnational governments are allowed to run their own pension regimes, when they own banks, and when they make concessions to the private sector without adequate regulation from above.

Autonomy of Subnational Governments to Stay Within Budget Constraints

The second group of institutional factors relates to subnational governments' having the capacity and autonomy to stay within the budget constraint. The first one in this category is *expenditure autonomy*. Unless subnational governments (SNGs) have autonomy over their expenditure, no fiscal decentralization and no macrofiscal problem are likely to result. Giving SNGs autonomy over spending is, of course, the way in which decentralization can improve efficiency in matching the needs and desires of a diverse population. But to live within a sound budget constraint, SNGs must have authority to control their costs. Too often central governments keep for themselves decisions (such as teachers' and doctors' wages) that critically affect the level of costs of SNGs, and a liberal decision may throw them into deficits. In particular, SNGs must have the authority to spend less, particularly to cut personnel, salaries, and pension benefits, collectively the largest item of subnational expenditure, in order to be able to adjust to shocks or to contribute to needed fiscal retrenchment. If central rules constrain this authority, it is more difficult to reduce deficits, and expectations of a central government bailout are higher. Unsustainable deficits should be less likely if subnational governments have authority to cut their costs.

Revenue Autonomy

With fiscal decentralization, SNGs usually obtain certain tax bases, but for reasons of politics, equity, and efficiency, these bases rarely cover all the expenses of SNGs. It is commonly believed that SNGs will have smaller deficits if they rely more on their own tax bases (and have the power to change tax rates on the margin), because they have the ability to adjust to shocks by increasing revenue. In addition, as discussed above, relying on one's own resources may strengthen the incentives to control spending. Therefore, unsustainable overall public sector deficits are less likely if subnational governments raise much of their own revenue and have enough flexibility to change rates or impose new taxes.

Political Ability to Enforce Hard Budget Constraints

Political institutions determine the capacity of central governments to enforce hard budget constraints. The rules for intergovernmental fiscal relations and the way in which they are implemented result from the political relations between levels of government (Riker 1964; Stepan 1997; Willis and others 1997). Why does the central government say yes or no to an SNG's request for more resources? Why do the SNGs take on additional tasks or accept reduced transfers in order to help the central government balance its budget? The answer depends in large part on the relationship between the president, the national congress, and local elected officials. Systems with strong presidencies should be better able than systems with weak presidencies to fend off pressures to cover the states' deficits. The presidency is the only office with a national constituency and as such is more likely to take into account the interests of the overall economy, while the members of congress represent regional constituencies and their parties.

We can analyze the power relationships between the national and subnational levels in four steps, corresponding to four conditions. Unsustainable deficits arising from fiscal decentralization are less likely if presidents are constitutionally strong at the national level, and if governors and mayors have little constitutional autonomy. These conditions are not necessarily beneficial for all aspects of governance and, of course, fiscal decentralization presumes that governors have enough political autonomy to be considered a politically separate level of government rather than just a field representative of the central government. Governors and the president indirectly contend for resources, especially through congress and the parties, whose effects on the intergovernmental balance of power we must also consider. The central government should be more able to maintain a harder budget constraint if electoral rules orient congress toward national, not local, issues, and if party discipline is strong. The balance between these forces depends on the interaction of the constitution, electoral procedures, and party discipline. The constitution is a given at most times, as are electoral procedures. Therefore, party discipline is the dependent outcome. But constitutions and electoral procedures change with some frequency in Latin America, and they reflect the political balances and party characteristics at the time of each change.

Outcomes and Institutions in Four Latin American Countries

With these 12 conditions as a framework, the next section examines the outcomes and institutions in four countries.

Argentina: The successful institutionalization of a hard budget constraint on provinces.

Fiscal deficits at the federal level were a major problem in Argentina before 1991, leading to hyperinflation, which reached over 5,000 percent in 1989. Provincial deficits and indirect bailouts of provincial banks, which had access to central bank credit, contributed to the financial difficulties of the period. Provinces accounted for at least half of the public sector deficits that fueled the hyperinflation. The high inflation itself disrupted and substantially devalued the tax and transfer system in real terms, making state finances shrink in real terms. By the end of the decade, hyperinflation had also greatly eroded the real value of domestic debt, leaving governments at all levels with little domestic debt to repay, although external debts remained substantial.

In addition to major improvements at the national level—committing legally to currency convertibility at a fixed rate with the dollar (the Convertibility Law), cutting the budget deficit, and privatizing major industries—the steps to improve subnational finances in the 1990s were also important for the success of macroeconomic stabilization. In the reconciliation of intergovernmental obligations inherited from before stabilization, it turned out fortuitously, but not accidentally, that the debts between each of the states and the federal government netted out to about zero. From 1991 until 1994, the real value of revenues to subnational governments grew rapidly, both from their own taxes and even more from the growth of taxes collected by the federal government and shared with the provinces. The federal government restrained its own spending rate to less than the growth of revenue and negotiated a series of agreements with the provinces, getting them to accept additional responsibilities. To accomplish this politically, the government used party discipline and fiscal transfers (limited in the aggregate) to small states that had a lot of congressional votes per capita. In addition, the governors understood the need for overall fiscal adjustment to sustain the economic revival and growth of their revenues, and the federal government guaranteed floors on the level of transfers.

In the early 1990s, many of the provinces borrowed heavily, even though their revenues were growing strongly. Borrowing from banks, including those owned by the provinces, was the most important form of subnational indebtedness in the early 1990s. The provinces pledged their *coparticipaciones* (revenue sharing payments) as a guarantee to private creditors. The federal government was a party to this arrangement in that Banco de la Nación would deduct the debt service from federal tax receipts and transfer only the remainder to the provinces. Aggregate provincial debt grew more slowly than gross doemstic product, however, because the most important province, Buenos Aires, and another large one of the next rank, Santa Fe, ran balanced budgets or only small deficits. They exercised this discipline, in step with the adjustment program at the national level, because the governors in these provinces belonged to the president's party and supported the overall economic program.

The economic crisis of 1994–95, ignited by the currency and debt crisis in Mexico, tested the hard budget constraint put in place by the Convertibility Law, the new central bank charter, and the debt-servicing arrangements. The crisis not only raised the interest costs of provincial debt but also reduced revenues from local taxes and revenue sharing. Provinces at first reacted by trying to borrow more. They forced suppliers and personnel to accept bonds in lieu of payments on overdue bills and wages. These bonds could be converted to cash at a discount at provincial banks and then used to pay taxes. This forced lending accounted for more than half of the debt incurred in 1994–95. Provinces with debt servicing difficulties suddenly found that Banco de la Nacibonds could be converted to cash at a *coparticipaciones* to pay to creditors. Eventually they had to cut investment programs, lay off nonpermanent staff, give regular staff time off without pay, and implement emergency revenue measures. In some cases the federal treasury facilitated refinancing of provincial debt, but at market rates with no bailouts. And neither the federal government nor its agencies took over any provincial debt; the law forbade it. Most of the smaller states, along with Córdoba and the city of Buenos Aires (both run by the opposition party) had to make strong structural adjustments. They have kept their debt in check since then.

The one channel for aid to the provinces in present-value terms was the federal takeover of most of the state employee pension plans. In the early 1990s the federal government offered to take these over; most states resisted at first, for political reasons, but the economic crisis forced them to accept. This measure will prevent future accumulation of unfunded pension liabilities by the provinces.

The strong anti-inflation commitment after 1991 and tight limits on central bank credit to the public sector in Argentina limited subnational spending and deficits in two ways. First, it allowed the federal government to reject provincial pleas for more resources after the Tequila shock, with the rationale that it could not increase transfers without endangering the stabilization gains and the survival of the Currency Board system. Second, it constrained the ability of the provinces to borrow from their own banks by tightening bank regulations and eliminating local government access to the central bank rediscount facility. After the 1994–95 economic shock, most provinces had to recapitalize or privatize their banks—borrowing from them was not an option. Eighteen of the provincial banks were privatized during 1994–96 and more have gone through the process since then (World Bank 1998).

The timing had been good. Making changes before the crisis had forced the provinces to adjust turned out to be of critical importance for the institutionalization of the hard budget constraint in subnational finances in Argentina. When the crisis came, the deficit hawks in the central government needed to have just enough political leverage to veto a change in the status quo, not to impose a new one, which would have been a much harder task. Political timing in getting the budgets balanced in the largest states (of the president's party) when revenues were growing was also right. This made it politically easier during the economic crisis for the president to enforce a hard budget constraint on the main opposition states.

Brazil: Repeated rescheduling. No hard budget constraint for the states.

A state debt crisis was not the main macroeconomic problem that observers expected from decentralization in Brazil. They feared that the large increase in tax sharing mandated by the 1988 constitution would provoke federal deficits, because the federal government would not cut its ordinary (non-transfer) expenditures or raise federal taxes by an equivalent amount. At the outset, this deficit situation seemed likely to happen, because the congress rejected a proposal for expenditure decentralization intended to match the new division of revenues.

Nevertheless, fiscal adjustment ultimately occurred at the federal level. Part of the adjustment took place on the expenditure side in the early 1990s. Having failed to decentralize federal functions formally, the federal government succeeded in giving the responsibility for certain expenditures—hospitals, highways, and urban transit systems—to subnational governments on an ad hoc basis. Service from the federal level declined to the point that it sometimes became politically attractive for a municipality or state to take on the responsibility. The largest part of fiscal adjustment at the center, however, occurred through adjustments in revenue. On the revenue side, at first the federal government used the guise of economic stabilization measures to claw back some of the increase in the constitutionally mandated transfers, namely reducing by 20 percent the portion of income and industrial-product taxes subject to sharing. The federal government also increased the rates of taxes that it was not required to share with subnational governments, such as social security taxes and a new tax on checks. Because agreements required federal and state governments to share the most efficient taxes, they created an incentive to increase inefficient taxes, as Argentina did in the 1980s. Consequently, the federal deficit and spending remained roughly constant as a share of GDP over this period, contrary to initial expectations, and state and local governments expanded strongly, resulting in a larger public sector overall.

The main macroeconomic problem with decentralization, however, arose from excessive state deficits and then mismanagement of the debt. In Brazil, as in Argentina, subnational deficits contributed to the fiscal problems in the high-inflation periods prior to the stabilization that started in 1994. Dealing with the deficits and debt of the states has been one of the main challenges to sustaining the stabilization since then. There have been four rounds of crises and rescheduling of state debt—in 1988, 1993, 1994–95, and 1998–99.

In the earlier debt crises, the debt agreements established three precedents that influenced subsequent agreements. First, the federal government actually put the state debt on its books and then provided relief in the form of rescheduling, rather than forgiveness. Second, through the combination of grace periods, rescheduling, and debt service caps, the agreements reduced the debt service burden of sitting administrations, leaving the fiscal consequences to their successors. This reinforced the perception that the federal government was prepared to provide debt relief to any state requiring or requesting it. The repeated cycle of the federal government refinancing state debt, coupled with caps on debt service, had the perverse incentive effects that one would expect. By the time some consensus for action had been reached, the number of bankrupt states was too large to allow them all to fail, and their debt had grown too large for any solution without substantial debt relief to work. The lack of discipline in the political parties and the strong autonomy of the state governors, in contrast to Argentina, put the federal government in a weak position to negotiate with the states, so the terms of agreement were often relatively generous.

At the beginning of the 1990s, Brazilian subnational debt as a share of GDP was at a level similar to Argentina's, but by 1997 it had more than doubled. Unfortunately, the Brazilian stabilization program of 1994, the most successful to date, left unchanged many rules and institutions, which motivated the states to let their debt grow. Most of this debt was owed to the central government or to state banks, and until the debt-rescheduling agreements in 1998, much of it was not being serviced by the states. Interest was being capitalized. As a result, state debt and deficits were a direct fiscal problem for the central government and for the overall public sector. State debt accounted for one-third of the increase in domestic public debt from 1994 to 1997.

The situation has evolved in several ways since the mid-1990s, some of them positive. First, the Ministry of Finance and the central bank have set some ex ante limits on state borrowing. The limits are not air tight, and they reinforce the unfortunate impression of a federal guarantee for existing state debt. Still, they tend to limit state deficits to unpaid service on outstanding debt. Second, the agreements of 1998 are written in a way that requires the federal government to withhold debt service from transfers, as in Argentina. Even when the much-publicized refusal of Minas Gerais to pay debt service resulted in the federal government's covering the state's debt service in order to protect the national credit rating, the state was effectively forced to pay, because the federal government deducted the state's payments from transfers. (The most recent crisis in 1998–99 has not yet been fully resolved.) Third, São Paulo—the largest state—has become one of the reform states. This is likely to shift the balance of political power in the federal congress in favor of the reformers, making it easier to impose budget constraints on the remaining spendthrift states. If this strategy works, the recent crisis may end up being as important for Brazil as the 1994–95 crisis was for Argentina—as it tests the system and sets precedents.

Colombia: Attempting to establish hard budget constraints through ex ante regulations.

Unlike Argentina and Brazil, Colombia has had a strong centralist tradition for a century, since the 1886 constitution. This centralism was partly a reaction to geographic fragmentation, civil war, and losses of territory in the nineteenth and early twentieth centuries. Political decentralization came recently in the form of elected mayors in 1986, and elected governors in 1991. In contrast to Argentina and Brazil, Colombian political decentralization was implemented without the additional trauma of a transition from military to civilian rule and without the complication of hyperinflation. Indeed, Colombia has enjoyed a tradition of and reputation for sound macroeconomic management, which was associated in some minds with central fiscal control. In the 1990s, however, the expanding political and fiscal decentralization has coincided with the expansion of fiscal deficits and a failure to share in the general increase of macroeconomic stability in most other parts of Latin America.

Total government spending grew at the same pace as GDP in the late 1980s and then grew much more rapidly during the 1990s, increasing from 11 percent of GDP in 1991 to 18 percent in 1997. Revenues, in contrast, increased from only 10 percent of GDP during 1987–90 to 13.6 percent of GDP in 1997. This increase was just partially effective because current revenues are shared up to 40 percent with subnational governments. The national government's primary spending (net of interest and of transfers to the territorial governments and entities) has roughly doubled its share of GDP since the late 1980s, from 5 to 10 percent. The national government increased its own expenditures for the military and judges—as a response to increasing violence from drug traffickers and guerrilla warfare—and for social security, as a consequence of the social security reform of 1993. It did not reduce central administration outlays, however, which should have occurred with the transfer of other functions to the subnational levels. During the 1990s the national government deficit has grown from less than 1 percent of GDP to almost 5 percent. The transfers to provinces (departments) and municipalities increased by only about 1 percentage point of GDP each, corresponding to only about one-third of the increase of central government expenditures (Clavijo 1998).

At the departmental level, spending and deficits increased by only 0.1 or 0.2 of a percentage point of GDP in the 1990s. Municipal spending, however, has increased by almost 2.5 percentage points of GDP. The aggregate municipal deficit rose, nevertheless, by only 0.2 of a percentage point of GDP, because transfers from the national level and tax revenues had also risen by about 1 percentage point of GDP each. The increase in transfers to departments can be attributed mostly to the central government's objective of increasing the coverage of social services, especially basic rural health and education, and to salary increases negotiated by the central government. Scheduled increases in the transfers to municipalities have increased and will continue to increase the fiscal burden on the central government. Some transfers came through matching-grant investment programs, which at least until 1997 had considerable political discretion in the allocation of projects. Until the mid-1990s the transfers increased in importance, reaching 40 percent of total transfers to municipalities. Since then they have declined slightly and in 1997 were made into soft loans from the Colombian development bank Financera de Desarrollo Territorial S.A. (FINDETER), with perhaps more transparency (Ahmad and Baer 1997).

Revenue sharing has complicated stabilization efforts. At present, more than 40 percent of all current revenues are automatically transferred to departments and municipalities, and the constitution has mandated that the share increase further. Unlike the other major decentralized economies of Latin America, the Colombian national government has virtually no unshared tax bases, not even inefficient ones (Perry and Rodriguez 1991). Successive tax reforms, attempting to mitigate the growth of the national deficit, have thus automatically increased subnational expenditures. The government has presented legislation to congress to earmark part of the transfers for pension reserves, a large unfunded liability of the states which looms large on the horizon in Colombia, as in Brazil and elsewhere.

In Colombia the controls on subnational borrowing have varied over time. Up to and including the 1980s, all subnational borrowing had to have approval from the Ministry of Finance. It was rarely granted. This was natural, since the subnational entities were appointed representations of the central government and had no political or fiscal autonomy. In the late 1980s and the 1990s, the ad hoc approval process gradually allowed more freedom for domestic borrowing, as subnational political and fiscal autonomy increased. From 1991 to 1998 the total debt stock of departments and municipalities actually declined as a share of GDP, but the debt nonetheless reached a crisis point for several entities twice during this period (in 1995 and 1998). The decrease was due to amortization of external debt, part of which was taken over by the national government in 1992.[7] Domestic debt of the subnational governments grew in the 1990s, especially to the banking sector in which debt rose from 2.6 percent of GDP in 1991 to 4.6 percent in 1997.

The departments' debt in Colombia has been problematic mainly because they have little discretion over their receipts or spending, most of which has to go for salaries. Neither the departments nor the creditors took sufficient account of this inflexibility in their ex ante evaluations of the ability to pay. In the case of municipalities, the debt crises were related to runaway expenditures financed with the pledge of increasing transfers. The inclination of private banks to lend to subnational governments that had little debt to the national government meant that the national government was not heavily exposed to the threat of territorial default, in contrast to Brazil. In Colombia, the subnational borrowing has not been large enough potentially to cause a general banking crisis that would require national government intervention. Nonetheless, subnational governments in fiscal straits have often received ad hoc bailouts from the center, most notably Bogotá in 1991 and Medellin in the late 1990s for its debt from the construction of a metro. They have also restructured their debts with private lenders several times, and recently this has been without financial help from the national government.

Witnessing the high rates of growth of subnational debt to domestic banks in 1993 and 1994 (more than 60 percent per year in real terms, according to the Superintendency of Banks) and the debt crisis of several subnationals in 1995, the national government attempted to exert some control over it. On the supply side, in 1995 the Superintendency of Banks tightened banking regulations, which slowed the growth of subnational debt in real terms for a while. A law enacted in 1996 aimed to prevent indebtness in excess of the ability to pay, through a system of warning signals that would prompt direct control from higher levels of government.

A rating system for subnational borrowers (established by the so-called Traffic Light Law) scheduled for full effectiveness in 1999 has not been able on its own to prevent unwise borrowing, but has worked as a complement to bank regulation. Now banks have to provision against loans to departments and cities that do not score well enough on the rating system, which may make the banks more cautious in lending. Whether these measures will be enough to to prevent excess lending will depend on whether the national government refuses to bail out overindebted states and municipalities and their creditors in the present crisis. In 1998 the consortium of creditors to the department of Valle de Cauca (Cali), under pressure of the combination of bank regulation and the Traffic Light Law, renegotiated the debt and the fiscal program. If this arrangement with other departments requires that they and their creditors bear the primary responsibility and costs of fiscal adjustment and debt renegotiation, it will provide an incentive to all creditors to make responsible borrowing decisions. As experience in the other countries shows, creditors will not lend to bad credit risks where they have no hope for a bailout from above.

Mexico: Ex ante controls and political grip as budget constraints. What does the future hold?

Constitutionally, Mexico is a federal structure, and since the 1980s considerable spending has been handled by the states. One party, the Partido Revolucionario Institutional (PRI), has dominated governments at all levels for decades, however. So the country has operated almost like a unitary state, with the president and the head of the PRI selecting the party candidates who would win the elections for governors and mayors of large cities. Two important changes took place in the 1990s. First, the political system opened up, allowing other parties to compete with the PRI. To date, these new parties have won almost one-third of the state governor seats and many municipal presidencies, and in 1997 the PRI lost its majority in the national congress. This activity has stimulated a federalism that had lain dormant in the constitution. Governorships have become important offices in the careers of politicians. The second important change has been the rapid increase in the transfer of resources to states and municipalities. At the same time, the authority of the states to control this spending has been reduced, while the authority of municipalities has been increased.

The transfer of nominal responsibility for health and basic education to the states in the early 1990s required unification of the state and federal components, which had previously operated as parallel systems. The national ministries remained in charge of establishing curriculums and standards and negotiating wages and terms of employment with the national union. In other areas of local public services, the congress in 1997 and 1998 voted for more decentralization transfers, but mostly to the municipalities and with reduced leeway for any control by the states over these funds, although the constitution requires that they appear on the books of the states. It remains to be seen whether the fiscal trend toward municipal federalism will continue, or whether it will somehow be reversed, perhaps as a result of the growing political prominence of the governors.

These developments in overall intergovernmental relations help explain what has happened in the areas of debt and fiscal management. State governments and a few municipalities have borrowed for some time from the national development banks; recently they have been borrowing from commercial banks as well. In the aggregate the state debt levels are low—about 2 percent of GDP—although the debt has been a fiscal problem for some states. The low overall indebtedness results mainly from ex ante controls on borrowing. First, the constitution forbids any subnational borrowing from abroad or in foreign currency. The rule has been observed, except for one or two state bond issues that were effectively indexed to the U.S. dollar. Second, each state congress annually sets borrowing ceilings for the state and its municipalities. (For the Federal District, where local elections were first held only in the 1990s, the federal congress still approves the annual budget and borrowing ceilings.) Third, creditors can get and almost always want a guarantee in the form of access to federal-state transfers. This requires a review by the Secretario de Hacienda y Credito Publico and proper registration. The Ministry of Finance can deny an application or request a reduced amount.[8] The development bank, Banco Nacional de Obras Publicas (BANOBRAS), also reviews the fiscal picture of borrower states. While some say that these reviews are perfunctory, they and the borrowing restrictions seem to have prevented extremes of excess borrowing. It remains to be seen how this will work with the loosening political grip of the PRI, greater political autonomy of subnational governments, and a growing private financial sector.

Defaults on state debt have arisen in three contexts in Mexico. The largest occurred in the context of economic and fiscal contraction after the economic crisis of 1994–95. Many states could not service their debt, so all got some degree of debt relief (and bailout for creditors) from the federal government in exchange for fiscal adjustment, although the terms for individual states varied. A second context was large infrastructure projects, like metros and toll roads that did not yield the return expected and necessary to service the bonds that financed them. Here again the federal government provided debt bailouts along with a takeover of the infrastructure assets.

In addition to these discrete episodes, every year until 1998 most states received some extraordinary transfers from the federal government, usually related to covering service on old debt or paying teacher salaries. The amounts varied from year to year and across states, even adjusting for population. Without the extraordinary transfers, the states as a group would have been running primary deficits during 1995–97, rather than primary surpluses. These bailouts were not important on a national macroeconomic scale, but they may have created an environment where creditors did not worry much about the creditworthiness of the states, and states faced no harsh penalty for overborrowing. The part of the budget allocated for these extraordinary transfers was cut back in 1998 and largely eliminated in 1999.

Thus, the federal posture toward state debt has been changing rapidly in the last few years. The new system is still taking shape—it remains to be seen how it will work in practice.

Summary of Cases

The first two cases—Argentina and Brazil—illustrate the problems of stabilizing high-inflation economies at the same time that finances are being decentralized and democracy is being restored. In Argentina, the federal executive was able to use the political dynamics of the federal system and the fear of hyperinflation (as well as the joy for its end, and the economic and fiscal rebound) to pressure the provinces to bring their fiscal policy to a stance consistent with the national stabilization program. Today the country seems to have institutions in place that impose an effective hard budget constraint on subnationals. In Brazil, the stabilization started later, and many states have not yet made the fiscal adjustment necessary to support the program. But in Argentina in the early 1990s (the first years after the stabilization) there were also many states that did not adjust their fiscal stance. The situation in Brazil seems more severe in that none of the largest states adjusted early on and the federal government continued to give bailouts—debt rescheduling—that established perverse incentives. The state debt and exchange rate crisis of 1998–99 could turn out to be a turning point for Brazil, similar to the Tequila shock for Argentina. That will depend on how the states and federal government react.

In the second two cases, Colombia and Mexico, the challenge has been to sustain fiscal stability and moderate inflation at the same time that substantially more resources are being transferred to subnational governments. Although these countries did not have governmentwide political transitions from military government to electoral democracy, as in Brazil and Argentina, they increased democracy at subnational levels and widened the range of parties that could effectively participate at the national level. Starting from strongly centrist systems, political decentralization has advanced through a combination of two processes. First, the traditional elites (in Mexico the PRI and in Colombia the two traditional parties, particularly the Liberals) sought to increase their legitimacy with those who were defecting from traditional parties and sometimes joining insurrection movements, especially in Colombia. Decentralization was a way to appease these groups; perhaps it was less threatening to traditional power relations than if the concessions had all come at the national level. Second, as the non-traditional parties gained footholds on the periphery of the political system—governors, mayors, members of congress and (in Colombia) the constitutional assembly—they voted and lobbied for decentralization of expenditure to the lower levels of government where they had a larger share of the power.

Decentralization Institutions and Fiscal Management

What institutional arrangements reduce the likelihood of excess debt by national or subnational governments as a result of decentralization?

Table 3.4 summarizes the 12 economic and political conditions identified at the start of the previous section as contributing to containing deficits in a decentralized fiscal system, and rates the four countries discussed above in a comparative way. Some conclusions emerge from this comparison.

Hard Budget Constraint for Transfers and Service Responsibilities

The rules and institutions for raising revenue and for spending are most directly important for determining the efficiency and equity in fiscal decisions. For overall macroeconomic management they are indirectly important, facilitating or hindering decisions and adjustments that come out of the borrowing process and the political process.

Certainly, fixing the amount of the transfers in the aggregate is important. The absence of a firm fix on the total was a major problem for Argentina in the 1980s and, counting the debt relief, has been a serious drawback for Brazil in the 1990s. For Colombia and Mexico, having special transfers that are decided on a case-by-case basis, without any hard ceiling on the overall program, has been a problem, although not yet an overwhelming one, thanks to debt constraints discussed below. Having some political discretion on the distribution of special transfers within a firm overall limit, as in Argentina, does not seem to pose major difficulties. Indeed, it may be a way to allow some leeway for unavoidable patronage games while making it clear to all players that the game is zero-sum.

A clear assignment of functions among levels of government is obviously important for a rational and efficient public sector. The aspect that seems most important for macrofiscal management is clarifying what subnational levels will take over along with the transfers, and what the

TABLE 3.4

Summary of Conditions for Reduced Danger of Excess Deficits

VARIABLE	ARGENTINA, 1991–98	BRAZIL, 1994–98**	COLOMBIA, 1991–98	MEXICO, 1994–98
HARD BUDGET CONSTRAINT FOR TRANSFERS AND SERVICE RESPONSIBILITIES				
1. Transfers are specified by legal formulas, not ad hoc.	Yes, set by formula and limited in aggregate, but important for some small provinces.	No; grants from the budget and tax sharing set by formula, but large debt relief sometimes.	Yes, but with important exceptions.	No
2. Central government effectively delegates functions to subnational governments to go along with the delegation of revenue sources.	Yes	No	Yes, for departments; No, for municipalities.	Yes for states; No, for municipalities.
BORROWING CONSTRAINTS				
3. Central government strictly controls subnational borrowing ex ante.	No, federal government has some authority but mainly requires reporting.	Yes, in principle; very sophisticated rules but also sophisticated loopholes.	Yes	Yes
4. Central government credibly commits not to have bailouts, prohibiting explicit bailouts and forcing subnational governments to service their debt.	Yes	No, cap on debt service allows interest capitalization.	No	No
5. Regulators force creditors to accept the losses implied by any failure to service debt.	Yes, but rare because debt service is deducted. from transfers.	No	Yes	No
6. The central bank (and bank regulators) are more autonomous and have a strong anti-inflation mandate.	Strong autonomy and commitment to fixed exchange rate.	Limited autonomy; discretionary monetary policy.	Yes	No
SUBNATIONAL AUTONOMY FOR FISCAL ADJUSTMENT				
7. Subnational governments raise much of their own revenue.	No	Yes, for large states; no, for small states.	No	No
8. Subnational governments have authority to cut their costs.	Yes	No, legally difficult to cut labor costs.	No for departments; Yes for municipalities.	No for states; Yes for municipalities.
INTERGOVERNMENTAL POLITICAL RELATIONS				
9. Presidents are constitutionally strong at the national level.	Yes, very strong through decree powers.	Yes	Yes	Yes
10. Governors have little constitutional autonomy (for example, no reelection; central government can intervene).	Yes, federal intervention common, at least until 1994.	No, no federal intervention.	Yes	Yes, but governors' autonomy growing.
11. Electoral rules orient congress toward national, not local, interests.	Yes	No	No, national at-large elections for senate may change this.	Yes
12. Party discipline is strong.	Yes, closed lists.	No, open lists.	No	Yes, very strong.

TABLE 3.5

Channels for Control of Subnational Borrowing

	FOR BORROWERS	FOR LENDERS
Ex ante controls	• Central government review of fiscal capacity to carry debt • Prohibition of international borrowing	• Credit rationing to states • Prohibition of international borrowing
Incentives: ex post consequences	• No bailouts • Government does not hold subnational government debt • Debt service withheld from transfers	• Regulations require provisioning against debt from fiscally weak subnational governments • Strong supervision of banks

national level is not expected to take over in case of a subnational fiscal crisis. In Argentina, part of the national-level adjustment was accomplished through agreements with provinces that they would take on additional functions, since transfers were increasing during the stabilization. In Mexico, on the other hand, a significant loophole in the budget constraint of states has been the willingness of the federal government to take over failing state projects in transport and electricity. In Colombia, the lack of an explicit assignment of exclusive responsibilities to municipalities contributed to the outcome of high and rising central government expenditures at the same time that municipal expenditures were increasing significantly.

Borrowing Constraints

Controlling borrowing by subnational governments has two main dimensions: their type or timing—ex ante controls or ex post incentives—and whether they act on borrowers or creditors. Together these make a matrix with four cells, as in Table 3.5.

One response to problem subnational borrowing, actual or anticipated, is to have ex ante controls or even prohibitions (Ter-Minassian and Craig 1997). If they are well implemented, they can help eliminate debt problems or make them more manageable. Sometimes the controls are self-imposed, for example, by a state in its constitution. These may be circumvented, although local voters may subsequently punish elected officials. Central controls (national controls on states or state controls on municipalities) are sometimes firmer, but they may be hard to enforce if there is substantial political decentralization. In addition, getting adequate information is difficult; if the borrower and lender both want to make a deal, they have incentives to collude in giving biased information to the regulator. Most important, if the central approval carries, or is believed to carry, an implicit central government guarantee of the debt, it will increase the likelihood that the subnational government and its creditor will want to agree on a loan even if they both know it is risky. They will conclude that if something goes wrong, someone else will pay—the federal taxpayer. All four countries described above provide examples of this problem, although it has been more frequent and of larger magnitude in Brazil. Brazil has the most elaborate ex ante controls, mostly put in place after the debts were already oversized, but due to lack of adequate enforcement they actually helped reinforce the moral hazard of expected federal bailouts. In contrast, Mexico seems to have had more success with enforcement. The reasons for different outcomes with the same instrument seem to lie in differences in political institutions, as discussed below.

Usually ex ante controls are imposed on the borrowers, but they might also be imposed on the creditors, as with the central bank moratorium on lending to states in Brazil or the Superintendency of Banks regulations in Colombia. In Mexico the constitutional provision against foreign borrowing by (and lending to) states and municipalities is an ex ante control on both sides.

The second row of Table 3.5 represents complementary approaches that ensure the consequences of default provide either the borrowers or the lenders, or to both, with incentives to discipline themselves. Of course, the worst incentives arise if the central government (national to states or states to municipalities) gives bailouts when subnational governments overspend and creditors finance the debt. Bailouts can take several forms—special transfers, takeover of costly functions, takeover of debt or contingent liabilities, or subsidized refinancing of debt. All of these reduce or eliminate the cost to the original decisionmakers, allowing them to make mistakes with other people's money. The essence of improving incentives is to ensure that those who make mistakes pay a substantial share of the cost. This can put the burden on borrowers by forcing repayment, for example, through deductions from their share of centrally collected tax revenue, as in Argentina (but without compensating special transfers as in Mexico). It can also operate by making creditors take losses for any subnational debt that is not being serviced, as in Colombia and Argentina. (See Box 3.1 for a discussion of the risks and costs in the source and terms of borrowing.)

Subnational Autonomy for Fiscal Adjustment

Reliance on transfers, rather than local taxes, does not appear to induce local governments to run deficits. At first, it may seem no accident that in some top-performing decentralized countries, like Switzerland and the United States, the subnational governments (especially the cantons or states) raise most of their own resources, while in developing countries with many macroeconomic problems arising from the decentralization process, the states get much of their revenue as transfers from the center. But this oversimplifies the problem; the relatively high share of local revenue in the largest Brazilian states did not prevent them from causing the biggest macroeconomic headaches. And some countries, such as the United Kingdom and Australia, rely on transfers to finance subnational governments, with no adverse macroeconomic consequences.

For short-term adjustment to macrofiscal necessities, the opportunity for subnational governments to cut costs, especially by reducing the number of employees and their salaries, seems critical. It helped in Argentina when provinces were given the opportunity to reduce wages. The lack of spending flexibility in subnational governments has been a problem in Brazil, Colombia, and Mexico. In Colombia and Mexico this lack has led to repeated special transfers, even with modest debt-to-GDP and total revenue ratios, because the terms of the transfers from the national level commit almost all resources of states (or departments) to paying salaries in education and health. Brazilian states have somewhat more discretion over spending because the transfers are not explicitly linked to paying salaries, but until very recently the constitution forbade layoffs or cuts in nominal wages. (The latter was not a constraint until after the stabilization of 1994.) In addition, national law (or the

BOX 3.1

Risks and Costs in the Source and Terms of Borrowing

Subnational borrowers face important tradeoffs in choosing the source and terms of their borrowing. Typically for each choice, there is a lower risk or a lower cost. Which the borrower prefers depends on the source of revenues and the macroeconomic context.

In choosing between domestic and foreign-currency-based loans, which are typically linked to the location of the creditor, foreign currency loans are usually cheaper, because the creditor does not like to bear the risk of currency devaluation. But they are only a better option for the subnational borrower if it is well positioned to handle the risk. If it has a revenue source, such as tourism, taxes, or petroleum royalties that are linked to foreign exchange, it is a good option for the borrower. If the borrower does not have a revenue source, it is taking a large and costly risk which, through diversification the creditors can probably handle more cheaply. What is more, foreign debt default may have broad external effects, making it more likely that the central government would succumb to pressure and bail out the subnational. For these reasons, most countries place stronger ex ante controls on foreign than on domestic borrowing by subnationals.

Loans with floating interest rates are similarly cheaper than fixed-rate loans, but carry the risk for the borrower that the rates will rise. That is a risk worth taking only for borrowers that expect rising disposable income and have a ready capacity to increase interest payments if needed. A short term to maturity for a loan also usually lowers the rate, and is a good deal for a borrower that expects to be able to pay off the principal when it comes due or that has a secure market access and expects the rate to be coming down. Otherwise, it is a costly gamble. A common feature of most debt crises is that the debtor was taking increasingly short-term debt.

constitution) mandates early and generous retirement for public employees at all levels. Such provisions encumbered the adjustment of states facing debt crises and contributed to the expectation that the federal government had the responsibility to solve the problem.

Intergovernmental Political Relations

These fiscal policy institutions do not stand in isolation, but derive their backing and commitment from the political system, although once in place the institutions can set some limits to political decisions. The power of the president compared with that of governors has been important for maintaining fiscal constraints in Argentina, Colombia, and Mexico, and party discipline in Argentina. In Brazil, meanwhile, the power of the governors, in their own states and in influencing congress, and the lack of party discipline all tended to make excessive state borrowing more likely.

The relations of political institutions to fiscal rules derive from three types of situations. In the baseline situation, the national executive (by itself or with the support of the attorney general and the courts) has enough power to enforce the spirit and letter of laws passed by the legislature. Colombia, Argentina, and Mexico, since the mid-1990s, are in this situation. In the second type of situation, the national executive has power to impose fiscal discipline that goes beyond the regular laws, either through party discipline (as in Mexico traditionally and Argentina in the 1990s) or through emergency interventions, as in Argentina and Brazil during the military periods and in Colombia at times before the constitution of 1991. In the third type of situation, the states have so much power, relative to the national executive, that they can block the national executive from carrying out even the rules agreed to in the national legislature. Since the restoration of democracy, Brazil has often been in this situation.

These differences in the relations of political institutions help to explain why in some situations the same instrument—for example, ex ante controls on state borrowing—worked effectively in Mexico (at least until recently), relatively well in Colombia, and in a rather perverse way in Brazil.

Conclusion

Econometric results reported here—on a worldwide sample—suggest that fast decentralization normally leads to higher overall public expenditures and serious problems in macroeconomic management. Indeed, the results show strong evidence that increases of subnational expenditures and deficits are associated with subsequent increases in national government spending and deficits.

The results also show, however, that in the long term, deeper decentralization is not associated on average with higher deficits—or surpluses—although it is associated with larger overall expenditures if states do not collect their own revenues. Therefore, decentralized countries seem to be able to eventually develop institutions and raise taxes, to avert the macroeconomic fears concerning deficits, though they have not escaped having large public sectors.

The four country cases examined show that it is not necessary to fulfill all of the proposed 12 conditions to achieve an effective budget constraint on subnational governments, and hence sound macroeconomic management in a decentralized context. However, the cases also show that if some institutional conditions are missing, the others must be stronger.

In the area of revenues, whether states raise most of their own revenue (as in Brazil but not in the others) seems less important than whether transfers to states (including debt bailouts) are non-discretionary. Clear formulas to set the overall level of transfers in the aggregate and to each state are the first step to prudent fiscal management with decentralization. Without that, the states have little incentive to take anything else seriously.

In the area of spending, clarity in allocating spending, though important, does not seem as important as having the authority to cut or control costs (especially those related to personnel) in the areas where subnational governments do take responsibility.

In the area of borrowing controls, ex ante restraints have had favorable effects in Colombia, because they were complemented by ways to make creditors bear some of the cost of states' overborrowing or to force the states to pay. In Brazil the ex ante constraints stand more in isolation and therefore may have had the perverse effect of increasing the impression that the federal government guarantees the states' debt. In Argentina, by contrast, the mechanisms to ensure that provinces pay their debts in full seem to have worked well in the later 1990s (after a painful test of the system in the Tequila crisis), despite the absence of strong ex ante borrowing controls. In Colombia and especially Argentina (after 1991), the debt constraints for states were reinforced by the autonomy of the central banks, which helped keep a relatively hard budget constraint on government at all levels. In the end, the name of the game is effective hard budget constraints on subnationals, and these can be achieved—and undone—in several ways.

The political factors are largely given from the point of view of the policymaker, but they are important. Political centralization, as in Mexico and Colombia before 1990, makes the other fiscal/institutional concerns almost redundant. But as the political system delegates more and more true autonomy, the fiscal rules become more and more important for providing the proper incentives for decentralized democratic fiscal management.

Notes

1. Bailouts of subnational governments occur not only as a consequence of excessive debt. Subnational governments may end up being insolvent due to unfunded contingent liabilities (financially unbalanced pension systems for state employees; excessive guarantees to private investors in infrastructure; losses of subnational public banks or public enterprises). Such cases are theoretically equivalent to excessive debt issuance.

2. In addition to these problems, there are other efficiency and equity concerns with which we do not deal here, including those arising from the following: lack of capacity at the subnational level, eventual capture of government by local elites, and inequality of service provision because of unequal tax bases or poor allocation of transfers, etc., which are examined elsewhere.

3. Primary spending is net of interest payments and budgeted transfers to subnational governments. Primary deficit is the usual definition of overall deficit minus the interest on debt (see also Treisman 1998).

4. First differences were used because with the regression in levels, the time series were non-stationary and the errors in the regressions were serially correlated.

5. These results show up when we look at changes between five-year periods, as well as annual changes.

6. The Argentina and Brazil accounts draw directly on Dillinger and Webb 1999a, and the Colombia account on Dillinger and Webb 1999b.

7. Much of this debt was to multinationals for electrification projects in the 1980s, before the subnational governments had political or fiscal autonomy.

8. Until 1997, the federal government essentially had an obligation to give these guarantees if the lending was within approved limits. In 1997 the federal government tried to absolve itself of this function by making the states responsible for themselves. But the commercial banks and states pressured the federal government into an equivalent arrangement where states could legally mandate this function back to the federal government. The arrangement was temporary and the finance ministry would like to terminate it in 1999.

CHAPTER 4

Empowering Municipalities or Schools? The Decentralization of Education

As we have seen, over the past decade, decentralization of government has become common throughout Latin America. The education sector is no exception; in the 1990s the number of countries implementing significant decentralization reforms has increased rapidly (see Figure 4.1). At the same time, there has been a worldwide trend to give schools greater decisionmaking autonomy, in the interest of improving school performance and accountability. School systems as diverse as those in Victoria, Australia; Memphis, Tennessee; and Minas Gerais, Brazil, have given authority to school heads, and then through a variety of mechanisms held them responsible for school performance.

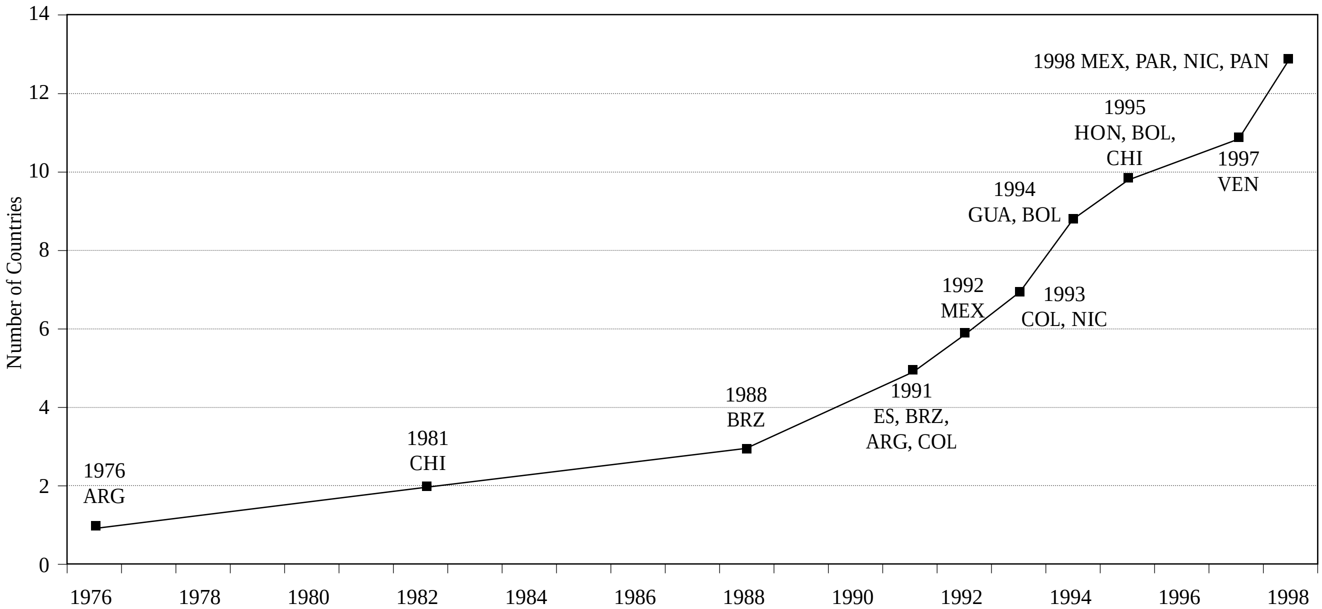
The two types of education decentralization—to lower levels of government and to individual schools—have very different origins and objectives. The decentralization of education to lower levels of government has almost without exception been undertaken in the context of a more general decentralization of government, the causes of which vary widely. In contrast, the decentralization of education to individual schools typically has been motivated by concerns about poor school performance. Both types of education decentralization are well represented in Latin America, and this chapter reviews the evidence to date of their various impacts on schooling.

The literature on education decentralization is growing rapidly, but is still primarily descriptive in nature. Attempts to assess the impacts of decentralization have suffered from weak baseline data and poor research design, mainly resulting from inadequate data. Weak evaluations are not limited to Latin America or developing countries. For example, Summers (1996) reviewed over 600 evaluations of school-based management in the United States and found only two with an adequate research design.

Several recent studies and evaluations of primary and secondary education, both in Latin America and in other regions, provide the basis for this chapter, of which three merit mention. The World Bank recently completed several studies on education decentralization worldwide (Fiske 1996; Gaynor 1998); the Inter-American Development Bank sponsored research on the effects of different organizational arrangements in education in Brazil, Chile, and Venezuela (Savedoff 1998); and the Centro Estudios para America Latina (CEPAL) worked with researchers in five countries (Bolivia, Brazil, Colombia, Mexico, and Nicaragua) to assess education decentralization strategies (di Gropello 1998). In addition, this chapter draws on several country-specific evaluations from Latin America and selected evaluations from outside the region.

FIGURE 4.1

Latin American Countries Implementing Education Reforms



Rationale for Education Decentralization

The economic rationale for decentralizing education is to improve social welfare and technical efficiency (Winkler 1992). Decentralized decisionmaking, it is argued, will give local voter-consumers greater voice in the service mix they receive and, hence, raise their welfare. Presumably, the more local the decision the greater the voter-consumer voice will be—that is, greater at the school level than at the municipal level—and greater in single-purpose government (for example, a school district) than in general-purpose government. If the financing and supply of education are determined locally, the improvement in social welfare will be still greater, because the median voter-consumer will tax himself or herself only up to that point where the marginal tax costs and marginal educational benefits are equal.

However, these arguments presume a world in which democracy works well, and in which all externalities are captured locally. If there is the risk that local elites will capture local decisionmaking, social welfare may not improve; this risk may be higher in societies with little experience in participative democracy at the local level. If the externalities alleged to result from education, especially basic education, are distributed beyond the confines of the locality, there is a strong argument for a high percentage of financing coming from centralized sources. Ensuring equality of educational opportunity, measured at a minimum by equality in educational spending, is a further argument for a high degree of centralized financing in countries where income inequality is high.

Improved technical efficiency is the other rationale for education decentralization. Here the argument has several elements. First, to the extent that prices and production processes vary across localities, there are obvious efficiencies resulting from letting local decisionmakers allocate budgets across inputs. Second, in situations where the capacity of central government ministries to monitor and supervise local schools has been weak, devolving these responsibilities to local voter-consumers may increase the accountability of the school for its performance. The interest of local voter-consumers may be higher if they are also contributing resources—financial or non-financial—to the school.

A final argument for decentralization is that having many suppliers rather than just one supplier is likely to lead to a wider variety of experiences and innovations. If there are adequate means for communicating and exchanging information on these experiences, a decentralized system may lead to more rapid innovation and change than a centralized one. There is some evidence for this argument in the case of Brazil (Xavier, Sobrinho, and Marra 1994).

The Educational Context of Decentralization

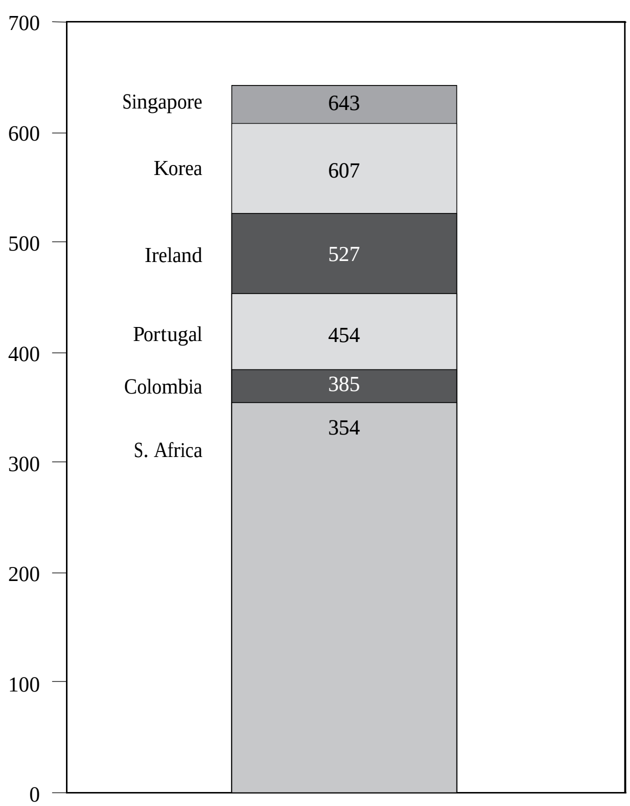
The problem of access to basic schooling has been solved for most children in Latin America. Now, there is a growing consensus that it is the quality of education that must be improved, especially in the public schools and especially for poor children (Summit of the Americas II 1998). Low quality is reflected in high rates of repetition and dropout, and low performance on standardized tests of scholastic achievement. Colombia, in an international test of science and mathematics, scored well below East Asian countries and only slightly above African countries (see Figure 4.2).

In addition, the evidence coming from a United Nations Educational, Scientific and Cultural Organization (UNESCO) test of educational achievement administered in 11 Latin American and Caribbean (LAC) countries shows that, excluding Cuba, the performance of most countries in LAC does not differ greatly, suggesting that most LAC countries would fare as poorly on international achievement tests as Colombia (see Figure 4.3). The low quality of basic education constrains the quality of higher levels of education and puts LAC at risk in its capacity to compete economically with the rest of the world. In addition, while children from all income groups now have access to basic schooling, there remain large inequalities in educational opportunity as measured by quality of schooling. Compared with children from economically advantaged homes, children from poor households are likely to receive lower schooling investments from both the home and the school.

While the rationale for decentralization is at least as much political as it is educational, the proponents of decentralization expect one impact to be improved quality. Other possible impacts are changes in efficiency and equity. Because of the importance of raising quality and the limited information available on efficiency and equity, this paper focuses on the impact of decentralization on educational quality in LAC.

FIGURE 4.2

Average Math Achievement Test Scores of Eighth Graders, Selected International Comparators



*Source:*IEA, 1996

Typology

Decentralization takes many forms. It varies by the level of government to which decisions are devolved, the kinds of decisions moved to other levels of government, and the orientation of the decentralization—whether it emphasizes governance or pedagogic changes.

Level of Decentralization

The level to which educational decisions are decentralized ranges from regional and local government to the community and the school. In many federal countries—Brazil, Canada, Germany, India—the states or provinces that make up the federation have had a constitutional responsibility for education. In other countries—Argentina, Mexico, Venezuela—education responsibilities have historically been located in the central government, but have been largely devolved to states or provinces over the past decade.

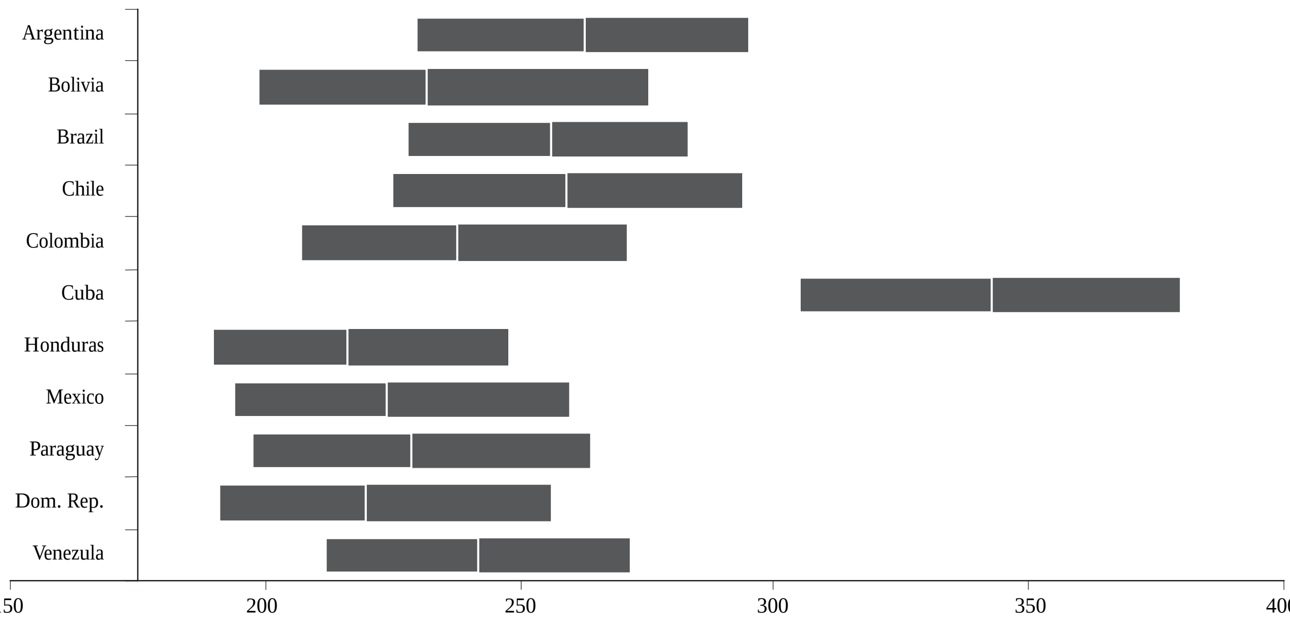
Local governments quite often have educational responsibilities, especially for primary and secondary schooling. In the United States, most state governments have devolved educational management to single-purpose local governments, or school districts. In other countries—Brazil, Chile, Colombia—municipalities have been given increased educational responsibilities over the past decade.

Finally, some countries have given school councils and schools significant autonomy in managing (but rarely financing) education. The Netherlands is perhaps the best

FIGURE 4.3

Third-Grade Language Achievement, Latin American Countries

(Median 25%, 75%)



*Source:*UNESCO data in PREAL/CIDE 1999

example of a country that has empowered parents to create their own schools with financing and other support from the central government. Recently, in cities like Chicago and Memphis in the United States, it is the school district that has given the school significant management autonomy.

Decisionmaking Powers

Some educational functions are decentralized, even within centralized systems, and others are centralized, even within decentralized systems. An Organization for Economic Cooperation and Development (OECD) survey of its members, for example, shows that schools make most of the decisions about the organization of instruction, even in centralized systems. These decisions include choice of teaching methods, textbooks, criteria for grouping students within schools, and day-to-day methods of student assessment. On the other hand, in most European countries, most personnel management decisions are made at a central level.

The OECD methodology for measuring the degree of education decentralization divides educational functions into four groups: the organization of instruction, personnel management, planning and structures, and resources. For the purposes of this paper, we adapted these definitions to be consistent with Latin American experience and available information. The content of each group is given in Table 4.1.

Structure and Content

Just as the composition of educational functions that are decentralized varies across countries, so too does the goal and orientation of the decentralization reforms. In some reforms, local control is the goal, either for political reasons or to strengthen accountability by the schools to their clients. The focus of these reforms is on structure, that is, transferring decisionmaking powers and responsibilities to lower levels of government or to school councils. Implicit in these reforms is the expectation that local control and accountability will improve efficiency, both in the uses of resources and in the match between client demand and the supply of school services.

In other reforms, the goal is improved learning, and the transfer of decisionmaking powers is simply a vehicle for attaining that goal. These reforms put more emphasis on the content of education reform than on the structure itself. Parental participation is valued by these reforms because it

TABLE 4.1
Types of Decisions that may be Decentralized

Organization of Instruction	School attended by student. Instruction time. Choice of textbooks. Curriculum content. Teaching methods.
Personnel Management	Hire and fire school director. Recruit and hire teachers. Set or augment teacher pay scale. Assign teaching responsibilities. Determine provision of in-service training.
Planning and Structures	Create or close a school. Selection of programs offered in a school. Definition of course content. Set examinations to monitor school performance.
Resources	Develop school improvement plan. Allocate personnel budget. Allocate non-personnel budget. Allocate resources for in-service teacher training.

is viewed as contributing to the success of education, and not because it improves accountability. Matching client demand with what the schools offer is important only to the extent that client demand is consistent with raising quality.

Although it is tempting to contrast structural reforms with reforms that emphasize content, this typology is in fact a continuum with most decentralization reforms encompassing elements of each.

Typology Applied to Recent Latin American Experience

Education decentralization has taken many forms in Latin America and the rest of the world. It always includes the transfer of authority and responsibility from higher to lower levels of government, but it varies considerably in terms of which decisionmaking powers are decentralized and who receives those new powers. Figure 4.4 illustrates the variation in the location of important educational decisions in Latin American and OECD countries. In addition, since education decentralization is often part of a broader education reform effort, there is considerable variation in practice in terms of accompanying school improvement measures.

In the discussion that follows, the typology will be applied to the experiences of Argentina, Brazil (with a focus on the state of Minas Gerais), Chile, El Salvador, Mexico, and Nicaragua.

Level of Decentralization

The level of education decentralization varies widely within Latin America. In Argentina, primary and secondary education and the normal schools were transferred from the central government to the provincial governments (in 1976 and 1991, respectively), and today most decisionmaking authority remains concentrated in the provincial education ministries. In this respect—the concentration of decisionmaking authority at the regional level—Argentina presents a unique model in Latin America, although Mexico appears to be quickly evolving in a similar fashion (see Annex Table 4.A.1).

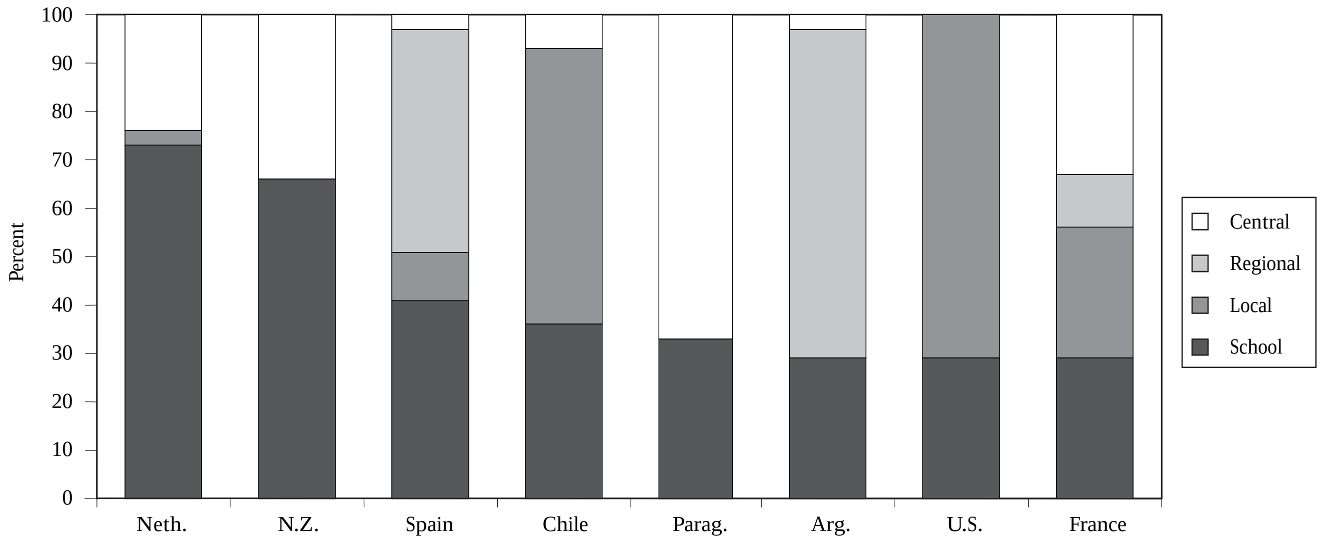
Brazil has a long tradition of decentralized education, with most authority concentrated at the state government level. The state's preeminent role in secondary education was confirmed by the 1988 constitution, and municipalities were given the preeminent role in financing and delivering preschool and primary education. In addition, during the 1990s, some states (for example, Minas Gerais) have transferred significant decisionmaking authority to the level of the school.

Chile's education decentralization effort is long and complicated. It began in 1981 with the transfer of decisionmaking authority to the municipalities, on the one hand, and to nonprofit schools, on the other. It continued in the 1990s with the central government's exercising stronger pedagogic leadership and working directly with the schools to bring about school-level improvements.

El Salvador's decentralization effort was not universal but, instead, targeted rural areas where central government schools failed to function during the civil war. Hence, while for traditional public schools, educational decisionmaking remained concentrated at the level of the central government, the new rural Educación con la participación de la Comunidad (Education with the Participation of the Community [EDUCO]) schools were given significant decisionmaking authority and autonomy. The success in implementing the EDUCO model has led to current efforts to decentralize traditional schools as well.

Mexico's education decentralization is a combination of the Argentinian and El Salvadorian models. The 1993 Ley General de la Educación transferred most educational decisionmaking authority for primary and secondary schools to the state governments, but the central government's important role in financing education through negotiated transfers to the states resulted in continued de facto

FIGURE 4.4
Level of Decisionmaking in Education Sector



*Source:*OECD 1998.

centralization. Real decentralization to the states occurred only in 1998 when educational transfers became automatic. In addition, the central government continues to directly operate a system of rural (National Board for Educational Improvement [Consejo Nacionalde Fomento Educativo—CONAFE]) schools to ensure learning opportunities for remote rural, and especially indigenous, children. While not nearly as autonomous as El Salvador's EDUCO schools, the CONAFE schools give parents a considerably more important role than is found in the traditional public schools.

Finally, Nicaragua's education decentralization has evolved from an emphasis in the early 1990s on muncipalization to a clear policy in the late 1990s to transfer most important educational management and finance decisions to the level of the school.

Several other countries in the region not included in Figure 4.4 have also adopted education decentralization policies during the 1990s. Colombia decentralized primary and secondary education to departments (regional governments) and municipalities, and Bolivia is slowly implementing a similar policy. Guatemala and Honduras have followed the model of El Salvador's EDUCO schools with their own programs of autonomous rural schools. In the Region, only Costa Rica, Ecuador, Panama, and Uruguay have chosen to retain centralized educational systems.

Decisionmaking Powers

What does it mean that education has been decentralized to a particular level? As noted earlier for OECD countries, several educational decisions, such as choosing textbooks, selecting teaching methods, and taking responsibility for implementing school improvement plans, tend to be located at the school level irrespective of the level of decentralization. Others, such as setting the core curriculum or administering and reporting results on achievement examinations, tend to be located at the national level irrespective of the level of decentralization. Table 4.2 illustrates the focus of key educational decisions in several countries in Latin America.

Decentralization is mainly characterized by the locus of decisions on personnel and budgets. The greatest consistency is found in teacher and school director recruitment and hiring decisions and the budgeting of non-personnel expenditures. In Argentina and Mexico these decisions are located at the regional (provincial) level, in Chile at the local (municipal) level, and in El Salvador and Nicaragua at the school level. Teacher pay decisions are sometimes retained at higher levels of government (as in Minas Gerais, El Salvador, and Mexico), and in most cases are heavily influenced by national policy setting minimum pay conditions (for example, Chile) or national decisions about education finance (for example, Minas Gerais).

Of course, simple descriptions of decentralization fail to capture important nuances. A case in point is the school improvement plan. Almost every country in LAC now requires that schools or local jurisdictions develop improvement plans, but as a recent assessment of the Chilean experience illustrates, such plans are often carried out as a bureaucratic exercise and fail to meet minimum standards of quality and community participation. When schools do develop plans, they often lack the authority to implement them, as in Colombia. And even when they have the authority to implement, they may have no source of financing.

Another case in point is the allocation of the personnel budget. The multiple constraints of national or regional pay scales; collective bargaining agreements on working conditions, including class size; and national curriculum requirements may translate into little real discretion at the decentralized level.

Structure and Content

Have decentralization reforms in LAC been mainly structural in nature—focused on increasing local control and raising accountability—or have they been more concerned with content and viewed as a vehicle to raise quality? The answer, of course, is not simple.

The education decentralization experiences of Argentina, Chile in the 1980s, El Salvador, and Mexico can be viewed as mainly structural in nature, but for very different reasons. In Argentina, primary and secondary education were devolved to provincial governments for mainly fiscal reasons. Hence, the goal of the reform was simply to move expenditure responsibilities to the provincial governments. There was little concern as to whether this would lower or raise quality.

In Chile, the Pinochet government simultaneously introduced a modified voucher scheme and municipalized public education to increase competition among schools for students, and thereby raise the accountability of schools to parents. In El Salvador, the EDUCO model has put the emphasis on the creation of school councils to receive and manage government funds for the purpose of providing schooling. While the main objective of EDUCO has been educational—to improve access in rural areas—its focus has not been on interventions to alter the content and raise the quality of schooling. In Mexico, education decentralization has been an integral part of a broader decentralization of powers to state governments in keeping with the political liberalization of the country. Finally, Nicaragua's policy of school autonomy as the principle focus has been giving voice to parents and civil society on educational issues and,

TABLE 4.2

The Locus of Key Educational Decisions and Responsibilities, Selected Latin American Countries

GROUP	DECISIONS	ARG	MIN GER	CHILE	EL SAL	MEX	NIC
	Level of decentralization	R	S	L	S	R	S
ORGANIZATION	Choice of textbooks	S	S	S	S	N	S
	Teaching methods	S	S	S	S	S	S
PERSONNEL	Hire-fire school director	R	S	L	S	R	S
	Recruit/hire teachers	R	R	L	S	R	S
	Set or augment teacher pay	R	R	L	N	N	S
PLANNING	Set performance exams	N	R	N	N	N	N
	Implement school improvement plan		S	S	S		S
RESOURCES	Determine expenditures	R	R	N, L	N	R	N, S
	Allocate personnel budget	R	R	L	N	R	S
	Allocate non-personnel budget	R	S	L	S	R	S

N = national, R = regional, L = local, S = school.

in this way, increasing operational efficiency (Arcias and Belli 1998).

In contrast to the cases described above, Minas Gerais and Chile (since 1990) have focused on changing the content of education and raising its quality through decentralization. Minas Gerais granted a significant degree of autonomy to the public schools financed by the state government to define their goals, develop a school pedagogical project, and manage financial resources with the overall goal of improving education. Chile has attempted to balance the structural reforms of the 1980s with content reforms in the 1990s to raise educational quality, especially for the poor. While the recent reforms have been top-down in their design and the goals they pursue, they have attempted to deepen the decentralization process and move pedagogic decisionmaking to the level of the school. For example, beginning in 1992, teachers have been encouraged to work together to develop school improvement projects, which the education ministry funds on a competitive basis. The Teachers' Statute was revised (in 1995) to allow school directors to directly manage funds and to provide school-based financial incentives for performance. Further, beginning in 1997, a competition to fund the best education improvement projects proposed by secondary schools both provides financial incentives for performance and gives school directors full management responsibility for implementing the projects.

Evaluation Decentralization

While the reasons for educational decentralization in Latin America are often political or fiscal in nature, from an educational perspective there is the expectation that decentralization will improve schooling outcomes. Schooling outcomes can be defined in a variety of ways, but at a minimum involve measures of the level and distribution of learning and years of schooling attained by schoolchildren.

For three reasons it is difficult to use these measures to evaluate educational decentralization. First, time series of these measures are seldom available. Second, these school outcomes usually change slowly in response to any kind of educational intervention, including decentralization. Third, it is very difficult to control for external shocks—ranging from natural disasters and fiscal crises to teacher strikes and changes in national education leadership—which may also influence school outcomes.

Given the difficulty of isolating the effects of decentralization on learning and educational attainment, our approach is to look at how decentralization changes factors known to be related to learning. First, we ask what is the received wisdom on what characteristics define effective or high-performing schools. Second, we ask how these characteristics are reflected in the school environment. Third, we ask how decentralization directly or indirectly affects any of these factors.

High-Performing Schools

There is a growing qualitative and quantitative research literature on the characteristics of high-performing or effective schools (Mohrman and Wohlstetter 1994; Creemers 1994; Darling-Hammond 1997) that mirrors the much larger literature on successful organizations (Barzelay 1992; Lawler 1992). This literature concludes that high-performing schools are characterized by strong leadership, highly qualified and committed staff, a focus on learning, and responsibility for results. Another set of literature reviews the evidence for the process by which schools improve, and yields conclusions that are consistent with the effective schools' research. For example, in an evaluation of school improvements on three continents, Dalin (with others 1994) concludes that essential ingredients in successful reforms are a sustained commitment to quality improvement, local empowerment to adapt programs to local conditions, strong emphasis on school and classroom practice, and strong support linkage between education authorities and the school "via information, assistance, pressure and rewards" (see Annex Box 4.A.1). In the discussion that follows, we group the variables associated with high-performing schools into the four characteristics used in the research: leadership, excellent teachers, focus on learning, and responsibility for results.

Characteristics of Effective Schools

Strong leaders have the capacity to effectively develop and communicate a schoolwide and communitywide commitment to a common mission and vision for the school, and to manage the implementation of the school's improvement plan. The common mission and vision fosters teamwork inside and outside the school and, most importantly, the process of developing them makes teachers and parents the "owners" of efforts to improve learning. Leadership is espe-

TABLE 4.3

Characteristics that can be Stimulated Through Decentralization

CHARACTERISTICS OF EFFECTIVE SCHOOLS	DECENTRALIZATION VARIABLES THAT CAN CONTRIBUTE TO SPECIFIC CHARACTERISTICS OF EFFECTIVE SCHOOLS
LEADERSHIP	School directors are selected by the community using transparent criteria. School improvement plans are developed locally. Resources are transferred to schools for the implementation of school plans.
SKILLED AND COMMITTED TEACHERS	Schools are given the authority to make curriculum and pedagogic changes Teachers have significant responsibility for developing school improvement plans. Directors are given the authority to provide a substantive evaluation of teachers' performance. Schools are given the authority (and resources) to make their own decisions about the type of training to be given teachers.
FOCUS ON LEARNING RESULTS	The school improvement plan emphasizes goals of improving learning (and associated results, such as reducing dropout and repetition). Information on learning at the level of the school is transparent.
RESPONSIBILITY FOR RESULTS	Directors have fixed-term appointments that may not be renewed if improved learning goals are not met.

cially important in a service industry like education, where the contribution of individual teachers is difficult to measure, and thus difficult to directly reward. In the absence of strong individual incentives, leaders must motivate teachers to improve. These characteristics can be stimulated through decentralization. Table 4.3 summarizes our findings.

Decentralization cannot, of course, convert school directors who are used to passively following ministerial orders into dynamic leaders overnight, but it can and often does provide a transparent, competitive selection process for school directors, which selects in part for leaders. A good example of this is the Minas Gerais decentralization which (a) established a procedure for certifying qualified candidates to compete for school director positions, (b) required candidates to present their proposals for school improvements as part of the competition, and (c) empowered school councils to make the final selection of the school director.

Excellent teachers commit to the high goals and standards of the school, have the strong teaching skills required to meet those goals, continually work to improve teaching and student learning, and do their work in a supportive work environment. Teacher commitment is essential to developing the teamwork required for schools to continually diagnose their own problems and devise their own solutions. Teamwork is also essential to permit the sharing of teaching experience required to continually improve teaching practices. Effective evaluations of teaching performance are critical to giving teachers information on what and how they need to improve. The time required to participate in the management of the school and the improvement of teaching is unlikely to materialize in a work environment where teachers are not given time for these activities within their normal work schedule. In many LAC countries, where double and triple shifts are common, it may be logistically challenging to find the space and time for teacher participation.

Decentralization can contribute to excellent teaching in a variety of ways. When decisions on significant pedagogic matters are transferred to schools, teachers are empowered and motivated to work collectively to improve the services delivered to students. When school directors are given the authority to carry out meaningful evaluations of teaching staff, teachers can focus their training on what they need to improve. When resources for training and training decisions are given to the school, teachers and directors can purchase the training they need (demand-driven) rather than the supply-driven training provided by the education ministry.

Excellent teaching focuses on student learning. A school system that is focused on learning provides a pedagogy, a curriculum, and resources appropriate to student needs. In most cases, it is the local school and its teachers who are best placed to diagnose and find pedagogic solutions to individual student and collective school learning problems. Different kinds of students—rural, indigenous, poor, urban youth, and so forth—are also likely to have different learning needs, with implications for the distribution of financial resources to schools by higher levels of government. Rural children may require smaller class sizes, reasonable commuting distances, or bus transportation. Indigenous children may require more costly bilingual instruction. Poor children may require school lunches and subsidized textbooks.

Decentralization can facilitate and reinforce a focus on student learning by providing the information required to assess learning problems, devolving appropriate pedagogic decisionmaking to the school, and allocating additional resources to schools with special needs. The visible product of this process is a solid school improvement plan, constructed with the active participation of teachers and the community, and with real possibilities of being implemented. Good information on student learning and on the value added by the school is essential to the diagnosis of learning problems that is a fundamental part of the school improvement plan. Good information is also essential to monitoring progress toward attaining learning goals. The devolution of appropriate pedagogic decisions is critical to the local design of solutions to local learning problems. Finally, financing is important, both as a means of implementing school improvement plans and making possible the adoption of pedagogy that meets special needs. In particular, in the absence of additional resources, children from educationally disadvantaged homes are unlikely to meet the educational goals required for them to escape their parents' poverty.

Establishing responsibility for results provides the incentives necessary for sustained educational improvement. A school system with responsibility for results requires a set of measurable learning goals, up-to-date information on school performance toward meeting those goals, rewards for meeting goals and sanctions for not meeting them, and active monitoring of progress. The participant held accountable is typically the school director or the staff of the school. The one holding the school accountable may be the education ministry, a school council, or both. In Latin America, the failure by ministries to hold schools accountable is often cited as the rationale for the creation of elected school councils, which have local knowledge of the school but often lack sophistication in systematically evaluating performance.

There can be no accountability at the local or school level in the absence of devolution of authority to make pedagogic and resource allocation decisions at the local level. Decentralization can contribute to accountability at the local level by (a) devolving decisionmaking; (b) establishing performance contracts between schools and financing bodies (including central government ministries and parent-led elected school councils) that specify learning goals; (c) inventing information systems, including standardized tests of students' knowledge, to permit contract enforcement; and (d) creating performance-related rewards and sanctions, including the dismissal of school directors. For example, the decentralization reform in the Chicago, Illinois, school system replaced tenure for school directors with four-year contracts and required each director to sign an annual performance contract with the system specifying measurable goals for the year. Schools that consistently fail to meet goals may see their director dismissed and teaching staff reassigned (see Annex Table 4.A.2).

The Consequences of School Decentralization

In this section, we attempt to evaluate each of the education decentralization cases discussed in this paper in terms of its potential to raise learning, especially among children from poor households. In some cases, such as Argentina, decentralization was just one component of a larger education reform. In other cases, such as Chile, education reform and changes in decentralized responsibilities have evolved over more than a decade. Given the complexities of evaluating reforms, we do not attempt to separate out the "decentralization" component for evaluation, nor do we try to evaluate the initial reform. Rather, we try to make an assessment of the reform as it looks today.

The criteria for this evaluation are the characteristics of decentralization that the research literature and professional opinion attribute to high-performing schools (mentioned in the section on "High-Performing Schools," above). Below we give a summary assessment for each country reviewed in this paper (Table 4.4); more complete information on each country's education decentralization is given in Annex Tables 4.A.1 through 4.A.8.

Leadership

The decentralization experiences reviewed here vary greatly in terms of the extent to which they have created the conditions that may give rise to strong local leadership. Neither Argentina nor Mexico have given school directors any significant authority and responsibility. Chile has recently granted more authority to directors of municipal schools, and, of course, the directors of the private, subsidized schools have long had a high degree of authority. The EDUCO schools of El Salvador are mostly small and often without school directors, and school autonomy is only slowly being granted to the traditional public schools. Minas Gerais and Nicaragua are the two examples where school directors have significant authority, and in Minas Gerais, in particular, the open selection process implicitly values the leadership qualities of candidates.

TABLE 4.4
Assessment of Education Decentralization

CHARACTERISTICS OF EFFECTIVE SCHOOLS	DECENTRALIZATION VARIABLES RELATED TO EFFECTIVE SCHOOLS	ARG	MIN GER	CHILE	EL SAL	MEX	NIC
LEADERSHIP	Community selects director		√		n.a.		√
	School improvement plans		√	√	√		
	Transfer funds to school		√	√	√		√
SKILLED AND COMMITTED TEACHERS	School curriculum authority	√	√	√			
	Teachers develop improvement plans		√	√	√		
	Directors evaluate teachers		√	√	n.a.	√	√
	Schools decide training		√	√	√		
FOCUS ON LEARNING	Learning goals specified		√				
	Transparent information	√	√	√	√		
RESPONSIBILITY FOR RESULTS	Fixed-term appointments for directors		√		n.a.		√
	Competition for students			√	n.a.		√
	Parents have effective voice		√		√		√

n.a. = not available

Teaching Excellence

Strengthening the teaching capacity of teachers has been a high educational priority for most countries in Latin America in recent years. Argentina has embarked on a major upgrading of its normal schools. Minas Gerais has emphasized the use of distance education to upgrade teacher skills. Chile has provided competitive grants to universities to improve their teacher training programs and has sent large numbers of teachers abroad to strengthen their teaching skills. Mexico has introduced a program, the Carrera Magisterial, to strengthen teacher evaluation and performance incentives.

However, few of the region's efforts to upgrade teaching capacity have been accompanied by in-depth evaluation of teachers, additional compensated time to participate in school activities and prepare lessons, and incentives for teachers to work and learn in teams. Among the countries reviewed here, Chile has the policies best aligned with changing teacher behavior and training. Teamwork among a school's teachers in Chile is encouraged through (a) competitive funding of teacher-designed and implemented school improvement plans, (b) bonuses (equal on average to one month's salary) to the 25 percent highest-performing schools as assessed using school performance indexes, and (c) provision of staff time to participate in professional development groups, with financial support from the education ministry.

Focus on Learning

The emphasis on improving quality and raising student achievement is clear in the Argentine education reform, the Minas Gerais decentralization reform, the evolving Chilean reform of the 1990s, and some of the policies and programs carried out in Mexico. It is less clear in El Salvador, where the emphasis has been more on raising access; and in Nicaragua, where the focus has been more on parental participation than on scholastic achievement. However, even in those countries where national education reforms and policies are focused on student learning, the conditions are not always present for effectively creating a school-based focus on learning.

Argentina has adopted an ambitious reform to train teachers, supply sophisticated feedback on individual student performance (at the secondary level), and provide additional financing for children with special needs. However, schools, teachers, and local communities have almost no authority to diagnose their own needs and design their own interventions. Minas Gerais, in contrast, encourages schools to diagnose, monitor, and evaluate; and expects schools to produce improvement plans. The state government provides funding for these plans and provides feedback on student achievement. However, the focus of all this effort is not necessarily specific learning goals, and teachers and community members are not always active participants in the process.

As in Argentina, the Mexican educational reform has been guided and driven at the national level. While decentralization efforts have not been focused on improving learning, other components of the reform—including changes in teacher evaluation and pay, and additional resources for poor and indigenous rural children—are focused on learning. However, excluding the CONAFE schools, teachers and parents are not yet actively engaged in bringing about learning improvements at the level of the school (Gershberg 1998a).

Chilean reform efforts since 1990 have been focused on student learning, especially for poor children. Teachers have been actively involved in diagnosing their own needs and developing their own school improvement projects. The Catholic University (1998) evaluated the school improvement projects carried out during 1992–95 and concluded that the largest change was increased innovation in teaching practices, especially increased use of interactive learning processes, and increased teamwork among teachers. The evaluation also found that, on average, schools that implemented improvement projects experienced increased student achievement. However, only 60 percent of all schools experienced achievement gains, reflecting the fact that not all improvement projects were focused on improving learning, and some projects attempted to simultaneously accomplish too many objectives.

In addition to funding school improvement projects, the Chilean education ministry has provided additional funding for special needs, such as with the P–900 program, which provided extra resources for the 900 poorest schools in the country. Average student test scores are annually published for each school in the country, and the schools making the most progress over time are eligible for financial rewards. While the education ministry could improve the monitoring and evaluation of specific learning standards, Chile has most of the conditions in place to bring about significant learning improvements.

Responsibility

It is in the realm of responsibility for results that Latin American decentralization reforms are found to be most wanting. In Argentina, Chile, and Mexico at least one critical element is missing for there to be real accountability. In Argentina, performance goals are not specified, systems to systematically evaluate performance are still under development, and no one is at risk of losing their job or suffering lower pay due to the low performance of the school in which they work. Performance goals are not specific in Chile either, and there are few risks to schools that do poorly. The same is true for Mexico. Furthermore, in all three countries school councils are largely nonexistent, so schools are accountable to neither parents nor higher levels of government.

In contrast, school councils are active in Minas Gerais, El Salvador, and Nicaragua; school staff can lose their jobs for poor performance in El Salvador and Nicaragua; and school directors are at risk of losing their jobs in all three countries. On the other hand, learning goals are rarely specified with any precision, and the systems for monitoring and measuring school performance with respect to specific goals need considerable strengthening.

Empirical Findings

While rigorous evaluations of education decentralization are difficult to find, a few do exist. We review the findings to date of evaluations carried out in El Salvador and Nicaragua with the assistance of the World Bank, and we complement these findings with evaluations of decentralization in Brazil and Chile, and in two large U.S. cities, Chicago, Illinois, and Memphis, Tennessee.

The evaluation of El Salvador's EDUCO program by Jimenez and Sawada (1998) compares teacher absenteeism and student achievement in EDUCO schools with that of traditional schools, controlling for student characteristics and selection bias (since the EDUCO schools were not randomly selected). Two results merit attention. EDUCO schools, with their close community monitoring of the school and the potential sanction that teachers would not be rehired, had fewer days of teacher absenteeism than traditional schools, but student achievement in EDUCO schools was no different from that of traditional schools. These findings on student achievement complement an earlier evaluation that compared mean differences in variables between EDUCO and traditional schools (Ministry of Education 1997). Surprisingly, that study found no difference between EDUCO and traditional schools in terms of the number of decisions made at the level of the school, which suggests that the EDUCO model may not be fully implemented. On the other hand, EDUCO parents are three times more likely to engage in day-to-day classroom activities than parents in traditional schools, teachers in EDUCO schools spend considerably more time meeting with parents, and EDUCO teachers are much more likely to visit the family to inquire why a student has been absent from school.

In contrast to the El Salvador findings, an evaluation by King and Özler (1998) of Nicaragua's autonomous schools found that autonomous schools make significantly more schooling decisions than do traditional schools, especially on personnel matters and in determining the school plan and budget. However, even the autonomous schools seldom make teacher-training decisions. Another key finding of the evaluation is that the degree of decisionmaking actually exercised by autonomous schools varies greatly, and there is a positive and statistically significant relationship between the degree of decisionmaking exercised and student achievement. Furthermore, the strongest positive relationship to learning was found for variables measuring decisionmaking on teacher staffing and monitoring of teacher activities. Nicaragua also illustrates the potential role of the central government within the context of decentralization: A recent qualitative assessment of Nicaragua's school autonomy discovered that educators strongly welcome the active intervention of the central government in promoting a pedagogy of active learning (Fuller and Rivarola 1998).

The Minas Gerais reform has not been systematically evaluated, but the results of the Brazilian national education test put Minas Gerais at or near the top of student achievement in every grade and subject matter (Instituto Nacional de Estudos e Pesquisas Educacionais [INEP 1998]) The reforms undertaken by the state of Minas Gerais in Brazil have been replicated in part by several other states. In particular, several states have now adopted (a) the establishment of school councils, (b) the direct transfer of resources to schools, and (c) the local election of school directors. Using state-level, pooled time-series, cross-sectional data, Paes de Barros and Silva Pinto de Mendoça (1998) have analyzed the relationship between these reforms and a number of schooling outcomes: gross enrollment rates, repetition rates, age-grade lags, and student achievement as measured by the Brazilian national educational test. They found statistically significant but mixed results. The establishment of school councils and the direct transfer of resources are associated with increased attendance and reduced age-grade lags, but have no statistically significant relationship to student achievement. The local election of the school director, on the other hand, is positively associated with student achievement gains, but not with the other measures of schooling outcomes.

As noted earlier, Chile has passed through two reform phases. The first, begun in 1981, emphasized changing the structure or organization of education through municipalization and the introduction of competition and choice. A simple comparison of student achievement scores across the 1980s shows a decline in learning, but during this period real per-student education expenditures also declined, making it difficult to isolate the reform effect. However, a 1998 study by McEwan and Carnoy assembled school-level panel data to examine how the degree of competition and choice across municipalities and over time affects public school quality, as measured by changes in student achievement test scores. They conclude that this aspect of Chilean education reform has had no effect on public school quality. This finding confirms the qualitative evaluations made by other scholars that municipalization did not lead to any substantive changes in behavior and achievement in the public schools (Espinola 1997).

The second phase of the Chilean reform began in 1990 and, as noted earlier, simultaneously deepened decentralization and set clear goals of raising quality and equity. In contrast to the 1980s, student achievement on Chile's standardized exam, Sistema de Medicion de la Calidad de la Ensenanza (SIMCE), increased significantly, both in language and mathematics (Cox and Lemaitre 1998). Nationally, the number of correct answers increased by about 18 percent. However, here, too, it is difficult to separate the effects of decentralization reforms, such as introduction of school improvement projects, from other reforms (for example, in teacher training), and from significantly increased spending over the decade.

The findings for El Salvador, Nicaragua, and Chile are complemented by two careful evaluations carried out in two large U.S. cities having large populations of poor and minority students—Chicago and Memphis. As discussed in Box 4.1, Chicago introduced largely structural reforms in 1990 and followed up with a much stronger content-based reform in 1995. A consortium of academic institutions led by the University of Chicago has carefully monitored and evaluated the Chicago reform from day one. The most recent evaluation report concludes that year-to-year gains in student learning have risen significantly (for example, a 19 percent gain in achievement for fifth graders between 1992 and 1996) since the beginning of the reform, despite the fact that the socioeconomic level of students has been gradually decreasing (Bryk and others 1998). Earlier evaluations demonstrated, also, that school reform efforts resulting from autonomy are as likely to be initiated in poor as in rich neighborhoods.

In contrast to Chicago, the Memphis reform has been heavily content-based from the beginning (see Box 4.2). The evaluation of the Memphis school reform confirmed the Chicago results of sustained improvements over time. Prior to implementation of the reform, the experimental schools (those subsequently undertaking school-based reforms) had smaller student gains in learning than a group of control schools. After one year of implementation, the gains of the experimental and control schools were the same, and after two years of implementation, student achievement gains in the experimental schools were significantly higher than in the control schools (Ross and others 1998). Finally, an evaluation of the Memphis decentralization confirmed that school director leadership and teacher support for reforms were critical to its implementation.

Taken together, the El Salvador, Nicaragua, Chile, Chicago, and Memphis evaluations provide strong evidence that educational decentralization can improve learning. What is notable is that those cases demonstrating the largest positive gains have emphasized school autonomy with pedagogic reform, especially true in Chicago since 1995, in Memphis, and in Chile since 1990.

Conclusion

Education decentralization is a worldwide phenomenon, and Latin America is no exception. Although there are economic and education arguments for decentralization, the particular forms of decentralization in most Latin American countries have been driven mostly by politics. Given the magnitude of education decentralization efforts in the region over the past decade and the forms they have taken, it is time to assess their effects.

The evaluation of decentralization reforms is difficult due to lack of baseline data, incomplete implementation of many reform elements, lags between implementation, and changes in such factors as behavior and resource allocation,

BOX 4.1

Chicago: An Initial Emphasis on Governance

Chicago has adopted two education reforms. The first, initiated in 1988, focused on governance, while the second, effective beginning in 1995, decentralized some powers and put the focus on improving learning. The 1988 reform created elected, parent-led school councils with the power to hire and fire the school director. The council works with the director to prepare and monitor a school development plan. Tenure for directors was replaced by four-year contracts. Directors were given increased powers to hire teachers, increased discretion in allocating the budget, and increased control over curriculum decisions.

By 1995 there was the widespread perception that educational improvements initiated in 1988 were not occurring rapidly enough in Chicago. As a result, the mayor took control and named a central district school board and a corporate-style management team. The board was given the right to impose sanctions on poorly performing schools, including disbanding the school council, and evaluating and dismissing principals (in conjunction with the councils). One of its first actions was to put 109 of the 557 public schools in Chicago on probation because of poor academic performance. The 1995 reform also established a central body responsible for the review and evaluation of the performance of each school, with recommendations for actions to improve performance. Finally, it increased the budgetary autonomy of each school, including giving each director the freedom to outsource a wide variety of school services.

BOX 4.2

Memphis: Decentralization Focused on Improving Learning

The schools of Memphis, Tennessee, serve a largely poor and educationally disadvantaged population. Frustrated with the persistently poor academic performance by students, in 1995 the city decided to grant limited autonomy to individual schools with the objective of stimulating school-level educational reforms. Each school formed an advisory school council consisting of the director, teachers, parents, and community members. The principal functions of each council were technical—diagnosing needs, agreeing on reforms, and monitoring progress in student learning. But although the council was legally advisory in nature, its opinions were taken seriously.

Each school in the Memphis district was required to adopt a school-based reform from a menu of eight different school-restructuring models. While the pedagogic orientation of the models differ, they share several characteristics: increased school autonomy (especially, on pedagogic matters); a common vision of school goals reflected in the school development plan; performance contracts with specific, quantifiable targets between the school director and the central administration; extensive teacher development activities at the school level; teamwork within the school; and constant monitoring of progress, including the use of standardized examinations.

The central Memphis education office continued to play a strong role in setting high standards (for example, today all students in grades 3 through 8 must pass set exams in mathematics and science in order to be promoted. The education office was also committed to (a) mandating minimum standards and core curriculums; (b) facilitating teacher development by offering a broad menu of training options and opportunities; (c) providing additional financing to cover the costs of implementing school development plans (with larger amounts for schools serving the poor); and (d) establishing monitoring and evaluation systems to provide constant feedback to individual schools on their performance.

which affect learning. The difficulty in evaluating reforms argues for caution in interpreting results. The lack of much rigorous evaluation of Latin American experiences has led us to rely to some extent on well-supported evaluations of decentralization efforts outside the region for our overall conclusions.

The fact that few evaluations exist of the impact of decentralization on learning outcomes has also led us to an alternative approach to infer impacts by looking at the extent to which characteristics of decentralization reforms are consistent with the characteristics associated with high-performing schools. The fact that two well-evaluated and successful U.S. school reforms—in Chicago and Memphis—have shared the decentralization characteristics that professional educators associate with public schools lends credence to this approach. Interestingly, many of the recommendations made by educators for creating effective schools are consistent with the prescriptions economists might make.

Designing decentralization reforms to improve learning is complicated by the nature of education. For example, it is difficult for anyone outside the school to monitor the school's performance and hold the school accountable. After all, the outputs of the school are several, and almost all are difficult to measure. Experience has shown it is especially difficult to measure the value-added of the school in producing scholastic achievement (Ladd 1996). Other characteristics impede reform. Teachers often work in isolation and may shirk their responsibilities, with little risk of negative consequences. Finally, strong labor unions and regulatory protection (often embodied in teacher statutes in Latin America) make it difficult to penalize poor-performing teachers even when they can be identified.

To economists, these agency problems argue for a number of solutions. First, intense efforts should be made to provide good information on the performance of schools and teachers, taking into account the complexity of the educational production process. This may require establishing an independent agency to carry out external audits of schools that go beyond merely identifying outputs, but also provide diagnoses of problems and propose solutions as well. Second, school directors should be given a large degree of authority, presuming they have considerably better capacity to monitor school and teacher behavior than do local political agencies, including school councils. Third, teaching should be organized in a way that minimizes shirking and provides peer rewards and sanctions for performance. This requires that teachers share experiences and work together as much as possible. Fourth, given the high risk of shirking, teachers must themselves become the proponents of efforts to improve teaching, including deciding on their own training. Externally imposed (that is, top-down) solutions to educational problems are likely to fail in the absence of an effective campaign to enlist the support of teachers.

Of the Latin American reforms reviewed here, two—those in Chile and Minas Gerais, Brazil—include a large number of the elements that arguably give rise to the characteristics of effective schools. Neither reform has yet been subjected to rigorous evaluation, although the available evidence for Chile is positive. Two other Latin American reforms—more limited in scope than Chile and Minas Gerais—have been evaluated in terms of impact, with somewhat contradictory results. El Salvador's EDUCO program has not yet demonstrated positive effects on learning, while Nicaragua's charter school program has. Nicaragua's reform granted substantial authority to school directors, which Brazilian research has found to be associated with learning gains.

In sum, there is growing evidence that at least some of the characteristics of education decentralization reforms that focus on school autonomy, as opposed to municipal or regional autonomy, contribute to higher-performing schools. Decentralization to subregional governments may also yield some educational benefits by allowing greater innovation and greater flexibility to adapt to local conditions, but they have not yet been demonstrated.

Annex

TABLE 4.A.1

Characteristics of "Decentralized" School System Argentina, Education Reforms 1976–1991

	COMMENT/SUMMARY JUDGMENT
Resource Management	All power is at level of provincial government.
Personnel Management	All power is at level of provincial government.
Governance	All power is at level of provincial government. School councils have no decisionmaking authority.
Choice	No significant choice.
Finance	Provincial government is the financial source of all regular operations of the schools. Central government is source of finance for compensatory education programs.
Pedagogy	Not enough information
Information	Test scores are publicly available at the level of the schools.
Incentives	Very weak incentives for teacher or director performance.

TABLE 4.A.2

Characteristics of "Decentralized" School System Chicago, IL, Education Reforms 1988–1999

	COMMENT/SUMMARY JUDGMENT
Resource Management	Schools must develop school improvement plans. They have gained greater control over allocation of the non-personnel budget and now receive most of federal Title I funds as discretionary revenue.
Personnel Management	School councils can hire and fire the school director, and directors have increased authority over new hires. The process for firing incompetent teachers already at schools has been streamlined somewhat. Directors can assign teaching responsibilities.
Governance	Councils have a voting majority of parents and can select the director.
Choice	Little or no traditional choice plans. Parents can select high schools but schools cannot generally have admissions requirements.
Finance	Schools cannot raise their own funds, though revenues do follow students within the system.
Pedagogy	School directors, in conjunction with the council, can influence the non-core curriculum and have some power of pedagogical approach.
Information	Public test scores and other school-level evaluation measures are readily available, though the public measures do not assess value added. The evaluation is done independently of the school; in addition, the central district has created both an inspector general to investigate financial management and an accountability council to review school performance and determine which schools are failing.
Incentives	Incentives within the system appear to be strong. Directors lost tenure and can now be fired by either the council or the central district for failing to improve outcomes. Teachers are largely still protected.

TABLE 4.A.3

Characteristics of "Decentralized" School System Chile, Education Reforms 1981

	COMMENT/SUMMARY JUDGMENT
Resource	Most resource decisions are made at municipal management level, including development of a municipal education plan. School directors have newly granted authority to manage funds. Most schools have developed school improvement plans that have been financed by the central government.
Personnel Management	Municipalities have the authority to recruit and hire teachers. Teacher pay is set at the municipal level, but it is constrained by the national minimum pay scale. At the school level teachers can define their own training needs.
Governance	No school councils. Weak parental participation in municipal schools.
Choice	High degree of choice of school for parents.
Finance	90 percent of revenues come from central government, which allocates according to a set formula. Revenues follow students.
Pedagogy	Strong central government role.

(Table continues on next page)

(Table 4.A.3 continued)

Information	Published test score data are available at the school level. Very strong financial auditing tradition but no performance audit is conducted.
Incentives	There is competition for students and competitive grants for school improvement and teacher training which requires teamwork. Salary bonuses to teachers in highest quartile of performing schools.

TABLE 4.A.4

Characteristics of "Decentralized" School System El Salvador, Community-Managed Schools (EDUCO)

	COMMENT/SUMMARY JUDGMENT
Resource Management	Community Education Associations (ACEs) devise an annual plan for the school and are responsible for administering funds according to its assessment of the educational needs of the school. They are also in charge of the maintenance and equipment of schools. The selection of textbooks falls under the responsibility of the Ministry of Education.
Personnel Management	ACEs have the authority to hire and fire teachers according to the Ministry's criteria for selecting teachers, and supervise their attendance and performance. The Ministry is in charge of teacher training and setting a pay scale.
Governance	Creation of ACEs. These are bodies of elected members drawn from the community and are usually parents of the children attending EDUCO schools. ACEs do not select the school director. In most cases the principal works closely with the councils; however, some view the ACE as a threat to their authority.
Choice	EDUCO schools are located in very remote areas and tend to be the only means of delivering educational services there. As a result, parents do not have a choice.
Finance	ACEs enter into a one-year renewable contract with the Ministry of Education, through which they receive earmarked funds on a monthly basis to cover teacher salaries and operating costs, including school materials. Another source of funds for the school is the "bonus," which is a small discretionary amount transferred to the school. Both of these funds are based on a formula that considers size of school and number of teachers. ACEs may raise additional funds by negotiating with other government agencies and international donors and by mobilizing local support.
Pedagogy	The EDUCO Coordinating Unit within the Ministry of Education is responsible for aspects of the program designed to increase classroom effectiveness, including curriculum development.
Information	The Ministry conducts audits of the ACEs when regional supervisors report the existence of serious problems.
Incentives	Teacher job security is affected by student performance. As a result, the main reasons teachers leave EDUCO and go to the Ministry's regular system are job stability and related benefits.

TABLE 4.A.5

Characteristics of "Decentralized" School System Memphis, TN, Education Reforms 1995–1999

	COMMENT/SUMMARY JUDGMENT
Resource Management	Schools must develop a school improvement plan that includes the strategy for allocating resources to support the chosen pedagogical restructuring model. This model comes complete with textbooks. Non-personnel funds were essentially decentralized to the directors through school-based management reforms that took place before the pedagogically driven reform in 1995.
Personnel Management	The school councils cannot hire and fire the principal, who in turn has relatively limited power over teaching personnel: They cannot really fire teachers, and they have some limited extra control over hiring new teachers. They have some limited power over assigning teaching responsibilities but must remain within union guidelines. Pay scales are set centrally. Professional development is design-specific depending on the pedagogical model chosen and takes place at both the school and at sites determined by the organizations that provide a particular design.
Governance	School councils are advisory in nature and have a majority of school staff. They do not select the director or any other school staff.
Choice	Parents can choose from among public schools, although this choice is limited by availability, and school neighborhood residents are given priorities. Only magnet schools can have admission requirements.
Finance	Schools cannot raise their own revenues, but funds do follow students.
Pedagogy	The entire pedagogical approach is determined by the model selected by the school. Schools must choose one of the models approved by the central school district, but the range of choices is very wide.
Information	The Tennessee Value-Added Assessment System (TVAAS) is one of the most well-respected evaluation systems nationally. It specifically provides value-added achievement results, which are available to the public on a school-by-school basis.
Incentives	Directors are evaluated heavily based on the TVAAS, and poor performers can be removed by the central district. Teachers, in contrast, have more substantial job security.

TABLE 4.A.6

Characteristics of "Decentralized" School System Mexico, Education Reforms 1992–1998

	COMMENT/SUMMARY JUDGMENT
Resource Management	Because schools have little power over resources, they have little ability to influence a school improvement plan. The Ministry of Education pays only for its textbooks.
Personnel Management	Little or no school-level power over personnel.
Governance	Officially councils exist but they do not function and have few powers.

Choice	No significant choice.
Finance	Schools cannot raise significant revenues and it is not clear that funds follow students.
Pedagogy	Schools have little choice over curriculum and pedagogy.
Information	School-level test scores available for most schools. There are no measures of value added.
Incentives	Very low level of incentives for either teachers or directors.

TABLE 4.A.7

Characteristics of "Decentralized" School System Minas Gerais, Brazil

	COMMENT/SUMMARY JUDGMENT
Resource Management	Schools are in charge of developing a school improvement plan, an aspect of which is to prepare a pedagogical project defining the aspects to be improved in teaching-learning process. Schools also have the authority to select their own textbooks and allocate non-personnel budget.
Personnel Management	The State Education Secretariat/Minas Gerais (SEE-MG) is responsible for establishing the academic requirements and qualifications for teachers and promoting and providing them with training. Schools are in charge of hiring, determining which teachers will receive training, evaluating teacher performance, handing down disciplinary actions, and firing teachers. Salary levels and benefits are set at the state level. The schools can assign teaching responsibilities. Principals may not be dismissed without an SEE-MG investigation. Professional development is demand driven because the school board (composed in part of teachers and other school staff) has the responsibility of developing training plans for teachers.
Governance	School councils, called colegiado escolar, are elected by the community from teachers, other school staff, parents, and students over age 16. Candidates for principals are first required to take a written exam. Those with the highest scores are asked to present a work program to the community, which then elects the principal by a secret vote.
Choice	No significant choice.
Finance	Bulk of revenue transferred from SEE-MG, however schools may raise additional funds through public or private donations. School revenues are formula-driven. Discretionary funds (those spent according to priorities established by schools) are determined using a formula that takes into account the number of students enrolled, the socioeconomic level of the clientele attending the school, and the location of the school. Earmarked funds (materials and services approved by the SEE/MG) are based on a per capita amount multiplied by the number of students, plus a certain percentage according to type of school (full-time, special education, and so forth).
Pedagogy	Taking into account basic educational patterns and legal requirements regarding the annual number of school days, each school has the authority to design its own calendar, curriculum, and pedagogical approach, including methods for evaluation and organization of students in classes.
Information	The SEE-MG has established a mechanism of external assessment of the school unit called the Assessment Program of the Public Schools of the State of Minas Gerais. It is a periodic testing designed to measure students' achievement on basic knowledge and skills, and the scores are made public.
Incentives	The election process has given the community the power to replace principals who are not performing according to the community's interests or expectations.

TABLE 4.A.8

Characteristics of "Decentralized" School System Nicaragua, Education Reforms 1993–1998

	COMMENT/SUMMARY JUDGMENT
Resource Management	School-level resource management increased significantly in some autonomous schools. School directors receive monthly capitation grants to pay teachers and all other major expenses, including utilities. Schools also charge fees (or, rather, voluntary contributions) and any revenues generated are allocated by the school council. Schools can select their own textbooks, but the central government pays only for the ones that it chooses.
Personnel Management	School councils can officially hire and fire the school director and, with greater difficulty, teachers. However, in practice most councils have not challenged centrally appointed directors. There are cases of councils firing directors, but their direct control over the hiring process is more suspect. Still, the incentive for the director to please the council members seems credible. If fee revenue is substantial, councils tend to use it to augment teacher salaries.
Governance	Councils have a voting majority of parents and include the director, teachers, and students. Council members are officially selected based on various objective criteria, but in some schools they are democratically elected while in others they are selected by the director or the Ministry's municipal delegate.
Choice	No significant choice.
Finance	Schools can raise revenues through parental contributions and the annual school budget is determined by number of students enrolled.
Pedagogy	Directors, in conjunction with the councils, have some discretionary power over the non-core curriculum, but it is limited and rarely exercised. Primary pedagogical approach, the *methodologia activa*, is developed and disseminated by the central ministry.
Information	There are no public, school-level measures of value added or other test score results. The central ministry is developing a national achievement evaluation system in conjunction with the World Bank.
Incentives	There are incentives for directors and teachers to raise revenue, and for teacher attendance in those cases where school revenues (which in turn depend to some extent on parent satisfaction) are sufficient to provide bonus pay. Teachers can also be fired by the director, perhaps in consultation with the school council. Overall, the incentives for all staff to perform appear higher in autonomous schools.

TABLE 4.A.9

Summary of Characteristics of Decentralized Schools

	Chicago	*Chile*	*El Salvador*	*England*	*Nicaragua*	*Memphis*	*Minas Gerais*
GOVERNANCE							
School councils elected.	√		√	√	√	√	√
Councils select school director.	√		√	√	√	√	√
CHOICE							
Parents select school for child.		√	n.a.	√	√	√	
School sets admission requirements.		n.a.		n.a.			
FINANCE							
Raise own revenues.				√	√		
Revenues follow students.	n.a.	√	n.a.	√	√	√	n.a.
PEDAGOGY							
Set the non-core curriculum.	√					√	n.a.
Choose pedagogical approach.	√			√		√	n.a.
RESOURCE MANAGEMENT							
Develop school improvement plan.	√	√	√	√	√	√	√
Allocate non-personnel budget.	√		√	√	√	√	√
Selection of textbooks.	√	√	√	√		√	√
PERSONNEL MANAGEMENT							
Hire and fire school director.	√		√	√	√	√	√
Hire and fire teachers.			√	√	√		
Set or augment teacher pay scale.			√		√		
Assign teaching responsibilities.	√		√	√	n.a.		√
Demand-driven professional development.	√		√	√	n.a.		n.a.
INFORMATION							
Independent public audit or inspection.				√			
Public test scores.	√	√	n.a.	√	n.a.	√	√
Public measures of value added.	√					√	
INCENTIVES							
Director job security tied to implementation of school improvement plan.	√			√		√	√
Teacher job security affected by student performance.				√	√	√	
RESULTS							
Increased test scores.	√				n.a.	√	√
Improved teacher absenteeism.			√		√		
Improved student attendance.			√		√		
Higher parental satisfaction.							

n.a = not applicable

BOX 4.A.1

What Has Been Learned from Effective Reform Strategies?

1. Educational reform is a local process. The school, not the ministry or the district administration, is the center of change. Schools determine the degree of success; they can block implementation, enfeeble it, or bring it to effective life. For schools to improve the quality of their programs effectively, they need to play an active and creative role.

2. Central support is vital. The issue for the central ministry is learning to support local schools in their efforts, in other words, how to make demands on support, encourage, empower, enable, and build a strong local school. More responsibilities to the individual school presuppose a strong support structure from the system at large, one that must be built around the real needs of schools in development. For the central level it implies that a system of reform and a division of labor is needed to effectively support the local level.

3. Effective system linkages are essential. The strategy in complex systems is to identify effective linkages, nonbureaucratic in nature, between the national, district, and local levels. For communication within the system to be effective, local empowerment is needed, usually as a consequence of more decentralization. A clear administrative role that combines pressure and support and secures the delivery of needed resources is also required.

4. The reform process is a learning process. The process is evolutionary and developmental in nature. It cannot be blueprinted ahead of time. The key to success is to get good data from all parts of the system on a continuous basis, studied and worked on at the school district level, and subsequently at the central level. This implies a competent supervision and monitoring system.

5. Think systemic and big. A vision of reform that affects school life substantially will have more effect than a cautious, incremental approach. Any major reforms in complex systems need to build structures and capabilities at all levels. Ad hoc solutions will not work in the long run; only institution building based on sustained commitment works.

6. Focus on classroom practice. The clue is to focus on the dynamics of the classroom and the individual school, since this dynamic to a large extent determines implementation success. It is essential that the supporting materials are of good quality, whether nationally developed and locally adapted, or locally built from the start.

7. See teachers as learners. Good materials and facilities are a necessary but insufficient condition. Teacher mastery is crucial for impact on students, and that can best be developed through a systematic local learning process that includes in-service training, supervision, and coaching in a collegial atmosphere.

8. Commitment is essential at all levels. It is crucial at the central level for sustained effort and the maintenance of needed support structures. It is also essential at the district and school level; however, it cannot be transmitted directly to schools. Commitment at the school level results from empowered successful action, personal mastery that starts with good assistance and develops from practice. In effect, local empowerment builds emotional as well as administrative and problem-solving capacity.

9. Both local and central initiatives work. An innovative idea that starts locally (Colombia), nationally (Ethiopia), or with external donors (Bangladesh) can succeed, if programs meet the criteria of national commitment, local capacity building and linkage, in a configuration that makes sense for the particular country.

10. Parent and community participation contribute to success. Parent and community participation lead to commitment and contribute to outcomes, and are essential for the development and maintenance of primary schools in rural areas. Effective participation includes a real role for parents in school decisionmaking.

Source: Dalin and others 1994.

CHAPTER 5

Empowering Mayors, Hospital Directors, or Patients? The Decentralization of Health Care

Health sector reforms are becoming common throughout Latin America. This is not surprising as most health systems suffer from rising costs, low coverage, inefficient operation, and patient dissatisfaction. Reform has occurred in a variety of ways. Some countries have attempted to decentralize the provision of public health services, transferring responsibility for primary health care and lower tiers of acute care (hospitalization) to subnational units of government. Others have introduced competition into health services, by forcing government owned hospitals to compete with private hospitals for government health care funds.

This chapter reviews how decentralization reforms in the health sector have been designed and implemented. It is based on the experience of six countries: Argentina, Bolivia, Brazil, Colombia, Chile, and Mexico. It begins, however, with a clarification of the nature of health care itself.

Three Kinds of Health Services

Unlike education programs, health care programs provide some goods and services that are almost "pure" public goods. That is, they are both "nonrival" in consumption (consumption by one person does not reduce the amount available for others) and "nonexclusive" (benefits cannot be restricted to only those people willing to pay for them). Examples are provided in the first row of Table 5.1. These goods and services (or activities) require central government financing if they are to have any chance of being provided in quantities that would be efficient from the standpoint of the economy as a whole. Some of these activities have largely localized benefits, that is, benefits that, while not confined to individuals, are confined to local jurisdictions. Vector control and disease surveillance are examples. While there may be a case for some local financing of such activities, they also have important cross-jurisdictional externalities. Central governments must therefore be concerned that finances are adequate and a regulatory structure is in place to ensure that local government units or private firms recognize these externalities across subnational political borders.

From the consumer-citizen standpoint, individuals may benefit from the pure public health goods and services without even knowing that they exist (for example, vector control), although they are generally well aware when the services are not adequately supplied. Management of the activity may not include interactions between suppliers and beneficiaries, so the direct client for services may be a government functionary rather than the end user, creating principal-agent issues but also leaving open to cost and quality considerations whether the relevant governmental unit prefers to own-manage the activity or contract it out.

A second set of services (Table 5.1, row 2) in health is rival in consumption but nonexclusive in benefits. One

TABLE 5.1

Suggested Financing and Provision for Different Types of Health Services

	CHARACTERISTICS OF GOODS AND SERVICES	EXAMPLES	REGULATION	FINANCING		PRODUCTION
				PUBLIC OR PRIVATE?	CENTRAL OR LOCAL?	
1.	Pure public goods in health (nonrival, nonexclusive)	• Health information • General health education • Disease surveillance • Environmental health • Vector control • Regulation (market failures in information and insurance)	• Central	• Public: otherwise underfinanced	• Decentralization for localized public goods, as long as national standards are maintained	• Public • Contract out (public bureaucracy is the client)
2.	Household health inputs with strong externalities (rival, nonexclusive)	• Immunizations • Sanitation • Safe water • Prevention of communicable disease	• Central	• Public and some private	• Decentralization for goods with strong local characteristics, as long as national standards are complied with	• Private preferred (reduces principal/agent problem of public provision)
3a.	Household health inputs that are fundamentally private goods (rival, exclusive)	• Acute care	• Central	• Private • Public (in case of insurance market failures)	• Central	• Private
3b.	"Equity goods" in health	• Acute care	• Central	• Public (to finance indigent)	• Central	• Private

example is immunization. A large part of the population must use this service if it is to be effective as a medical intervention for the population as a whole. Immunizations may provide widespread immunity, however, at a level of coverage substantially lower than 100 percent. Thus they provide benefits to people who choose not to be immunized. Although, there is a willingness to pay for the service, there is also an incentive to take advantage of the free ride; hence a strong rationale exists for, at least, partial government financing or compulsion to force private parties to purchase adequate quantities of the service. In practice, these services tend to receive heavy if not exclusive public financing, although some jurisdictions do handle them primarily through regulations rather than through financing (for example, requiring children to have immunizations before they enroll in school, and requiring coverage in basic insurance benefit packages).

From the consumer's standpoint, these services require direct interaction between medical personnel and patients (or for water and sanitation, between the seller and the consumer). A large share of the population actually must use them if they are to be effective as medical interventions for the population. It is important that the service function in a manner that pays attention to the client. Thus the management of the service at the point of delivery is important.

Because these two groups of services involve inherent market failures, they require some form of government intervention in determining how much, and what, will be provided. The case for government intervention in the third group of services is less clear-cut. These services—consisting largely of acute (or curative, as opposed to preventive) forms of care—are essentially private goods. The government may find itself involved in the financing of these as a substitute for private insurance systems that fail to develop (Table 5.1, row 3a). Governments may also be involved to ensure that those who cannot afford insurance have at least a minimum level of access to acute care (Table 5.1, row 3b).

Many Modes of Service Delivery and Financing

No government is required to become directly involved in the delivery of the services. Even in the realm of public goods, it may choose to contract for such activities as disease surveillance. Its choice should probably depend on the relative quality and efficiency of contracting for the service or providing it directly. Table 5.1 demonstrates, however, that as benefits of health services become increasingly confined to individual consumers, the case for government participation in production diminishes. While the public sector's role in regulating and financing acute care remains strong, its comparative advantage in provision is less so.

In the history of health care provision, this distinction between public and private goods, on the one hand, and impersonal versus personal services, on the other hand, has been confused . As a result, governments and social security institutes have found themselves financing and delivering all kinds of services even though many could be delivered as well or better in a competitive market. Central governments, having entered the business of medicine, then consider decentralization to be a matter of decentralizing the management of facilities and personnel, when in fact lower levels of government may not have any advantage in skills, incentives, motives, or negotiating power to improve the management of such services.

This framework is perhaps too simple to capture the true role of the public sector in health or to fully understand the decentralization efforts that have taken place in Latin America (see, for example, Musgrove 1999; and Preker, Harding, and Girishankar 1999). However, it emphasizes two simple issues that should be addressed in decentralization policies in health.

First, should responsibilities and financing of the high-externality functions in health be distributed across political entities, recognizing that many of these goods would benefit from local customization while also meeting minimum national standards for results (for example, management of water-, air- and vector-borne diseases)? Second, how can services be improved in historically large, expensive, and poorly functioning government-owned-and-operated delivery systems? While movement along the political decentralization axis may affect service delivery to some degree, this second issue is fundamentally an incentive problem that can be addressed through a variety of actions. One of the most promising involves splitting the financing function from the provision function.

This reform—termed the purchaser-provider split—involves two elements. The first is a shift in the mode of financing, from inputs to outputs. Under a traditional input-based system, government health expenditures are allocated as line items in the budget: personnel, equipment and supplies, and so forth. This gives health unit administrators little incentive to reduce costs. Under an output-financing system, health units are paid according to the volume and type of services they provide. This not only encourages efficiency, but can also boost quality because health units are forced to compete for clients.

The second element is management autonomy. Without autonomy, hospital administrators cannot respond to the incentives inherent in output-based financing. Management autonomy can be achieved in different ways. In some countries (for example, Chile), hospitals and clinics remain in the public sector but are organized as corporations to ensure their management autonomy. In other countries (for example, Brazil), the majority of health care providers belong to the private sector, and the government's role in health is largely limited to finance and regulation.

What has been Decentralized in Latin America and How

Decentralizing health care has meant different things in different places. This section summarizes the experience of six countries.

Argentina: From Central Monopoly to Provincial Monopoly

Judging by the proportion of the health budget that is executed at the subnational level and by the decision powers that have been transferred to the provinces, decentralization of health services in Argentina both in the territorial-political and the economic sense is quite advanced. Only about 14 percent of health spending in the public sector is done at the national level; 70 percent is done at the provincial level, and another 16 percent is done at the municipal level. Less than 1 percent of inpatient facilities are administered by the national health authorities, some 70 percent are administered at the provincial level, and 20 percent are administered at the municipal level (Gonzalez-Prieto and Alvarez 1999).

The public sector provides health coverage to about 46 percent of the population and accounts for about 23 percent of total health spending in the country. The social security system (based on the so-called "Obras Sociales") provides coverage to 47 percent of the population and accounts for 35 percent of health spending. The private sector covers 7 percent of the population and accounts for 42 percent of health spending (insurance and out-of-pocket). The public sector owns about 37 percent of health facilities and 54 percent of hospital beds, while the private sector owns 61 percent of health facilities and 43 percent of hospital beds (Gonzalez-Prieto and Alvarez 1999).

The first wave of health sector decentralization in Argentina (1978) was aimed at the provincial—rather than the municipal—level. The primary motive for decentralization was the alleviation of the fiscal burden at the central level, rather than a quest for efficiency or equity. Responsibility for running health facilities and budgets was transferred to the provinces. The resources transferred from federal to the provincial level were not earmarked for the health sector; provinces could therefore choose how much they wanted to allocate to the health sector from their own budgets and from the federal transfers. The early 1990s brought a second wave of decentralization with the transfer of the last federal hospitals to the Municipality of Buenos Aires, and the transfer of some provincial health responsibilities (especially primary health care) to the municipalities.

The second wave also introduced the concept of the autonomous public hospital. The scope of autonomy of these hospitals was to include the ability to bill the social security system and private health insurers for services provided to their beneficiaries and to retain a part of their earnings. Adoption of the autonomous hospital model has been uneven, however. Two provinces (Córdoba and Neuquén) have rejected the concept entirely, fearing that it would lead to duplication of facilities and equipment, and to discrimination against the uninsured population (as hospitals become more and more dependent on reimbursements from insurers). Other provinces have adopted the concept but have implemented it slowly, fearing that it would increase the public deficit. They also feared strong opposition from labor unions and reduced political power at the provincial level. With one exception—the province of Salta—no province has given its autonomous hospitals control over personnel management.

Mexico: From Deconcentration to Decentralization

The public health sector in Mexico consists of several entities. Historically, the Ministry of Health (SSA) has been responsible for the definition of health sector policies and the regulation and supervision of, and strategic planning for, the health system, and for the provision of health care for the uninsured population (currently about 42 million people) through its own extensive network of health facilities. In addition, the Social Security Institute (IMSS) provides comprehensive health insurance to some 41.5 million people through its own provider network. Sixty-seven percent of IMSS health insurance revenues come from payroll taxes and 33 percent from general taxation.

Another insurance scheme, jointly funded by the SSA and the IMSS, brings coverage to an additional 11 million people, mostly in rural and indigenous communities. Parallel social security schemes exist, such as those for public employees and for the national oil company. The private sector, on both the provision and financing sides, is small but growing. Currently some two million Mexicans have private health coverage.

Decentralization efforts, initiated in 1983, constituted an effort to share political power with the state governments, reduce the fiscal burden at the central level, rationalize the supply structure, and improve management. The process was a gradual one involving only 14 of the 32 states and limited in scope. It did not involve either health jurisdictions or health facilities. Resource allocation autonomy at the state level was limited to revenues obtained locally. Budget execution remained highly centralized: The share of their budget executed at the state level was the same for decentralized states (24 percent in 1995) and for those states that had not been involved in the process (21 percent in 1995) (Centro Estudios para America Latina [CEPAL 1998]). The period was characterized by rival efforts on the part of the IMSS to deconcentrate (more for self-preservation than to promote devolution).

With the arrival of the Zedillo administration in 1994, decentralization was back on the agenda. Although the government was primarily motivated by pressure to share political power with the state governments, the Zedillo reforms also aimed to increase coverage and improve the quality of care for the uninsured population as well as increase the efficiency of public administration. The second phase of decentralization was initiated in 1996. It differed from the first phase in that it involved all of the states and made the sharing of roles and responsibilities between levels more explicit, but it resembled the first phase in that decentralization did not reach the level of health jurisdictions or facilities.

The second phase of decentralization brought about the creation of "decentralized public organisms" (OPDs), semi-autonomous state agencies whose governing board includes the state governor, a representative of the federal Ministry of Health, a trade union representative, and the state health minister. Clarity has been achieved in a number of areas. Resources from the federal level to the states are allocated according to well-established criteria; the transfer of human resources from the federal level to the states has been negotiated with the national union; infrastructure, goods, and equipment have been transferred to the states; and municipalities have been given limited responsibilities in the areas of planning and infrastructure. Monitoring and conflict resolution are done by the National Health Council.

With the reform, the states became accountable for all health care services for the uninsured population, and obtained control over the execution of its health budget. The decentralized budget increased from 4.8 million pesos in 1995 to 16.4 million pesos in 1999. The functions of the federal Ministry of Health were concomitantly redesigned and its normative and planning role strengthened. Spending at the federal ministry level decreased from 12.2 million pesos in 1995 to 9.5 million in 1999.

The IMSS has been involved in parallel deconcentration efforts, with the creation of seven regional directorates in 1995, and 139 medical zones in 1997 (each providing health care to a population of between 100,000 and 200,000 people). These medical zones are expected to evolve into budget-holding "medical areas of autonomous management." So far deconcentration has fallen short of the planned full management autonomy in such areas as personnel, procurement, equipment, infrastructure, and maintenance. Plans for the next few years, however, hold promises of a purchaser-provider split involving development of the purchasing function within the IMSS and introduction of reimbursement to providers through risk-adjusted capitation and Diagnostic Related Group (DRG) systems.

The political decentralization process within the SSA is making slow progress, and autonomy and capacity at subnational levels are gradually being strengthened. In contrast, there seems to be little or no progress in separating financing of purchasing from the provision function. The decentralization process in the IMSS has been equally slow, but there are more explicit plans to operate a purchaser-provider split. The initial steps toward this split are evident in the recent agreements signed with the Ministry of Finance and the Ministry of Auditing and Administrative Development, which are aimed at financial autonomy and commitments by the IMSS to sign agreements with specialty hospitals and medical zones.

Bolivia: Municipalizing the Physical but not the Human Assets

The public sector provides health coverage directly to about 30 percent of Bolivians, and the social security system provides coverage to another 14 percent. The private sector provides coverage to some 30 percent of the population. The remaining 26 percent either have no access to health services or use traditional medicine (Ruiz Mier and Guissani 1997).

Health care decentralization in Bolivia has been used as an instrument of democratization. After a number of failed efforts in the 1980s, the process was precipitated by the so-called "popular participation law" of 1994, which provided for the recognition of 311 municipalities. This law transferred assets of health centers and medium- and high-complexity hospitals, including national referral hospitals, to the municipalities. The responsibilities transfered included infrastructure maintenance, equipment, and input supply. The process was further advanced with the administrative decentralization law of 1996 that transferred some personnel administration responsibility to the departmental level (departments are administrative subdivisions of the central government). The central ministry, however, continued to be responsible for personnel recruitment and firing, and for negotiating salary levels every year with health sector unions. Decisions on the number of staff, both administrative and medical, allocated for public health centers is determined centrally, and municipal governments do not participate in the decisionmaking process.

Thus one of the particularities of the Bolivian experience of decentralization has been the sharing of roles and responsibilities between the municipal and the departmental levels. Although many countries have delegated primary health care to municipalities, and more complex health care to departments, the demarcation line in Bolivia has been the control of particular types of inputs. The municipalities are responsible for the maintenance and equipment of the health infrastructure, and the departments are responsible for personnel administration. In this model, municipalities and departments each have control over some of the factors of production, and close vertical coordination is needed to ensure effective service provision. In addition, municipalities and departments have to coordinate upward with the national Ministry of Health, which plays a regulatory role and is responsible for the administration of essential drugs, and downward with the local communities to ensure that local concerns are considered.

Local health directorates have been created in an attempt to achieve coordination among all the participants in the health sector. These are formed by representatives of the municipal government, the departmental health directorate, and the local community. The mandate of these directorates includes (a) preparing and proposing to the municipal government annual operating budgets and investment plans for the health sector, (b) negotiating for health personnel, and (c) proposing and negotiating health service provision agreements with different participants. To date, these directorates have fallen short of these goals. In fact, since all three levels of government have a stake in service provision, accountability for quality and coverage has become increasingly diluted.

Decentralization efforts have increased spending at local levels and have allowed municipalities to invest more in the maintenance and operation of the health facilities. Only about 12 percent of health spending is done at the national level; some 62 percent is done at the departmental level; and the remaining 26 percent at the municipal level. The major source of funding for the health sector remains transfers from the central level. This transfer-based financing system limits the actual degree of autonomy and control over inputs at subnational levels. The new model has also actually diminished financial autonomy at the facility level: Facilities have lost their autonomy to municipalities that now manage the user fees collected by the facilities. Financial autonomy at the facility level has also been reduced with the implementation of Maternal and Child Insurance (1998). Public health providers, which are required to provide free care to pregnant mothers and children under 5 years of age for diarrhea and respiratory diseases, are typically inadequately compensated by the municipalities for these services.

Although there has been a definite transfer of responsibilities to the lower administrative levels in the health sector, little progress has been made in separating the financing from the purchasing functions. Apart from those who require Maternal and Child Health Insurance and Old Age Medical Insurance, health purchasers are not clearly identified. The type and scope of services to be provided are not clearly determined, leading to a disconnect between demand and provision. Health providers, for their part, are not given the instruments to behave in a more profit-oriented fashion; indeed, the last few years have seen a reduction in the degree of autonomy of the health facilities to retain payments for services provided, and to decide resource allocation and medical inputs.

Brazil: Public Financing with Private Production

Brazil's decentralization process in the health sector was initiated in conjunction with efforts to integrate the social security institute, which provided health care to urban formal sector employees and their dependents, with the Ministry of Health, which provided health care to rural uninsured workers and indigents. The integration was achieved in 1988 with the establishment of the Unified Health System (Sistema Unice de Saude [SUS]), which provides near-universal coverage. SUS operates as a subsidized insurance scheme, in which the federal SUS administration reimburses providers for services rendered. The vast majority of such reimbursements go to private hospitals and clinics. State and municipal facilities of course are also eligible. While SUS is generally considered a success, it has suffered from financial problems. The reimbursements to public and private providers have been substantially lower than the costs of services (especially for preventive care). Private participation in the SUS is therefore decreasing, and private health care insurance is becoming more widespread.

Publicly owned health care facilities are generally operated by municipalities. The process of enabling municipalities to manage their own health systems has been very gradual and has involved a formal qualification process. By December 1996, 137 municipalities, accounting for 16 percent of the Brazilian population, administered their own health systems. These mostly urban municipalities administered some 20 percent of hospital expenditures of the SUS. Approximately 2,300 more (or 42 percent of the total) municipalities had gained incipient autonomy, which allowed them to participate in planning activities and licensing private providers in their territories. Their ambulatory and hospital care budgets were, however, still prepared and approved by the federal government. For their part, states were responsible for reviewing policy implementation, monitoring and evaluating systems, and providing technical and financial assistance to municipalities in their jurisdictions.

Because SUS reimbursements fall short of the cost of health services, municipalities are often forced to subsidize their hospitals from general municipal revenues.

Notwithstanding the numerous shortcomings of the system, Brazil's health system has definite virtues: The purchasing side is integrated; the purchasing and provision functions are separated; the provision of private health goods is largely done by the private sector (private providers account for over 70 percent of publicly funded hospital admissions); and the financing of public goods, goods with externalities, and "equity goods" (basic health measures, nutrition, epidemiological and sanitary surveillance, and so forth) is central, although their delivery tends to be through federal agencies rather than municipalities.

Chile: Municipalizing Production, Centralizing Financing

The health care decentralization process in Chile initiated in the early 1980s was part of a wider reform process that aimed at introducing market mechanisms in the health sector. Primary health care facilities and personnel were transferred to the municipalities. This had two important effects. First, the transfer of personnel to the municipalities led to their loss of civil service status. Henceforth, primary health care workers would negotiate their work conditions directly with the municipalities. In principle, this gave local governments considerably more autonomy in setting wages and benefits (although in recent years there has been increasing pressure from the labor unions to recentralize the personnel hiring and management functions.)

Second, it led to a change in the mechanism for financing public health providers, from one based on inputs (line item budget allocations) to one based on outputs, or the quantity and quality of services provided. This was expected to encourage municipalities to expand coverage and make more efficient use of staff and other resources.[1]

While municipalities in Chile were given relatively more control over inputs than in other Latin American countries, their autonomy is constrained by the fact that to a large extent the Ministry of Health determines their primary health care spending. The quality of health care they provide is therefore heavily dependent on the level of government financing. The municipalization of primary health care delivery in Chile has nonetheless been considered a success that owes much to the continued commitment by the Ministry of Health to primary health care, the clear definition of responsibilities of municipalities, the simplicity of the outputs to be delivered, the clarity and simplicity of payment mechanisms, and the improvements in municipal administrative capacity.

Decentralization was not the government's only reform in the health sector. In pursuing its market-oriented approach, the government also encouraged the use of private health insurance. Private health funds were allowed to operate and collect compulsory payroll contributions to provide private health care. As a result, the share of people covered by private insurance plans increased substantially (to about 27 percent of the population in 1997 from near zero in the early 1980s) and the proportion of hospital beds in the public sector decreased from 90 to 75 percent.[2]

Colombia: Conflicts Between Decentralization and Privatization

Over the last 30 years, health sector reform in Colombia has evolved from focusing on deconcentration (1960s) to the decentralization-devolution and privatization (1990s) of service provision. Since none of these reforms was ever fully implemented, the current situation inherits a little from each of the earlier phases. Devolution started in 1990 when the Ministry of Health mandated the transfer, over a five-year period, of primary health care facilities, personnel, and budgets to municipalities, and of secondary and tertiary hospital care to provincial governments (departamentos). The transfer ran into implementation difficulties (burdensome certification requirements and insufficient resources to pay for the cost of decentralization) and only a handful of municipalities assumed their responsibilities.

Progress was made in the decentralization process with Law 60 of 1993 (Ley 60). Transfers to departments for health and education increased significantly (from 15 percent of government revenues in 1993 to 24.5 percent from 1996 on). These transfers are administered autonomously in those departments that have been certified. Transfers to municipalities for health, education, and other infrastructure expenditures increased from 15 percent of the central government's revenues in 1994 to 17 percent in 1997, and are expected to increase to 22 percent by 2001. The main problem with these transfers is that they bear little relation to local health needs or to the cost of services.

In the midst of implementing decentralization reform, a more radical reform was enacted at the end of 1993 (Ley 100). The reform strategy included separating financing from the provision of services, promoting competition among insurance suppliers and service providers, providing direct targeted subsidies for the poor, and aiming at providing health services to the population irrespective of ability to pay. Two insurance plans were created to implement the new approach: a contributory plan designed to cover salaried and independent workers, and a subsidized plan for the poor (a direct subsidy to pay for a basic package of health care services).

Implementation of the Ley 100 reform is to be highly decentralized. The subsidized regime is to be administered and financed through municipalities, which will be responsible for (a) identifying poor beneficiaries, (b) affiliating the beneficiaries with a private or public health insurance company (Administradora del Regimen Subsidiado [ARS]), and (c) authorizing payment of corresponding premiums to the ARS. Other decentralized features of the system include the devolution to departments and municipalities of a number of financial, organizational, and personnel responsibilities, with departments achieving a greater degree of autonomy than municipalities. The area of slowest progress has been personnel management; the margin of maneuver for renegotiating salary levels and employment conditions has been almost nonexistent. At the departmental level, government hospitals are being transformed into autonomous enterprises. The process of hospital autonomization has been hampered by lack of clarity as to who will pay the pension debts and within what time frame, and the conditions, including the state of the infrastructure, under which hospitals will be transformed.

Major Issues in Decentralizing Health

As these six case studies suggest, health decentralization in Latin America has been a varied experience. Although five of the six countries are experimenting with various forms of purchaser-provider splits, health care continues to be dominated by the public sector in both its financing and production. Decentralization has largely been limited to the transfer of parts of the public sector system from the central government to subnational governments. Central governments have tended to retain responsibility for policymaking, overall financing, and operation of highly specialized medical care centers (cancer, for example), while the states or provinces have often been given responsibility for provision of secondary and tertiary hospital care, and municipalities responsibility for primary health care (Colombia, Brazil, Chile, and to a lesser extent Bolivia).[3]

Labor Management

Even this much decentralization has been rather tentative. Labor management, for example, continues to be centralized. In most of the case study countries, the price of labor and the conditions of employment are controlled not by subnational governments or administrators of health facilities, but by the central government, which enters into national negotiations with health sector unions every year. This has stymied efforts to develop management autonomy to the level where it is most likely to have an impact—to the individual health unit. Directors of government-owned health facilities have generally little power over their labor input.

Table 5.2 summarizes where the six countries stand in terms of personnel management. It indicates that in most countries, subnational governments and health care facilities have only limited personnel management responsibilities and are constrained by strict national labor codes regarding health care workers. In some cases, state health secretaries have the power to hire, fire, and transfer hospital directors and staff (Argentina, Bolivia, and Mexico). Chile is perhaps the sole case where primary health care workers were effectively transferred to municipalities and lost their status as federal civil servants in the process.

Recurrent Financing

Most health care providers (hospitals and primary care networks) continue to be financed by direct historically based budget allocations either through deconcentrated Ministry of Health offices in states or through earmarked transfers to states and municipalities (in Bolivia, Chile, and Mexico, and in Colombia to departments where health has not yet been decentralized). In Argentina, central transfers to provinces are not earmarked for health; transfers from provinces and municipalities to health care facilities are historically based. Transfer formulas to political sublevels are generally complex and have a large population-based weighting. These transfers then become the basis for local governments to finance services, which is typically done through an input-based, historical budgeting approach that ignores output and quality. Correspondingly, most countries charge no fees (or only nominal fees) for health care in central or decentralized facilities, and highly subsidized fees, if any, for hospital services and inpatient or outpatient diagnostic-related activities.

This continued reliance on input-based financing provides no incentive for improvement in efficiency or cover-

TABLE 5.2
Authority to Manage Personnel by Different Levels of Government

GOVERNMENT LEVEL	SALARY DETERMINATIONS (PRICE)	HIRING AND FIRING (QUANTITY AND INCENTIVES)
Central	Bolivia, Chile, and Mexico	Bolivia
State/Department/Province (municipalized*)	Argentina, Brazil, Colombia (if non-municipalized)	Argentina, Brazil, Chile (Health Regions), Colombia (if non-municipalized), and Mexico
Municipal	Colombia (if municipalized*)	Brazil (for service providers); Chile for PHC workers; Colombia (if municipalized)
Facilities where purchaser-provider split operates		Brazil (limited autonomy in public hospitals); Colombia (corporatized hospitals)

* subject to central government guidelines

age. Moreover, the introduction of subnational governments into the health care system has raised new financing problems. Health decentralization has generally been predicated on continued central government financial support, but this has not always been forthcoming. This has been a problem particularly where there is central control over salaries. In Colombia, while labor costs are set by the national government, the funds transferred to subnational governments to finance health services do not fully reflect the costs, resulting in constant shortfalls, disputes among government levels, and financial pressures on local governments. One result in Colombia and other countries is little interest on the part of subnational governments to accept health service responsibilities in their territories because the responsibility is transferred without adequate resources to carry it out or authority to manage the costs.

At the same time, decentralization reforms have resulted in a heavier fiscal burden for central governments. To a large extent this has resulted because formula-based transfers to municipalities, and in some cases to states, have been made, in part for political reasons, with new monies rather than with reallocations from existing health expenditures. In Bolivia, municipal transfers created by the Popular Participation Law are a fixed percentage of government revenues and represent additional resources for social services, including health. Budget allocations to pay subnational governments for increased salaries of health staff and accumulated pension and other benefits are another source of increased net expenditures on health. Overall, increased expenditures in health have represented over 2 percent of GDP in some countries (Bolivia and Colombia), although not all the increase can be attributed to decentralization.

Investment Decisions

Unlike most other health activities, investment decisions have been fully decentralized in many Latin American countries (see Table 5.3). While this has quickened responsiveness to local needs, it has also created problems. First, since all three government levels are allowed to invest in infrastructure and have the money (often earmarked transfers) to do so, a tendency exists to overinvest in infrastructure and equipment. Typically, there is no explicit charge for rental of capital and equipment or for depreciation, so there is no countervailing incentive to use capital productively. Second, wherever states and municipalities have not also been responsible for financing personnel, they have tended

TABLE 5.3
Authority to Make Infrastructure Investments

GOVERNMENT LEVEL	PRIMARY HEALTH CARE	HOSPITALS
Central		Bolivia, Chile
State	Mexico	Argentina, Colombia, Mexico
Municipal	All except Mexico	Brazil (plus some state cofinancing)
Purchaser-provider split operated		Colombia (from user fees)

to overlook the recurrent cost implications of those investments. In those countries it is common to find empty health care facilities because the central government has not filled the new staff positions or vacancies because of central budget constraints. The central government has even been reluctant to allow municipalities and community organizations to fill those vacancies for fear that the new positions will eventually have to be absorbed by central government payrolls as a result of pressure from labor unions.

The Political Economy of Reform

The partial and haphazard way that health care decentralization has been implemented reflects to some degree the powerful forces arrayed against it. While the potential beneficiaries—the citizen-patients—are many and diffuse, the opposition groups are concentrated and focused. One such opposition group has been health sector workers, who have seen decentralization as a threat to their union power and as a way for the government to divide them. In most cases, health sector workers have agreed to decentralization-deconcentration only after receiving assurances (usually by law or supreme decree) that labor code regimes and associated benefits are maintained for themselves, and often for new staff as well.

Central governments have also been less than enthusiastic. In part this reflects financial concerns. Decentralization reforms cost additional money because, at least initially, there is (a) some duplication of expenditure (central government employees are rarely transferred to other locations, for example), (b) a need to rehabilitate hospital and primary health care networks, and (c) a necessity to train personnel to handle newly decentralized responsibilities. Where more radical decentralization reforms have been planned, the cost of accumulated pension benefits for health workers has been one of the main obstacles. Under planned reforms in Colombia and Venezuela, provinces were to take charge of all personnel and payroll (under national civil service codes) and pension benefits. The central government promised to pay all accumulated pension benefits up to the moment of the transfer or when the decentralization law was enacted. This has proven difficult.

National ministries of health have also dragged their feet on decentralization, fearing a loss of their prerogatives. Arguing that subnational governments are incapable of receiving and providing health services, they have imposed cumbersome and often unnecessary certification requirements before permitting service provision to be decentralized. Furthermore, those certification requirements are never clearly specified with respect to content, dates, and process, but are left to the interpretation of central government bureaucrats, leaving ample room for discretionary practices and negotiations, and for stopping the process

BOX 5.1

Lack of Reliable Information

One other obstacle to decentralizing health may be the lack of reliable information with which to monitor progress and signal problems in coverage, quality of service, and efficiency. Quality and coverage indicators, when available, are often unreliable. Reports of inefficiencies and misuse of funds come from the press rather than from reliable information systems. This situation is not surprising insofar as a centralized system may simply not produce much information because the information has little value. In such systems there are few transactions involving money, there is little competition, there is almost no incentive to regulate effectively, and decisions and resources are dictated from above. Decentralization, or for that matter any reform that multiplies the loci of decisions (autonomization, corporatization, privatization), increases the numbers of transactions, independent decisionmakers, and alternatives to consider at each level. Providers can no longer survive without precise, up-to-date information on their cost structure and revenue prospects, and the public sector needs information to make sure that service and financial standards are being complied with. The amount of information generated is therefore endogenous to the system in place and the incentives it creates. Thus it is not surprising that the information systems in place in a centralized system fall far short of meeting the information needs in a decentralized system. Complaints of inadequate information may, ironically, be a sign of progress in decentralizing responsibility.

with a change of minister or other policies. In Brazil, Colombia, and Venezuela, for example, certification requirements include the following: a detailed yearly health operation and investment plan, the development of an information system, the incorporation of health personnel into state or municipal payrolls, and a working referral network. Most state and local plans are never implemented because states and municipalities control few of the inputs, except in the few fully decentralized states and municipalities in Colombia.

Finally, there has been a marked lack of interest by subnational governments in taking on the new responsibilities. To a large extent, this lack of interest results from a fear that the central government will not fulfill its financial obligations and a fear of having to deal with powerful health sector unions. In Argentina these fears also apply to hospitals that are in the process of obtaining autonomy from the provinces. In Colombia, for example, because of their desire to retain control over hospitals and budgets, departmental politicians have successfully resisted or slowed elements of the national reform to improve accountability of services to clients (by splitting provision from financing).

Conclusion

Overall, it might be argued that decentralization has damaged health care provision, at least in some Latin American countries. It is difficult to imagine that sharing responsibility for factors of production between levels of government, as is done in Bolivia, is conducive to improving the delivery of health services. Decentralization in Argentina and Mexico, which has consisted of transferring resources and responsibilities down one level of government, is equally unlikely to improve service delivery or contribute to containing costs. The perverse result of the partial decentralization that has occurred in many Latin American and Caribbean countries is that although some elements of management financing have been devolved, accountability has been dispersed.

These results are not the inevitable consequences of decentralization. They reflect the particular form in which decentralization has been implemented. Evidence from the six case-study countries suggests that improving the quality of health care will have to go beyond transferring assets and staff to municipal governments. It may require more fundamental changes in the role of the public sector, including an increased role for the private sector in the provision (as opposed to the financing) of health care, and a shift in the focus of government financing from inputs to outputs.

Happily, there are signs of movement in this direction. Brazil, as noted earlier, has already largely shifted to the private sector mode of production and output-based financing. (Government-owned hospitals in Brazil, however, continue to receive input subsidies from their respective subnational governments.) Chile has also introduced output-based financing for primary health care (although it recently shifted to a capitation-based reimbursement system for primary care, while introducing payments for DRGs in regional hospitals). In Colombia, public hospitals, which have adopted the form of Social State Enterprises under Law 100 of 1993, have a hospital directorate and director who can manage labor contracts, time schedules, and contract services. With the recent introduction at the provincial level of reforms giving more autonomy to hospital facilities, hospital managers are just beginning to have more power over personnel in Argentina (Abrantes and Díaz Legaspe 1999). These trends are perhaps indications that policymakers are coming to terms with the limitations of simply transferring assets and staff as a means of improving the delivery of health services.

Notes

1. One result was a vast expansion in output, resulting in a change of the financing system for municipal health services from fee-for-service to capitation in 1994. Public hospitals—as opposed to primary clinics—were transferred to the 25 quasi-autonomous health service units, which have been given less autonomy over personnel. Personnel are paid according to fixed payrolls, following pay scales and personnel administration rules that are established by the Ministry of Health. With the introduction of new payment systems (payments by DRGs), it was expected that personnel services could be included in the fee schedules. However, this has been difficult to implement.

2. This has led to some concern that Chile is developing a two-track system of health care, with high-quality care for those able to afford private insurance and inferior care for those who must rely on the publicly financed system.

3. One practical problem with this division of responsibilities between government levels—with hospitals devolved to states and primary health centers to municipalities—is that it complicates the workings of the referral system, however well it might have functioned previously. This occurs to a large extent because the financial transfers for states and municipalities are usually disconnected, with both receiving direct transfers, often by formula, from the central level to meet their specific service responsibilities. In addition, neighboring

municipalities find it difficult to develop compensatory economic arrangements to pay for services rendered to their residents in other jurisdictions (Argentina, Bolivia, Brazil, and Colombia). In practice, however, responsibilities among government levels have often been ill defined or have changed repeatedly over a short period, hampering the consolidation of institutional and other arrangements at subnational levels.

CHAPTER 6

Decentralizing Roads: Matching Accountability, Resources, and Technical Expertise

Over the past decade a wave of political and administrative decentralization has swept over Latin America. Today, local authorities are publicly elected in almost every country in the region, and local governments are responsible for the execution of a broad range of public functions previously handled by national governments. Decentralization has been pursued as a strategy to improve efficiency in the provision of public functions and reduce public sector spending, based on the principle that policymakers and public administrators make better decisions about how to use resources when they are closer to the level at which activities take place. However, acting in the opposite direction are the institutional capacity and human resource constraints that result from the loss of economies of scale as responsibilities are moved from the national to the local level.

It is easy and often misleading, therefore, to make simplistic statements about the desirability of decentralized sector management. The transport sector, with its "lumpy"" investments and combination of national, regional, and local interests, represents a particular challenge to decentralization strategists. Road, rail, port, airport, and mass transit systems all pose a series of complex issues that must be addressed in order to evaluate the costs and benefits of decentralization, and the preconditions and strategies for implementing it. In this regard, the road sector has been the focus of numerous decentralization efforts. This chapter will present the Latin American experience in road management decentralization, provide an analytical framework for the review of these experiences, and propose some directions for the future of the road sector based on the lessons from these experiences.

Decentralization in the Road Management Sector

Roads are an important part of any country's economy. They are a productive asset used for the transportation of 60 to 80 percent of passenger and freight cargo, and they often provide the only form of access to rural communities. As such, roads are at the heart of economic and social development. As Latin America continues to move toward regional market integration and strives to compete in the global economy, the extent and quality of its road network will need to grow, providing access to remote regions and increasing the mobility of people and goods within the region. Current road densities are still low compared with those of industrial economies, suggesting that access problems still exist and that future extension of the networks will be required.

Roads also represent an important proportion of public expenditures in the region, and in many cases they represent an asset value of up to 40 percent of annual gross domestic product (GDP). At the same time, road use generates significant tax revenues through the application of road user charges, such as fuel taxes, road tolls, vehicle registration, and license fees. Road construction and maintenance also contribute significantly to employment, especially in less-developed, labor-abundant countries. Overall, roads are big business, contributing as much as 6 percent to the total GDP.

Although significant improvements have been achieved over the past four decades in the expansion of road networks in developing countries, the sector confronts a persistent problem of inadequate maintenance of roads, which results in greater need for rehabilitation and reconstruction investments. Road agencies around the world have generally shown significant ability to build or improve roads, but have repeatedly faced difficulties developing and sustaining adequate maintenance practices. A decade ago worldwide estimates indicated that an estimated 15 percent of the capital invested in main roads in developing countries had eroded. This represented a loss of roughly US$43 billion, or about 2 percent of the countries' GNP at that time, a sharp contrast with the estimated US$12 billion in preventive maintenance that would have been required to keep the roads in proper condition (Harral and Faiz 1988). In Latin America, early in the l990s, it was estimated that it would cost about US$2.5 billion per year to deal with the maintenance backlog on the region's roads and to prevent further deterioration.

The persistence of maintenance problems cannot be explained solely as the result of a lack of technical capacity to carry out the necessary work programs. The road agencies that have been able to plan, design, and execute the significant number of road investments carried out in the past are certainly technically capable of performing the much simpler tasks of maintaining roads. A more broadly accepted explanation is found in the institutional framework within which roads are managed, and the distorted nature of the signals and incentives which these institutions receive. Road administrations have traditionally favored new construction over maintenance, a mentality often reinforced by political pressure. Funding has followed suit. Moreover, even when resources have been sufficient, funds are used inefficiently, especially in those administrations that depend on a "force account," that is, their own public sector labor force, to carry out works. Accountability to the road users is muted because of the indirect nature of the financing mechanism (general budget allocations), which is unrelated both to what users pay in terms of taxes and to increased vehicle operating costs of deteriorated roads.

A number of reforms have been applied in Latin America and elsewhere that are directed at improving the accountability of road managers and improving the responsiveness of road agencies to deteriorating road conditions. Decentralization of road agencies—devolving the responsibility for planning, building, and maintaining "non-national" and in some cases "national" roads to state and local governments—is one reform that has been pursued as a way of bringing road users and managers closer. The objective is to facilitate a greater correlation between the quality of roads that users are willing to support and those that are provided. There are a limited number of analyses of the impact of road decentralization. A World Bank review of 42 developing countries found that where road maintenance was decentralized, backlogs were lower and road conditions better. In the aggregate, the percentage of paved roads in poor condition dropped from 22 to 12 percent with decentralization, and the percentage of unpaved roads in poor condition dropped from 33 to 15 percent (*World Development Report 1994*; see also Humplick and Moini-Araghi 1996).

Nonetheless, the available experience with decentralization of road management in Latin America shows mixed results. While countries such as Argentina, Brazil, and Colombia have generally benefited from decentralized road management (mostly of secondary and tertiary networks), negative experiences have led to partial reversals of the process in Peru and Bolivia. This has created uncertainty in the sector about the merits of reform. There are many debates over the reasons for the success or failure of different decentralization experiences, and a deeper look into the nature of road management decentralization is required.

Several difficulties emerge in the attempt to understand the various factors involved. First, there is a need to be clear about which roads and which road management tasks are to be decentralized. Second, there has been little compilation of the experience in road decentralization across countries, and little data are available to assess the impact that decentralization may have had on the performance of the sector. Finally, parallel to decentralization, other reforms have been initiated including the practice of contracting road maintenance in place of using a force account, establishing road boards and related road funds, concessioning, and long-term, performance-based maintenance contracting, all of which increase accountability and provide a "voice" for road users, but whose benefits cannot easily be distinguished from those of decentralization.

This chapter seeks to address these issues by proposing a conceptual framework that can be used to understand the implications of road sector decentralization, and reviewing Latin America's experiences in road decentralization, in order to identify lessons and directions for the future of the sector. It argues that while decentralization can contribute to effective road management by bringing road users and managers closer together, there are a number of preconditions which must be in place or instituted as part of a longer-term strategy to ensure the realization of projected benefits.

In Search of a Model: The Latin American and Caribbean Experience

In general, three broad organizational systems can be identified for the management of road networks:

- Centralized systems, in which the network is managed by a single, national road agency (as in the Dominican Republic);
- Deconcentrated systems, in which regional agencies reporting to the national agency are set up to manage parts of the road network (as in Chile); and
- Decentralized systems, in which local or regional agencies are placed under the jurisdiction of subnational governments to manage parts of the network (as in Argentina and Brazil).

These organizational systems usually reflect the broader political organization of the country. Countries with a centralized system of government will normally exhibit a centralized road management system. Similarly, countries with a high level of political decentralization and strong subnational governments will usually have decentralized road management organizations. A discussion of road management decentralization, therefore, must take into account the broader context of the country's political organization, and considerations of country size, population distribution, and the complexity of the road network. The major challenge for Latin America is to determine a strategy and establish an appropriate set of policies for countries that are in the process of decentralization. In most instances, decentralization of roads is part of a broader political and fiscal decentralization, with limited attention paid to sectional conditions. The lack of an effective strategy for transition in the sector has been the major weakness in most of these initiatives.

What is Decentralization in the Road Sector?

Decentralization in the road sector entails the assignment of full responsibility for specific roads to subnational levels of government. Full responsibility in the road sector involves a combination of road functions, management tasks, and financing mechanisms that are closely interrelated to ensure the integrity of the road network. The first step toward understanding decentralization in the road sector is to clearly define what it is that is being decentralized. This requires the separation, or "unbundling," of the different building blocks that comprise a road management system and which could be subject to decentralization. Thus, our conceptual framework for the analysis of road sector decentralization is based on the separate treatment of three building blocks of effective road management: road functions, management tasks, and financing mechanisms.

Road Functions

Roads are classified by different levels according to their function. The function of a road refers to the role it serves within the network and the predominant type of demand by its users. Is it a road that mainly serves a national purpose (such as connecting major cities with key border points for trade), or is it a road that mainly serves local needs (such as getting locally produced goods to local markets)? This distinction helps to identify the constituency that cares the most about the characteristics and conditions of that road. Four different levels of networks are identified here:

- National networks (primary or main trunk), made up of roads that play a function of national interest that goes beyond the interests of the immediate communities near the road;
- Regional networks (also known as secondary, departmental, or state networks), consisting of interurban and rural access roads that benefit mainly the broad communities of a region, state, or province;

- Rural networks (including community roads, tracks, and trails), which provide access to outlying rural communities; and
- Urban networks (in turn divided into metropolitan and large urban, medium-size urban, and small urban networks), which provide circulation within cities and towns.

Conceptually, responsibility for roads should be assigned to the level of government that represents the community of users who benefit most from the road. In practice, however, gray areas exist regarding the designation of some roads as national or regional, and others as regional or rural, mainly due to the difficulty in distinguishing among the various users and their travel purposes. Many roads often serve both local and national traffic. Moreover, political considerations often play a significant role in the final designation. Local representatives will often lobby for inclusion of much of their network within the national network as a means of ensuring national funding.

There are a number of considerations in defining each type of road classification and the political, technical, and financial issues involved. For the purposes of this chapter, the focus is on the national and regional networks rather than on the rural and urban networks. Generally it is accepted by sector professionals that rural and urban roads should be devolved to state or local governments, although there remain issues of financial sustainability of such arrangements. The key debate, however, is over the national and regional networks.

Management Tasks

The second element of road decentralization is the transfer of managerial responsibilities for the roads placed under the jurisdiction of subnational governments. In the management of road networks, four clearly distinct tasks can be identified:

- Planning of road investments, which includes the definition of future network requirements and the establishment of priorities for investment;
- Rehabilitation and construction of roads, which includes detailed engineering and the contracting and supervision of works;
- Operation and maintenance of roads, which includes periodic and routine maintenance, signaling, and sometimes policing; and
- Formulation of policies and regulations, including regulation of road characteristics to ensure network connectivity and safety standards, and ensuring compliance with social and environmental regulations.

Table 6.1 presents a framework for the consideration of options for the decentralization of management tasks in the road sector. Again, the general principle is that managerial responsibilities for a road should be given to the level of government most associated with the predominant users of that road, as a means of ensuring greater efficiency in the establishment of priorities and the corresponding allocation of resources.

Concerns are often raised, however, about the lack of technical and legal capacity to absorb these tasks and the loss of economies of scale. Indeed, smaller countries with more limited secondary networks are not decentralizing road management. Experience has shown that transferring responsibility for roads from one inefficient public agency to another will not provide the necessary benefits. A range of technical capabilities is required to manage roads, including planning expertise and traffic engineering, investment analysis, engineering design and costing, and works planning. Changes in the use of the private sector have begun to alter the skill mix required in public agencies, reducing some of the in-house capacity previously considered necessary. Many agencies had depended on their own staff (force account) to carry out maintenance works with the inefficiencies associated with excess staff and no fuel or deteriorating equipment. Over the last decade, governments have contracted out such works to private contractors, which has increased the need for contract management over works management skills. There have been similar contracting arrangements for design and other services. This reduces some of the technical demands on decentralization.

Another related option has been to maintain ownership at one level of government while delegating certain road management tasks to another level. Construction and maintenance activities can be delegated from the national to the regional governments, in the case of the national network, to take advantage of economies of proximity. This is especially true in larger countries with the understanding that sufficient funding is provided by the delegating level of government. Delegation can also take place from the municipal governments to a regional or multi-municipal entity to achieve economies of scale and enhance network coordination. The delegation of maintenance

TABLE 6.1
Decentralization Options for the Road Sector

	PLANNING	CONSTRUCTION	MAINTENANCE	REGULATION
NATIONAL NETWORK	• Central	• Central • Concession • Rehabilitation and maintenance contract • Delegation to regional agency	• Central • Concession • Service contract to private sector • Delegation to regional agency	• Central
REGIONAL NETWORK	• Regional	• Regional • Concession • Rehabilitation and maintenance contract	• Regional • Concession • Service contract to private sector	• Regional
RURAL NETWORK	• Regional • Municipal • Delegation to regional agency	• Regional • Municipal • Delegation to regional agency	• Regional • Municipal • Delegation to regional agency	• Regional • Municipal • Delegation to regional agency
URBAN NETWORK	• Municipal • Multimunicipal (metropolitan)	• Municipal • Delegation to regional agency	• Municipal • Delegation to regional agency	• Municipal • Delegation to regional agency

functions to state governments is the most prevalent of these possibilities.

Financing Mechanisms

The third building block of road management is the financing arrangements for the construction and maintenance of the various road networks. It is perhaps the most controversial element and is essential for setting the right institutional incentives and ensuring the sustainability of the decentralization process. Perhaps the most common complaint of local authorities toward road decentralization is that responsibilities are being transferred to them without the transfer of sufficient resources to carry them out. Without careful consideration of what sources of funding to use and how to allocate funding for the different networks under decentralized systems, the objective of increased accountability can be jeopardized.

There are three major mechanisms for funding roads: budgetary resources, road funds based on assigned user-charge revenues, and tolls. The dominant source of funding for roads is the government budget. Where this method is used, road users have an impact only insofar as there is an effective representative governance system through which expenditure priorities are determined. When road management is decentralized, budgetary financing can be provided from either central or subnational revenues. Financing from central government revenues—that is, through transfers—has some advantages. Earmarked transfers allow the national government to monitor the ability and commitment of local governments to meet minimum standards. Full funding through transfers, however, raises concerns about local commitment. The depth of decentralization can be measured by the percentage of expenditures financed locally. A mixture of national transfers combined with a significant local contribution, assuming local ability to raise such funds, should offer the greatest balance between local ownership and efficient reliance on user charges. It also provides a basis for the national government to monitor progress and adjust incentives and technical assistance as required.

Using road funds is another means of implementing the user-pays principle, although indirectly. The funds are generally financed from revenues generated through user charges collected at the national level, mainly fuel taxes. Established at the national level, their use is often restricted to maintenance. Formulas are often agreed upon for the allocation of the money among the different networks and the corresponding levels of government. Transport sector professionals have promoted funds as a means of ensuring adequate and stable funding for maintaining existing road networks. Experience, however, has shown such funds to be highly sensitive to macroeconomic shocks. Thus, rather than protecting road maintenance from budgetary fluctuations, in practice, they have exacerbated it. Finance ministries have also complained of a lack of clear accountability in the use of such funds. More recently, a new generation of

BOX 6.1

The New Generation of Road Funds

Key principles for road fund viability:

- The road fund should be part of a wider agenda to commercialize road management.
- Only road user charges should be paid into the road fund.
- The arrangement must not subtract revenues from other sectors (additional spending on roads must come from extra payments by road users).
- The road fund should be overseen by a representative public/private board with members appointed for three- to four-year terms.
- The road fund should be managed by a strong, independent secretariat, separate from the main road agency.
- Independent technical and financial audits must be carried out.

Key operational features of the road fund:

- Use of funds is usually restricted to financing maintenance activities.
- The road fund should fully finance the expenditures associated with the national network.
- Regional and municipal road expenditures should be financed only through transparent cost-sharing arrangements that strengthen financial discipline.
- Subsidiary road funds may be set up to finance urban or rural roads.
- Revenues should be collected using a tariff consisting primarily of a fuel tax, vehicle registration fees, a supplementary heavy-vehicle fee, international transit fees, and fines for overloading.
- There should be consistent procedures for raising and lowering the tariffs.

*Source:*Heggie and Vickers 1998.

road funds has been developed (see Box 6.1) which incorporates a more robust accountability mechanism by creating road boards to manage the funds. The road boards include representatives of the various affected road users and of the public sector, and offer a management framework in which the users have a voice. It is still to be seen how these boards and related funds will evolve over time and whether they will be able to maintain a representative and dynamic exchange between the users and providers of road infrastructure.

The use of tolls offers a clear application of the user-pay principle by being location specific. Thus, toll roads have been the basis for concessions to the private sector, which is the purest form of commercialization of road management. Indeed, users in Latin America and elsewhere have given clear signals of their dissatisfaction when faced with what they consider high tolls for a poor level of service. However, tolls are only viable on very high-traffic segments of the network (generally above 5,000 vehicles per day). On low-traffic segments, which is the case for most state and local roads, the cost of collection is too high (and therefore inefficient) compared with other tax options.

Road Decentralization in Latin America

Over the past 10 years, the majority of countries in Latin America have decentralized road management responsibilities for non-national roads. Today, approximately 80 percent of the roads in the region are under the responsibility of subnational governments. The exceptions are Chile, which has a deconcentrated road organization, and small countries with a centralized political organization (such as the Dominican Republic, Honduras, and Uruguay). In this section, we review some of the Latin American experiences with road management decentralization in order to extract lessons and make recommendations for the sector.

Testing the benefits of decentralization is difficult. As indicated earlier, the main weakness in road management has been the lack of maintenance. Thus, the key measure of success would appear to be the condition of the network before and after decentralization, as indicated by a series of engineering indexes. While this measure is essential, it is complicated by the need to define what is an appropriate, economically viable condition. Roads with lower-traffic volumes do not warrant the same level of maintenance or condition as roads with higher-traffic volumes. One would also want to test the cost and efficiency of maintenance. Unfortunately, not enough data are readily available to properly compare the performance of road agencies in Latin America. This is particularly the case where road management decentralization has taken place, since it makes it harder for national agencies to collect and organize data from the various regional agencies. Nonetheless, some clear observations can be made based on a review of some of the experiences in the region.

Where Political and Fiscal Decentralization is Well Established

Road decentralization has worked best when it has been implemented in a country where political and fiscal decentralization is mature and well established, and where it is treated as part of a set of sector reforms that include (a) a clear separation of institutional responsibilities between different levels of government and (b) the establishment of adequate mechanisms for financing road maintenance and investment. This is illustrated by the Argentine experience.

Argentina has a federal system of government, with 24 provinces. The country's road network is classified into national, provincial, and municipal roads. The National Road Directorate (Dirección Nacional de Vialidad [DNV]) is responsible for management of the national network, while each province has its own Provincial Road Directorate (Dirección Provincial de Vialidad) for managing the provincial networks. Municipal networks, including urban and rural roads, are the responsibility of municipal governments. Each level of government is responsible for financing road maintenance and rehabilitation of its corresponding road network, with resources coming from general revenues and from the revenues generated by the application of road-user charges. Since revenue generated by a fuel tax is collected at the national level, the federal government transfers funds to provinces and municipalities according to a transparent formula agreed to by all and monitored by the Federal Road Council (Consejo de Vialidad Federal [CVF]). The CVF serves as a forum for the coordination of national and provincial agencies, mainly regarding the planning of new roads and the appropriation of earmarked funds from the fuel tax revenues for road investments at the provincial and municipal levels. These transfers account for about 35 percent of the resources used by subnational governments for roads, evidencing the high level of local ownership over the local road networks. Funds for the national network are provided from direct user charges (tolls) and from the national government's general revenue.

Argentina's decentralized system of road management has been successful in ensuring adequate maintenance of the road network at the various levels. The division of responsibilities between levels of government has been stable over the last 10 years, as has been the financing of the sector. At the national level, there has been a clear trend toward increased use of private sector contracting for road maintenance. Current discussions in the sector focus on the extent to which concessions can be used for the development of new roads and on the sustainability of contracts with the private sector in the event of macroeconomic instability or external shocks.

Brazil's experience also shows that when a clear separation of institutional responsibilities is made and adequate financial mechanisms are put in place, the decentralization of road management results in improved road conditions. Brazil is also a federal system, organized into 27 states with strong traditions of regional government. In 1988, a new constitution gave ample powers to the states to raise their own taxes, including a fuel tax. Until then, most taxes had been centrally collected and then partially redistributed to the states (this included fuel and vehicle taxes, which were partly earmarked for roads and redistributed to the states through a formula). The new constitution transferred some taxes to the states and municipalities, including a consumption tax (similar to a value-added tax) and the fuel and vehicle taxes. Earmarked funds were terminated. Expenditure responsibilities, however, remained unchanged. The state governments, now funded through their own consumption taxes and transfers from federal tax revenues (income and industrial taxes), have increased their revenues. However, the combination of excessive staff, high debt, and the disappearance of the inflation tax (after the implementation of the Real Plan in 1994), left few states with sufficient resources for investment. Nonetheless, although important regional differences in institutional and fiscal capacity exist, the states have assigned a high priority to road maintenance and rehabilitation, and most of them have been able to raise adequate funds in spite of important fiscal constraints.

Brazil's experience illustrates the complexities of decentralized road management. In Brazil, the granting of additional fiscal powers to the states was unrelated to the allocation of responsibilities for road management, even though one of the key new revenue sources (the fuel tax) was directly associated with road use. The National Roads Department (Departamento Nacional de Estrada de Rodagem) remained responsible for over 67,000 kilometers of federal roads, even though it had lost the significant revenues from the fuel tax. Between 1990 and 1997, however, the conditions of the federal network improved, reducing the number of kilometers of paved roads in poor condition from 30 to 11 percent. These improvements have been financed from federal general revenue, which demonstrates the priority of the sector relative to other sectors.

A recent review of the federal network based on road functions suggested that about 18,000 kilometers should be reclassified as state roads. This is the next challenge for the road sector in Brazil. The states have shown interest in assuming responsibility for additional roads, but have expressed concern about the poor condition of the roads that are to be devolved. Agreements have been reached between the federal and some state governments for the rehabilitation and subsequent devolution of the roads that are not of national interest. Federal roads have also been delegated to some states for their subsequent concessioning by the state governments. However, the sustainability of some of these agreements is still uncertain. These situations emphasize how difficult it is to establish and maintain a clear classification of road functions when different levels of government share network responsibilities. In the end, the challenge is to establish transparent financing mechanisms for road management (maintenance, rehabilitation, and new investments) that correspond to the allocation of responsibilities across the different levels of governments (the principle that "finance follows function") and provide the right incentives for the behavior of road agencies.

Dangers of Rapid Decentralization

Both Argentina and Brazil are countries with long-standing traditions of decentralized government and exhibit strong regional governments with relatively high levels of institutional capacity. Naturally, we expect decentralized road management to work best under such circumstances. Elsewhere in the region, decentralization of road management has taken place over a rather short period of time, usually concomitant with a broader process of administrative decentralization. Under such circumstances the challenges are greater and so is the risk of failure. Therefore, prudence suggests a gradual approach, which is supported by the available evidence. The arguments in favor of a gradual approach to road decentralization are strengthened by the experiences in Peru, Bolivia and Venezuela with rapid, wholesale decentralization.

In Peru all roads were transferred in 1984 to the recently established regional governments, including portions of the national network that had profitable tolls. The recurrent use of toll revenues to finance activities outside the road sector led to inadequate road maintenance and the decay of key portions of the national network. As a result, in 1991 the national authorities decided to recentralize the national network. While 78 percent of the total road system remains in the hands of the regional and local governments, regional agencies are poorly funded and institutionally weak. Today, they depend heavily on technical and financial assistance (and at times direct involvement) from the Ministry of Transport for almost every important activity. Road conditions in key sections of the national network have improved since recentralization, but the majority of the roads are deteriorating beyond the capacity of the central ministry to respond.

In 1995 Bolivia embarked on a broad process of administrative decentralization. The road sector had been originally organized in a system of nine deconcentrated districts under the national roads agency (Servicio Nacional de Caminos), which was responsible for the primary and secondary networks and some municipal roads. With decentralization, these organizations were placed under the jurisdiction of the regional governments *(prefecturas)* In addition, a number of regional development corporations that had been partially responsible for the tertiary network were pulled out of the sector. The Ministry of Transport, reorganized as a secretariat under the Ministry of Economic Development, received an unclear mandate and lost considerable power and support at the national political level. While the entire network was being transferred to the prefecturas at the same time that other sectors were being decentralized, no source of financing other than tolls was provided. Many of the experienced staff of the deconcentrated districts retired or left the sector during the reforms, leaving the departmental agencies with few resources for managerial and road maintenance practices. As a result, road conditions deteriorated to such an extent that in August 1998 the central government decided to step in and take back the management of the national network.

The Venezuelan experience, a case of mixed results, also deserves attention. The Decentralization Act of 1989 brought broad political decentralization to the country and established the responsibilities of the municipal, state, and national governments in a number of aspects of public life. With respect to roads, the Act permitted states to have "exclusive or shared" jurisdiction over all primary and secondary roads, bridges, ports, and airports in their territories. It also established that (a) any transfer of responsibilities from the central government would take place through negotiated agreements, and (b) the states would annually prepare coordinated investment plans consistent with specific amounts to be provided by the central government.

Benefits to National Networks of Devolving Non-National Roads

Decentralization of secondary and municipal networks as a first step in the process of reform has contributed to the clarification of the roles and responsibilities of the various levels of government, directing political attention from each level of government to the corresponding network level. In this respect, the first positive impact of decentralization of regional and municipal roads is that it serves to keep local politics at the local level, thus protecting the national network from political pressures that tend to divert resources and managerial attention to issues that are not of national importance.

The Colombian experience illustrates this point. In 1993, 32 percent of the road system under the national government was transferred to the regional departments under an arrangement that included agreed financing for operation and maintenance for three years. As a result of this transfer, the national road agency was able to focus on the improvement of the national network. Within five years, the national network has become a well-defined system of trunk roads and corridors, and rehabilitation and maintenance practices have improved significantly. This is clearly a positive effect of decentralization, even if somewhat counterintuitive. In contrast, departmental road agencies showed weak administrative and technical capacity, and conditions of the regional and local networks remained poor. The challenge under these circumstances was to strengthen institutional capacity and to set up adequate and reliable financing mechanisms at the local level in a relatively short period of time. Otherwise, there was a risk that public pressure would mount for the national agency to retake the roads, resulting in the reversal of the decentralization process.

Almost 10 years later, the results of this arrangement have been mixed. Local governments have proven to be better able to manage the road network than was the Ministry of Transportation, but most states face institutional and financial challenges to various degrees, which may threaten the sustainability of the reforms. One of the main problems is that financing for the sector varies significantly from year to year due to fluctuations in the value of oil exports (which are the source of over 50 percent of total public sector revenues) and the absence of significant road-user charges. In addition, significant differences exist in the institutional and fiscal capacities of the 23 states. As a result, this demand-based decentralization process has produced important discontinuities in the conditions of the national network, because many states have not been willing or able to fully assume their responsibilities Therefore, it is not yet clear whether this process will be sustainable over the long term. This experience highlights the importance of clearly separating the roles and responsibilities of the different levels of government, setting up adequate financing mechanisms for the sector based on road-user charges, and taking measures to preserve the connectivity of the overall road system.

Contribution of Parallel Reforms

In addition to establishing a clear separation of responsibilities between levels of government, road agencies in the region have made strategic use of the private sector for the management of high-volume roads, awarding long-term concessions for their rehabilitation and maintenance. Private sector participation has been sought as a tool to (a) secure adequate technical and managerial capacity for road management (maintenance, rehabilitation, construction); (b) establish clear accountability for performance; and (c) provide adequate financing for road management through commercialization of road use.

As discussed earlier, concessions are the purest form of road commercialization. In the 1990s more than US$35 billion has been infused into the road sector through private sector concessions in 13 countries in Latin America. The leaders in this area have been Mexico (53 concessions), Argentina (19 concessions), Colombia (12 concessions), and

Chile (10 concessions). The broad experience in the region with road concessions confirms that the commercialization of roads does have a number of positive results:

- Projects are completed on time.
- Modern technologies are applied.
- Higher road standards are achieved and maintained.
- Additional services are provided to users (for example, service stations and emergency attention).
- Additional financial resources are made available.
- Greater clarity is achieved in the analysis of the risk associated with investments.

However, the results have not always been positive. It is clear that the applicability of this model is limited due to high-traffic volume required to be financially sustainable, even with government guarantees or subsidies. The process of concessioning requires careful design and execution to ensure that the expected benefits are realized. Furthermore, due to the long periods of time required for the recovery of investments (often 20 years), concessions are highly vulnerable to macroeconomic fluctuations and require a clear and reliable regulatory framework to avoid uneconomic results.

As an alternative to road concessions, long-term, performance-based rehabilitation and maintenance contracts (Contrato de Recuperación y Mantenimiento [CREMA]) were introduced by Argentina's Dirección de Vialidad Federal (DNV) in 1997. The CREMA is a long-term, performance-based contract with a private firm designed to secure funding for road maintenance while creating incentives for cost-effectiveness and promptness in the execution of works and routine maintenance activities. Since 1997, 61 CREMA contracts have been awarded in the country, covering 12,000 kilometers, with an average cost of US$11,000 per kilometer per year (including rehabilitation and maintenance). Box 6.2 presents the key features of this new instrument. The CREMA model is also being implemented in Chile, Colombia, Guatemala, Paraguay, and Uruguay.

BOX 6.2

Key Features of the Contrato de Recuperación y Mantenimiento (CREMA)

Activities include:	Contract combines initial works (rehabilitation of roads, signaling, and surroundings) with road maintenance activities over the duration of the contract.
Payment:	Contractor is paid a fixed amount for the achievement of predetermined standards for road conditions: usually up to 45 percent for the execution of initial works during the first year and the balance in equal monthly payments during the remaining period.
Quality standards:	For paved roads: International Roughness Index below pre-established ceiling, no potholes allowed, maximum times established to correct cracks and other problems, execution of agreed maintenance activities, signals, drainage, surroundings, and other aspects.
Duration:	Usually four to five years. Length of contract provides incentives to ensure adequate quality of works, planning, and equipment of the contractor.
Award:	Contract is awarded through competitive bidding to the lowest bidder.
Road agency role:	Delegates operational responsibilities to the contractor (that is, planning and execution of works, selection of technical applications). Role of the road agency shifts to conceptual (and sometimes detailed) design of project, plus supervision and regulation of contracts.

Delegation of National Roads

As the capacity of local agencies improves and the national mechanisms for the collection of road-user charges and the allocation of funds across networks become more reliable, national authorities have also considered the delegation of management tasks to regional agencies under performance-based contracts with well-defined sources of financing. For example, Argentina's DNV was reorganized in 1992 and given a mandate to gradually involve the provinces in the operation and maintenance of the national network. Since 1995, routine maintenance of about 7,000 kilometers (25 percent of the national network) has been delegated to the provinces through two-year, activity-based and unit-price-paid contracts. To a lesser extent, a similar experience is taking place in Brazil, where the authorities are discussing the merits of completely delegating the management of the federal network to the states. These experiences, however, have come after the states (or provinces) developed a reputation for effective management of their regional networks. The experience of the region strongly suggests that considerations about the decentralization or delegation of the national network should really take place after the decentralized management of regional and municipal networks has been completed consolidated.

Conclusion

It is clear that although the concept of decentralization is accepted as a means of increasing road users' control over road management decisions, in practice, the results have varied widely. Much of the variation can be attributed to the fact that the main impetus for decentralization has come from the broader macro and political democratic initiatives that were not specifically designed for any one sector in particular. As a result, the transport sector has had to adapt to the various systems that have evolved. There are countries that have begun to show positive results (for example, Argentina, Brazil, and Colombia), and there are countries that have had to seriously reconsider and reverse course. (Bolivia and Peru). These cases, however, offer a set of lessons on which to build future initiatives as decentralization spreads throughout the region.

There has been a marked change in the attitudes of most national governments toward the importance of maintaining their road systems as well as the costs of neglecting them. In the past decade, Latin American countries have pioneered a wide range of efforts to address road network deterioration through a combination of strategies that has included institutional strengthening, concessions and service contracts to the private sector, increased budgets and dedicated trust funds, and decentralization and delegation of responsibilities to subnational governments. The most striking result has been the visible improvement in several countries of the conditions of the national (primary) road network. Although it may be difficult to attribute this result to decentralization, it does appear that decentralization has played a role in the process by allowing central agencies to concentrate human and financial resources on a more limited network of national roads. Just being able to draw a political firewall between the national and local networks seems to provide benefits that are reinforced through the institutional reforms of national road agencies and, in particular, through the move away from force account to private contracting.

The evidence of the impact of decentralization on state and local roads, however, is less clear. It is probably premature to draw any conclusions at this point, because the reforms are less than a decade old, and the development of local governance and technical and managerial capabilities at the local level takes time. In those countries with more developed forms of local governance, road sector decentralization has been more successful. The danger is that inadequate design of decentralization strategies in other countries will lead to frustrations and disincentives that could jeopardize the whole process.

From the experience in Latin America and elsewhere in the world, a number of preconditions can be established as critical to the success of a road decentralization program:

- Decentralization of road management can take place only where there is an adequate level of local governance in terms of legal, financial, and community participation.
- When there is little tradition of decentralized governance, a gradual approach to road decentralization should be followed, transferring first responsibilities for regional and urban municipal roads, while retaining management of the national network at the national level.
- When decentralizing road responsibilities, the designation/classification of road functions should be clearly related to the assignment of political responsibility for the roads. Municipal roads should be placed under

municipal governments, state roads under state governments, and national roads under national governments.

- Similarly, the management responsibilities associated with the roads to be decentralized (planning, construction, operation and maintenance, and regulatory policy) must be clearly designated, avoiding overlaps among the responsibilities of different levels of government.
- The mechanisms and framework for ensuring adequate financial resources should also be aligned with the devolution of responsibilities. They should be structured to reflect local commitment to road maintenance and development, and to allow for cross-regional redistribution of resources in order to maintain national standards and network connectivity.
- Special attention should be given to the assessment of technical capabilities of the receiving institutions, and the time frame for devolution should recognize the need for the transfer of technology and the dynamics of capacity development.
- A system of monitoring, with physical and financial accountability, should be put in place, in order to have sufficiently accurate information about the progress made and the difficulties encountered, so that corrections can be implemented promptly.

The process of road decentralization should include formulating an implementation strategy to carry out the reform within a time frame that takes into account the effort required to put these preconditions in place. Within countries, the capabilities of local governments, whether states, provinces, cities, or municipalities, will vary considerably. Experience shows that it is possible to move more aggressively in certain localities, while taking a longer-term strategy for those localities that require support in any of the key areas.

The most difficult but essential elements, however, are creating the financing mechanism and designing the national-to-local resource transfer mechanisms. As has been said earlier, the difficulty arises from the indirect nature of the user-charge instruments for raising road revenues, most of which accrue to the national government and are then transferred through various approaches to local governments. Moreover, the design of the transfer mechanism must be consistent with the overall transfer of resources under the decentralized regimes, many of which have been criticized for not being sufficient or equitable and are seldom related to road planning and management. This chapter has identified several new instruments that are directed at making such transfers more transparent, and that incorporate the views of the users in a framework that holds road agencies at the national and local level accountable to the public. The challenge will be to see how these various initiatives perform under the strains of macroeconomic and political instability.

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