Decentralization strategies: from “best practice” to “best fit”. The case of Bolivia

Jonas Frank

A. Introduction

Decentralization is transforming the structure of government in Latin America. Since the early 1980s, nearly all countries have seen a transfer of political, fiscal, and administrative powers to subnational levels of government. Often this was done with so-called “big-bang” reforms which aimed at sweeping changes in the exercise of power. Such strategies are now largely a phenomenon of the past; except for countries like Nicaragua or Bolivia, today only a few countries do decentralize aggressively and on a large scale. Most countries are busy with detailed implementation, administrative adjustment, fine-tuning, or, on the contrary, with fiscal damage control or even re-centralization. Still, Latin America is the most decentralized region in the developing world; in average about 25 percent of expenditures being executed from subnational levels.¹

The lessons from this first wave of decentralization have led to a catalog of key advice and principles that today are widely accepted and recognized. Resources and functions should be transferred together. Governments should honor the budget constraint. Politicians should be held accountable for their actions. Basic institutional capacity needs to be in place. Experts and practitioners debate whether regions or municipalities should be the focus of decentralization, but all agree that responsibilities among levels of government should be clearly delineated. Any country that does all this can reap the potential benefits of decentralization.

Yet in many countries there is growing awareness about the existing mismatch between the decentralization principles on the one hand, and outcomes on the other hand: in terms of efficiency, accountability, and better services for the people. There is growing awareness that the political economy of interests of stakeholders, incentives, as well as the institutional context, are limiting factors for “successful” decentralization. While there is more and more consensus about “what” should be done, there is more and more uncertainty about “how” it can be achieved.

In recent years, the World Bank has made a concerted effort in understanding these constraints. From civil service to budget management, from tax reform to decentralization, there is evidence that political economy constraints and incentive problems undermine successful implementation of public sector reforms. In a number of Latin American countries, Institutional and Governance Reviews (IGR) have been conducted that try to shed light on these limiting factors. The rationale behind this effort is to understand how incentives within each country determine the path of implementation—and reform outcomes eventually. There are important lessons learned: not only should reform strategies be adapted to the specific country context; more importantly, in designing reform strategies “best fit” should be given prevalence over “best practice”.

The goal of this paper is to discuss what “best fit” and the “fitting process” means in the implementation of decentralization. In a recently published Institutional and Governance Review titled “Towards an Inclusive Decentralization,” the World Bank applies this approach to Bolivia. In this country decentralization lies at the core for improving governance, regional equity, and service

¹ There are however, huge variations in the degree of expenditure decentralization: roughly 48% in Argentina; 40% in Brazil; roughly 25% in Colombia; 10% in Ecuador, and less than 5% in most Central American countries.
delivery. Due to the complex incentives present in the Bolivian public sector, this country is a suitable case to discuss how such a “best fit”-approach could look like in practice. The policy options that were recommended for Bolivia in the aforementioned report are contained in Annex Table 1. This paper, in turn, will discuss five areas of reform that are particularly relevant for decentralization: expenditure assignments, intergovernmental transfers, regional taxation, subnational debt, and institutional capacities. The rest of the paper is structured as follows: Section B provides the background of decentralization in Bolivia. Section C discusses five decentralization issues and “best-fit”-approaches to address them. Section D provides the conclusions and main findings.

B. The Decentralization Challenge for Bolivia

Bolivia is in the process of further decentralizing power and resources to subnational governments. This is taking place against the backdrop of the 1994 decentralization to the municipalities, the recent first popular election of governors, a referendum on regional autonomy held in July 2006, and the Constitutional Assembly initiating in August 2006. These developments are also occurring in the new environment created by the election of President Evo Morales, who took office in January 2006 as the country’s first indigenous leader.

The first phase of decentralization started in 1994 and was municipal in nature. Municipalities now play an increasingly important role in public service delivery. The second phase is now focusing on strengthening the regional level of government. The driving force of this second phase is the struggle over dividing the natural resource pie, which has taken the cloak of a demand for greater regional autonomy\(^2\) (autonomías regionales) and the proposed withholding by departments of a share of “locally produced revenue.” These proposals are based on the questionable use of information comparing amounts of central or total government taxes collected with a region’s expenditures.\(^3\) The issue is particularly strong in the resource-rich regions, which want to keep control over and decision-making about these resources for themselves as much as possible through the decentralization of responsibilities.

As a result of the thrust for decentralization, two decisions for decentralization have already been taken for this second phase:

- The popular election of prefectos. This is a milestone in the process as historically regional governments were never elected, and the prefectures will de facto be autonomous, irrespective of the decisions of the Constitutional Assembly.
- The new Hydrocarbon Law (HL) will provide roughly two-thirds of additional tax resources (an estimated US$240 million in 2006) to the regions and municipalities without transferring new responsibilities.\(^4\) As a result of the transfers, the degree of fiscal decentralization is deepening (Table 1).

\(^2\) Before proceeding, it is good to emphasize that there is a great deal of ambiguity in the way some words are used in Bolivia. The word autonomía, which one can translate as “autonomy,” is much used, as is the word “decentralization.” Decentralization tends to conjure up connotations of moving the control of government services from the national to the regional level and shifts in the locus of responsibility for raising taxes or undertaking expenditures. Though these things are on the table it is not clear that this is what the debate is really about or what people are thinking of when they demand or reject autonomía. Indeed, demands for autonomy seem to be for fundamental changes in the balance of political authority.

\(^3\) Some of the assertions derived from these comparisons are erroneous. Among other factors, saying that a region should retain a certain share of total taxes paid in it confuses local and national taxes. It is inappropriate to equate central government taxes collected in a territory with the central government taxes produced by activities of households and enterprises in that territory.

\(^4\) These new revenues to the regions and municipalities could increase significantly as an immediate effect of the nationalization of hydrocarbons recently made by the Government.
As a result of the entry points for decentralization that were selected there is a new incentive context in Bolivia. The election of the new regional government leaders has enhanced democratic participation. But this will also bring nine new bargainers to the table seeking greater shares of the national resource pool. The challenge for the country is now that this will make it more difficult to agree on the size of national public goods, like macroeconomic or fiscal stability. It will also limit the redistribution of resources among regions for better service delivery. Likewise, political decentralization may lead to additional spending pressures in the absence of rules and incentives for fiscal responsibility.

At the same time, municipalities perceive regional decentralization as a threat to their power. After all, municipalities have secured a “first-mover advantage” over regional governments in the initial phase of decentralization starting 1994. They were strengthened through the Law of Popular Participation, and are now naturally perceive an increased role of departmental governments as a threat to their resources and political power. This distributional conflict among regions and municipalities is also evident in how expenditure responsibilities could be assigned to each level of government.

As will be outlined with more detail further below, there are five key challenges for Bolivia:

(i) how to clearly align expenditure responsibilities of the different levels of government, in the context of unhealthy competition among departments and municipalities;
(ii) how to create tax income for departmental governments in light of fiscal constraints;
(iii) how to improve redistribution through the transfer system which is highly unequal;
(iv) how to ensure fiscal responsibility particularly in the take-off period when pressures to spend will be substantial; and
(v) how to assure minimum institutional capacities and transparency is in place, previous to deepening decentralization.

These challenges are all the more difficult to address due to the following three constraints: (i) the struggle over natural resources; (ii) the poor quality of public services; and (iii) the tight fiscal space. This environment set limits on the options for decentralization as some of its elements are mutually inconsistent: reducing public expenditures is not easy to reconcile with improving public services;

| Table 1. Decentralization Ratios Before and After the Hydrocarbons Law, 2004–2006 |
|---------------------------------|-----------------|-----------------|
| **Regions (prefecturas)**       | Before (percent, 2004) | After (percent, 2006) |
| Expenditure decentralization ratio  | 8.6          | 13.2          |
| Tax decentralization ratio       | 0.5          | 0.4           |
| Transfers dependency ratio       | 96.6         | 99.3          |

| **Municipalities**             |                          |                          |
| Expenditure decentralization ratio  | 18.3         | 21.5         |
| Tax decentralization ratio       | 5.4          | 4.5           |
| Transfers dependency ratio       | 67.6         | 74.2          |

| **Sub-national governments**   |                          |                          |
| Expenditure decentralization ratio  | 26.9         | 34.7         |
| Tax decentralization ratio       | 5.8          | 4.9           |
| Transfers dependency ratio       | 66.6         | 73.1          |

Notes: \( a = \text{expenditures of prefecturas}/\text{total public sector expenditures}; b = \text{taxes of prefecturas}/\text{total taxes of public sector}; c = \text{transfers}/\text{total resources. Analysis in departmental governments excludes payroll.}

meeting the political demand for more autonomy might not necessarily contribute to better governance; strengthening municipalities might conflict with creating departmental governments; increased autonomy might make it more difficult to reduce interregional disparities in terms of service quality. Managing these trade-offs represents a daunting challenge. Yet if not tackled properly, they can lead to a decline in service quality, additional fiscal pressures, and a deepening of regional conflict. In the following section this paper will discuss how the five challenges outlined above could possibly be addressed, within the constraints just mentioned.

C. Addressing the Decentralization Challenge: From “Best Practice” to “Best Fit”

1. Functions and Expenditure Responsibilities

The Challenge

The new resources from the hydrocarbons law are being channeled into an intergovernmental system with weak accountability and low levels of transparency. Expenditure responsibilities are largely disjointed and fragmented across levels of government and in the different sectors, for instance in education, health, and roads (Table 2). In education, for instance, teachers are paid by the central government; they are managed by the departments; their time is controlled by the municipalities; and the districts are responsible for their hirings and firings. With such fragmented decision-making, accountability is diluted, and no single government or service provider is in control.

Table 2. Responsibilities per Level of Government in the Health, Education, and Road Sectors

<table>
<thead>
<tr>
<th>Level of Government</th>
<th>Primary and Secondary Health</th>
<th>Primary and Secondary Education</th>
<th>Roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government</td>
<td>Financing</td>
<td>Financing</td>
<td>Servicio Nacional de Caminos: National road network</td>
</tr>
<tr>
<td></td>
<td>Planning</td>
<td>Planning</td>
<td></td>
</tr>
<tr>
<td>Prefectures</td>
<td>Deconcentrated SEDES: payment to health personnel (payroll)</td>
<td>Deconcentrated SEDUCA: payment to teachers (payroll)</td>
<td>SEPCAM: autonomous institution responsible for departmental road network</td>
</tr>
<tr>
<td></td>
<td>Management of health personnel.</td>
<td>Management of teaching personnel.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Control of norms.</td>
<td>Control of norms.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Infrastructure for secondary and tertiary care (if not transferred to municipalities).</td>
<td>Delivery of certificates.</td>
<td></td>
</tr>
<tr>
<td>Municipalities</td>
<td>Infrastructure (Hospitals)</td>
<td>Infrastructure (Schools)</td>
<td>Rural roads</td>
</tr>
</tbody>
</table>

Additional factors further complicate the situation. Departmental sector directors fill two—often conflicting—roles. They report to departmental governors but also depend on central government sector ministries. Moreover, departmental budgets are not clearly delineated. Due to the fragmented institutional arrangements, some agencies—such as the Departmental Road Agency SEPCAM, for

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5 Department governments participate in the elaboration and partly also in the execution of a number of ministerial budgets. Each sector has its own logic and pattern of involvement of departments. A substantial part of departmental budgets is, in truth, in the national budget.
instance—can be termed “floating institutions” since they neither report to the central government, nor to prefectures, nor to road users. Considering the current thrust for decentralization, there is a significant risk that this second phase will further complicate the assignment of responsibilities. As happened in the first phase, the decentralization process does not proceed in an integrated fashion among departments and municipalities. This makes it much more difficult to assign responsibilities clearly to each level of government. At the same time, there are considerable inequalities in public services, which are deficient across all sectors and regions. Decentralization could be a useful tool to improve services, but as demonstrated throughout Latin American countries, blurred responsibilities and weak accountability are obstacles to achieve this goal.

Policy Options and Strategy

Following international experience—accumulated in countries such as Colombia, Chile, Ecuador, and Peru, among others—a clear assignment of responsibilities can be achieved best when decentralization proceeds within a sector approach. A priority sector should be selected to initiate the process of transferring responsibilities; subsequently, this process could then gradually be expanded to other sectors. For instance, starting with transfers in the road sector and proceeding then on to the health sector. Before deepening responsibilities of departmental governments however, it seems like a logical and first step to divide responsibilities among levels of government. For departments, this may entail a transfer of responsibilities to the center. Likewise, service quality indicators should be defined early on and then tracked over time. The quality of services should be at least maintained, and then improved.

Would the stakeholders of regional “autonomy” accept such a strategy? Arguably, proposing such a sector strategy runs counter to the interests and incentives of the main players involved, which favor separate approaches for regional and municipal levels. One possibility to turn this situation around is to create interests in a sector strategy by offering financial incentives: resources and responsibilities are only transferred to departmental governments and municipalities which participate in negotiated sector agreements (convenios sectoriales). Bargaining packages could be crafted by which the central government offers responsibilities for the departments and municipalities willing to be monitored on the quality of services. Clearly, the condition of success is the credibility and commitment of the central government to stick to such sector approaches, and withstand the temptation to follow uncoordinated one-to-one bargains and faster decentralization.

The remaining question is how to deal with responsibilities which were inefficiently allocated to municipalities in the first phase of decentralization starting 1994—and which could be incompatible with a heightened role of departmental governments. These municipal responsibilities are, for instance, the construction and maintenance of schools if departments obtain full responsibility for primary and secondary education; and the maintenance of hospitals and health posts, should departments be made responsible for primary and secondary health care. The political conditions are likely to rule out any possibility to transfer these responsibilities from municipalities back to departmental governments, even if this is desirable from an overall efficiency perspective. This is one particular reform area where “best fit” should be given prevalence over “best practice,” in an effort to adjust to incentive framework

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6 The road sector budget, for instance, is agreed by each departmental SEPCAM individually with the Ministry of Finance directly, without being coordinated or rationalized with sectoral road policies, or departmental budget policy. The nine SEPCAMs, as autonomous institutions, illustrate the diffused, often confusing roles involved in the execution of departmental budgets.

7 For instance, departmental governments should not manage the payroll for teachers, if they will ultimately not be responsible for delivering education services.
2. Intergovernmental Transfers

The Challenge

The second phase of decentralization is essentially transfer driven: the new HL, adopted in May 2005, provides US$ 240 million of resources to both departmental governments and municipalities without additional expenditure assignments attached. The transfer system however is, from a technical point of view, problematic in at least four areas. First, one of the main issues concerning intergovernmental transfers is that the Law violates the principle of decentralization by which resources should be transferred with new expenditures and vice versa. Secondly, resource distribution is highly unequal. Fiscal transfers from the HL allocate, for instance, US$16 per capita to La Paz (which has one of the largest communities of the poor) while Pando (among the least poor) receives US$407 (Figure 1). This does not put Bolivia’s departments on an equal footing with respect to the level of public expenditures. Social inclusion, one of the main goals of the current administration, might not be achieved.

Figure 1. Transfers from Hydrocarbon Law (in USD per capita) and Poverty Criteria (GDP per capita), 2005–2006 (projected)

Note: For year 2005, numbers are based on the annual budget. For 2006, numbers are estimates only. Source: World Bank.

Third, transfers from “regalías” and HL provide ear-marked revenues to hydrocarbon “producing” regions. This eliminates the possibility of their being used for other beneficiaries and purposes, some of which might yield higher net social and economic returns. Fourth, a significant share of resources for

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8 In contrast with most Latin American countries, however, the resources made available originate from future revenue streams. From this perspective, the central government does not experience a revenue loss through decentralization (and could even still improve its fiscal position). Still, the additional revenue should be used by sub-national governments for additional expenditures and parallel reduction of central expenditures, but this is not the case.

9 Ear-marking has put additional fiscal pressures on the treasury, particularly through the Departmental Compensation Fund which however is not working properly. A provision of Bolivia’s regional pact on hydrocarbon earnings provides that, each time a “producing” department receives a higher share of these revenues, “non-producing” departments have to be compensated with additional treasury funds. But this has further drained scarce treasury funds from non-hydrocarbon sources.
sub-national governments is based on either volatile or uncertain\textsuperscript{10} resources. Hydrocarbons revenue is volatile in the future because of the uncertainties of future hydrocarbon output, as well as its prices. If the added revenues went to meet rigid administrative expenses at the subnational level, this could complicate budget management, and even perhaps obstruct any adjustments needed for fiscal stabilization.\textsuperscript{11}

**Policy Options and Strategy**

These four issues outlined above warrant a fresh look at the transfer system. But how to achieve efficiency-enhancing reforms when the distribution of resources reflects equilibrium of power underlying the new social contract that is currently being forged in Bolivia? Perhaps like no other event in the country’s recent history, the Hydrocarbon Law is a symbolic victory of regional interests over those of the central government, and reflects the balance of power among different social groups. It is unfortunate that the broad consensus on an egalitarian distribution failed so remarkably to achieve basic equity in resource distribution—at least when measured against a per-capita standard.

It is clear then, that although a complete overhaul of the transfer system is warranted from a technical point of view, from a political perspective the prospects for such an approach look rather bleak. Reformers seeking efficiency-enhancing measures would have only limited room to maneuver; it would probably only be wide enough to select a few entry points in an attempt to create leverage for deepening and expanding reforms later on in a phased and sequenced approach.

Following international experiences—among others in Argentina, Colombia, and Germany—it seems that a redistribution of funds among regions and levels of government can only be achieved either very quickly before new resources are spent at the local level and interest groups are formed with interest in maintaining the level of financing; or, conversely, reforms are postponed into the future, by adjusting the system only gradually and at the margin. Bolivia faces the same dilemma. Re-negotiating the transfer formula is therefore an important short-term measure. A new formula would ideally ensure basic equity and compensate for expenditure needs; it would be simple and transparent so that all stakeholders understand how resources are distributed. A per-capita formula has been working already for municipalities and the same approach is certainly valid for the transfers from hydrocarbons.\textsuperscript{12}

This re-negotiation of the transfer formula would need to be made attractive for departmental governments, which, in the recent past, have too often perceived a redistribution of funds as a zero-sum game. A bargaining package could be crafted by which a new equity-enhancing formula is introduced in return for departments obtaining more autonomy in resource use, by gradually reducing expenditure earmarking. Currently, departments are able to only spend about 8 percent of all funds according to their own preferences and discretion. Providing more autonomy over expenditures might therefore be a complementary measure that would increase the prospects for a re-negotiation of the transfer formula.

\textsuperscript{10} The HIPC funds for municipalities will be phased out in coming years. Moreover, resources from the general revenue sharing pool are sometimes not transferred in cash but in quasi-money instruments (Fiscal Credit Certificates; \textit{Certificados de Crédito Fiscal}, CCF).

\textsuperscript{11} This could happen, for example, if the resources were used to cover long-term obligations, such as the wages for newly hired employees contracted for over many years.

\textsuperscript{12} A poverty formula would also be valid, however it raises the need to define how much more a poor region receives, compared to a non-poor or less poor region.
On the other hand it is also clear that on political grounds it is warranted—and on economic grounds probably justified—to accept the claim of hydrocarbon-“producing” departments\textsuperscript{13} to obtain a larger share of the revenue than “non-producing” departments. Necessarily this share would need to remain small so that equity is not being undermined. Higher transfers for hydrocarbon-“producing” departments would not only compensate for negative externalities associated with exploitation of a non-renewable natural resource, but also increase acceptance on behalf of likely veto players; that is, those jurisdictions favoring the status quo.

Would departments accept to give up ear-marking of hydrocarbon revenue and rather be financed out of a national pool\textsuperscript{14} of revenue? Their acceptance would be more likely if they realize that a national pool of revenue provides a smoother revenue flow, instead of them depending only from a single and highly volatile source. However, overall the issue of ear-marking of revenue, though undesirable from an efficiency point of view, seems to be less pressing than improving the rules for distribution among departments first. The elimination of revenue ear-marking could therefore be postponed and enacted only in the long-term.


Ensuring subnational fiscal stability is another major concern for Bolivia’s decentralization process. In 1999, several municipalities could not pay their debt service after the 1994 decentralization process increased their expenditure responsibilities. At the time also, subnational debt was under-regulated and poorly monitored, and the situation was aggravated by adverse macroeconomic developments. As a result, particularly the most populous municipalities (most of them capitales de departamento) over borrowed.

Faced with this growing problem, the central government intervened in insolvent municipalities in 2000. It set up the Programa de Readeucción Financiera (PRF), a fund partially capitalized by revenue-sharing transfers complementing international financial support. The resources mobilized were used to pay suppliers and helped to reschedule the outstanding debt. This marked, for the first time since decentralization was launched, the Central Government’s establishment of a tighter framework for municipal finances. This action brought down the aggregate municipal debt without actual write-offs, but debt reduction has not followed in all the municipalities and prefectures. Some subnational governments have failed to respect their annually set debt targets, including Santa Cruz and Cochabamba, two of the larger municipalities.

Today, the total subnational debt is not fully or precisely known. Also, the size of the departmental\textsuperscript{15} and municipal debt stock (roughly 5 percent of GDP) is known to be understated because of unregistered borrowings and suppliers debt. Most municipal debt today is floating debt, particularly from suppliers, which is admittedly difficult to monitor. However, the system of debt capacity indicators now in place implies that the new HL resources will automatically provide both departmental governments and municipalities room to acquire more debt. It bears noting, too, that subnational borrowing has poor oversight and very limited transparency. Also, once the departmental governments are elected, their new leaders might conceivably not wish to recognize the debt stock contracted previously.

\textsuperscript{13} The term used in Bolivia for departments where hydrocarbon resources are located is “departamentos productores.”
\textsuperscript{14} Consisting of all tax and hydrocarbon revenue.
\textsuperscript{15} Although the stock of departmental debt appears to be limited (roughly to 0.5 percent of GDP), its size could increase rapidly if these governments do not follow responsible fiscal policies.
The rules for subnational debt are narrow and fail to encompass fiscal responsibility rules. New spending pressures could arise, particularly during the take-off periods of further decentralization. Theoretically also, there could potentially be new regional taxes to restrain excessive subnational spending—but their magnitude is likely to remain limited and, therefore, alone are unlikely to set a new incentive framework for responsible fiscal management.

Bolivia’s future thus seems particularly vulnerable to suffer some of the typical ills that afflict decentralizing states. A failure to follow prudent fiscal policies may create negative externalities on a number of fronts, some of which already materialized in the recent municipal debt crisis. Such behavior, if unchecked, could enlarge the country’s already existing “reputational risk” and perhaps even ultimately threaten the stability of its financial system, creditworthiness and overall macroeconomic order.

**Policy Options and Strategy**

How could a “best-fit”-approach to strengthen fiscal responsibility in Bolivia look like? In light of the limited enforcement capacity of the central level, one is tempted to recommend a marked-based approach to control subnational borrowing. Yet it is also true that past attempts at introducing market-based controls have largely failed, and that the small domestic financial market imply structural limitations for such an approach.

Still, it would be critical for the private sector and private banks to collaborate. One possible measure would be to provide incentives for private banks to seek disclosure of debt held by municipalities and departments—something which the central government alone cannot achieve due to its limited monitoring and enforcement capacity. For instance, financial market regulations could be established ruling that loans are only accepted on balance sheets of banks if certain information about them is made available and public. Needless to say, this measure would not control the floating debt problem; but it would establish basic transparency on a significant share of subnational debt. It would provide a starting point and the leverage to expand reforms later on.

All in all however, the circumstances in Bolivia warrant a rather conservative and cautious approach to get a hold on the subnational debt problem. This includes, for instance, establishing a moratorium on departmental debt until minimum transparency requirements are being met; the status and ownership of departmental debt is clarified; and basic fiscal responsibility rules are adopted and effective. Should the “20/200-rule” still continue to exist? Yes, although its limitations are well-known, and it provides insufficient control as a stand-alone rule without encompassing broader fiscal responsibility rules. For a start, fiscal responsibility rules should be introduced for one year at a time only, as the fiscal and economic situation appears to be too volatile for multi-year commitments—followed by Colombia, Peru, or Chile, among others—to be credible and enforceable. With these initial measures geared to seek the “best fit,” Bolivia would be in a better position than today to address the challenge of fiscal responsibility within a context of competing demands and incentives.

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16 The two most populous municipalities—La Paz and Santa Cruz—were required to have credit assessments by private banks, which however, were never accomplished. The domestic financial market seems to be too small for a large-scale private sector participation.

17 The “20/200-rule” foresees that debt service of municipalities or departmental governments must not exceed 20 percent of current revenues and debt stock must not exceed 200 percent. In the meantime, the indicators of the “20/200-rule” should be tightened, and de-linked from transfers and current revenue of subnational governments.

18 This rule does, for instance, not reveal commitments that are being converted into debt, and it does not offer a rules spanning over a period of time more than a year.
4. Regional Taxation
The Challenge

The Bolivian \textit{prefecturas} do not have access to own tax revenue. They administer a number of fees, but the revenue yield is only marginal. Departments are relative late-comers to decentralization while municipalities gained a “first-mover advantage.” They were thereby granted new tax bases, some of which would be suitable for departmental administration, for instance the automobile tax in addition to the property tax. As a result, departmental governments in Bolivia are extremely transfer dependent. Their revenues have relied 96.6 percent on transfers, which will rise to 99 percent in 2006 with the new hydrocarbon funds. Municipalities, in turn, are relatively less dependent on transfers than departments. Municipal transfer dependence has been close to 68 percent, and is increasing to over 74 percent in 2006 as a result of the HL.

It is clear that regional taxation is warranted in light of the experience of several Latin American countries. The lack of own revenue bases was a major stumbling block for many regional governments to deepen autonomy. Peru, Colombia, Ecuador, and Venezuela, have all demonstrated that if regions do not find reasonable access to own revenue, their fiscal dependence on the center will still dictate day-to-day management of the regional administration. Own revenue sources reduce transfer dependence on the center. In addition, local taxation implies that politicians “feel the pain of the marginal tax \textit{boliviano} they spend”; taxes can contribute to more efficient spending and fostering a hard budget constraint; and local taxation can stimulate accountability towards citizens.

Finding suitable regional taxes for Bolivian departments however is an extremely difficult undertaking. The fiscal situation of the central government remains fragile despite recent improvements\footnote{Bolivia’s overall projected budget deficit dropped to 2.3 percent of GDP in 2005 from 5.5 percent in 2004. This achievement together faster GDP growth—at close to 4 percent in 2005—have improved the public sector’s debt sustainability situation, helping to keep the nominal exchange rate stable, which is key to sustain solvency in a highly dollar indebted public and private sector. But Bolivia’s public debt remains high at around 80 percent of GDP.}; hence the center will be reluctant to ceding tax bases on which it depends. Municipalities will also be affected as any increase or decrease in the revenue yield from national taxes would directly result in corresponding changes in the amount of revenue-sharing (\textit{co-participación}) they receive. Also, some potentially buoyant taxes, like the personal income tax, do not exist in Bolivia. Likewise, there are no functioning tax administrations at regional levels; and there is low transparency as well as poor exchange of fiscal information among levels of government. Finally, little is known about the willingness of newly elected departmental governments to bear the political cost of taxation; but it is likely not to be uniformly high across all departments.

Policy Options and Strategy

In light of the numerous constraints for regional taxation outlined above, a “best fit” approach would probably need to sacrifice efficiency in tax administration for additional gains in accountability. One approach would be to introduce tax-sharing. Shared tax bases are applied in France and Spain, for instance. Applying this approach in Bolivia would imply that departments can use and exploit tax bases jointly with the national government or municipalities. For instance, the municipal property tax could be structured such that municipalities collect taxes on property ownership but departments collect taxes on change and sales of property. Incentive problems consisting in the overgrazing of the common resource pool are well-known. Both municipalities and departments would likely have incentives to raise tax rates above an efficient level.
If this approach appears too costly, the country could stick to its current system with individual tax bases assigned to each level of government. Two options could serve as a starting point for regional taxation. (i) There is the option to cede the domestic share of the Special Consumption Tax (ICE) to departments. It is currently administered by the central government and would imply a revenue loss both to the central government and municipalities, whose consent would be needed for this option to be politically feasible. (ii) There is the option to create a new tax consisting of the sales tax on gasoline and diesel fuel to be administered by departments. Coupled with some important administrative provisions that would ensure that these taxes mirror accurately local fiscal capacity, these sources could be used as a starting point for departmental taxation.

Would it make sense to initiate regional taxation before expenditure responsibilities are clarified? The tax-payers’ willingness to pay is likely to be higher when they know exactly which level of government delivers which public service in return. For this very reason, it seems reasonable to sequence measures such that responsibilities among levels of government are clarified first before regional taxation is introduced. From this perspective, regional taxation would be a long-term measure only. That regional taxation is despite its importance not the most significant short-term need becomes apparent when assessing the institutional capacities of departmental governments.

5. Institutional Capacities
The Challenge

The management capacity of the prefectures varies on a case by case basis, but is on average limited. This figured in the re-centralization of primary road network responsibilities in 1999 from the prefectures back to the national government. The main limitations in the prefectures are the following:

- There is lack of basic management system for the use of resources, some of which are prescribed by the SAFCO Law. This implies lack of oversight and limited transparency as well as limited exchange of information across levels of government.
- The prefectures have deficient planning and lack of prioritization of their resources. The absence, in many cases, of institutional strategic plans impedes prioritizing investment projects which, in some cases, have arisen due to social pressures. Often, the investment projects under consideration do not fall within the scope of prefecture responsibility. There is no focus on results; and there is no integration between planning, management, evaluation and monitoring, of investment projects.
- The organizational structure does not fully respond to the roles and functions of the prefecture.
- There is a high turn-over of staff. Each new prefect usually replaces many employees. The result is limited institutional knowledge within the prefecture.
- There is often excessive bureaucracy and red tape in processes and procedures, accompanied by a lack of coordination and a duplication of effort within the prefectures. Much of this is implied from the ambiguous relationship of the prefecture’s organizational units with the departmental agencies.

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20 Contrary to federal countries, the departments in Bolivia are unlikely to introduce regional revenue-sharing systems which benefit municipalities. Such a system works in Argentina, for instance.
21 Given the experience of other countries (such as Colombia), these two taxes are also suitable departmental taxes since they cannot be easily exported out of the taxing jurisdiction (contrary or foreign trade taxes, for instance); they do not influence much locational choices (contrary to the corporate income tax, for instance); they are not too difficult to administer locally (contrary to the VAT, for instance); and they are not used for inter-regional redistributive purposes (contrary to the personal income tax, for example).
22 The prefectures hire relatively few employees. Approximately 2,888 employees work in all of the prefectures (this number includes all sector departmental agencies like SEDES, SEDUCA, etc.). From all prefectoral staff, only about 2.5 percent are included in the civil service (this includes personnel working on specific projects financed by the national investment funds).
There is weak executing capacity. Only between 60 percent and 70 percent of planned budgets are also executed. If institutional capacities are the base for “successful” decentralization, the prospects of Bolivia reaping the benefits of this reform look particularly bleak.

Policy Options and Strategy

Bolivia is certainly not the only country in Latin America that has faced challenge of limited institutional capacities, although limitations of departmental governments appear to be particularly significant. However, the proposal here is to depart from other Latin American countries’ approaches in how these challenges were handled. These often assumed that it was most important to meet a set of ex-ante conditions which tended to measure the past performances of municipal and regional governments. As in Colombia and later Peru, formal “certification” processes were set up. Bolivia just followed the same approach.

However, certifications of subnational governments have—in the institutional context of many Latin American countries—often not been efficient. The reasons are, among others, the difficulty in finding objective and measurable indicators not only to assess general local government capacity, but also sector-specific capacity that is required to deliver decentralized services in health, education, or roads. Such indicators necessarily measure only past performance, and not the future potential of local governments. In addition, there is a high level of credibility and commitment that is needed from central government in refraining from transferring responsibilities to non-eligible subnational governments, in light of regional pressures and from the “bottom-up” to do so. These conditions do not seem to be present in Bolivia.

For these reasons, a “best-fit”-approach is to assess minimum institutional capacities primarily based on core systems for more transparency and accountability. Three administrative systems should be in place, previous to deepening responsibilities and providing more resources to departmental governments:

- procurement;
- human resources management system; and
- financial management system.

Hence, the overall strategy for Bolivia’s decentralization framework should be “forward looking”: what is important is to track performance for given level of service delivery; improve the quality of these services; and start with transfer of those responsibilities that are suitable for a large number of municipalities or regions. This would gradually commit subnational governments to providing improved services within an accountability framework.

At the same time, it is clear that the types of sophisticated decentralizations implemented in Canada, Spain and other European countries that are more results-oriented are not workable without very clearly delineated responsibilities. Unless such conditions are in place, intergovernmental agreements are unlikely to be very effective. Therefore, at the present status of Bolivia’s transition towards a more decentralized state, its possibilities of effectively pursuing results-based arrangements do not appear to be very strong.

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23 Decree No. 28666 of April 5, 2006, already establishes a certification system for Bolivian departmental governments, without yet defining the technical criteria to be used to assess subnational capacity.
D. Concluding Remarks

The policy options put forward in the Bolivia Institutional and Governance Review (IGR), as underlined earlier, do not purport to provide a comprehensive blueprint for the decentralization process. On the contrary, seeking the “best fit” is a concerted effort to adjust policy options to the constraints prevalent in the country; while at the same time providing decision-makers elements that would help them to better navigate through the complex political economy of actors and their incentives. Giving preference to the “best fit” over “best practice” does not imply that international experiences in decentralization are no longer valid for countries to design their own reform strategies. On the contrary, their analysis and assessment is fundamental to inform decision-makers about possible policy options, while avoiding to apply them without adjustment to the domestic institutional context.

While it is not clear what the precise limit is to yield and adjust to these institutional constraints and incentives present in each country, the international experiences from decentralization seems to indicate that only an incremental path of sequenced measures will increase the room for efficiency-enhancing reform. On this path, reformers will have to negotiate a series of trade-offs among different institutional designs. For all countries and Bolivia in particular, these trade-offs are higher at the regional level compared to the municipal level; they exist in the areas of political, fiscal, and expenditure decentralization. They imply that decision-makers will often be forced to make decisions, for instance, between higher efficiency in the use of resources, on the one hand, and more accountability on the other. Naturally, some policy options therefore appear to be controversial—for instance, postponing regional taxation and the deepening of expenditure responsibilities as long-term measures.

What can be realistically achieved should the recommendations be implemented? In this incremental path of sequenced measures, the expected outcome of a long-term decentralization scenario is that departmental governments have created more and more lines of accountability towards the tax-payers and citizens, while being more efficient in the use of resources. An increasing share of expenditures is financed from own revenue in the form of taxes. Subnational expenditures are equitable; and basic fiscal responsibility is in place.

Nevertheless, the prospect of decentralization to the departments raises the issue of much more dysfunctional types of decentralization. Such inefficient outcomes are particularly likely when political decentralization is introduced without proper institutional and fiscal arrangements. Such possibilities are hardly theoretical ones in the Latin American context. If the outcome of increased regional autonomy and decentralization in Bolivia is the creation of nine feudal Lords playing a non-cooperative game then it seems unlikely that governance will be improved or political conflicts calmed. Indeed the empirical results of Treisman (1999) suggest that it is precisely the type of decentralization that leads to the worst outcomes. Whether or not this will happen as a consequence of decentralization is unclear and doubtless depends on exactly how it occurs.

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Biography

Jonas Frank is a Public Sector Specialist at the World Bank in Washington DC. His primary responsibility is to advise governments in the Latin American Region on the implementation of fiscal decentralization. Between 1997 and 2001, Jonas Frank was Advisor of the German Technical Cooperation (GTZ) in Ecuador assisting government institutions on decentralization. Between 2000 and 2002, he was a lecturer for the international Masters Programme “Decentralization and Local Development” at the Universidad Las Américas (Chile-Ecuador). In 2004, he completed his doctoral degree in “Economics and Social Sciences” at Potsdam University in Germany, following a M.Phil. in “Economics and Political Science/Latin America” from University of Cologne, Germany, earned in 1997.

Contacts:
World Bank
1818 H Street, NW
Washington DC, 20433
USA
Tel. 202-473.9670
Fax 202-522.3133
jfrank@worldbank.org

Annex

Annex Table 1. Bolivia: Decentralization Options and Strategy

<table>
<thead>
<tr>
<th>Constraints for Decentralization</th>
<th>Diagnostic</th>
<th>Decentralization Strategy</th>
<th>Policy Options for the Short-term</th>
<th>Policy Options for the Medium-term</th>
<th>Policy Options for the Long-term</th>
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<tbody>
<tr>
<td>Fact One: Decentralization is driven by the struggle over natural resources.</td>
<td>(i) Lack of a coherent decentralization strategy: (ii) i) Sequence. (ii) Entry points levels of government, not sectors. (iii) The nature of regional governments.</td>
<td>(i) The Principles of Decentralization: Finance should follow functions; define responsibilities clearly; fiscal neutrality and responsibility. (ii) Strategy with five elements: • Develop a vision regarding roles of future regional governments. • Balancing symmetric and asymmetric elements. • Entry points and sequencing. • Incentive frameworks. • Manage transitions: sacrifice allocative efficiency for fiscal responsibility.</td>
<td>Decentralization Strategy: (i) Pre-condition: a minimum political consensus. (ii) Fiscal: achieve basic level of equity in transfers (per capita formula). (iii) Institutional: ensure basic institutional capacities.</td>
<td>Decentralization Strategy: i) Maintain, and (ii) increase the quality and efficiency of public expenditures, through separation of roles and responsibilities, sectoral funding formulae, and a reduction of earmarking.</td>
<td>Decentralization Strategy: Once there has been a successful application of measures proposed in the short- and medium-term: deepen decentralization through providing regional governments and municipalities with additional responsibilities and resources.</td>
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<td>Fact Two: Services are deficient across all sectors and regions.</td>
<td>Institutional Strengthening:</td>
<td>Fiscal Decentralization:</td>
<td>Institutional Strengthening:</td>
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<td>3. Inequitative fiscal decentralization (i) Ear-marking of revenue. (ii) Transfer of revenue without expenditures; (iii) Volatile and uncertain resource flow; (iv) High levels of transfer dependence; (v) High and increasing regional inequality in transfers; (vi) Weak fiscal responsibility and poor management of sub-national debt.</td>
<td>Fiscal Decentralization: (i) Gradual introduction of funding formulae in key sectors. For education (per student formula) and health (per capita formula).</td>
<td>(i) Transfers: refine per capita formula with other methods. (ii) Eliminate earmarking of revenue; stabilizing transfers. (iii) Taxes for departments: domestic share of ICE, sales tax for gasoline. (iv) Consolidate fiscal responsibility: multi-year commitments.</td>
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