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DECENTRALISATION'S EFFECTS ON PUBLIC INVESTMENT Evidence and Policy Lessons from Bolivia and Colombia¹

Jean-Paul Faguet²
16 May 2007

Abstract

This paper examines decentralisation in Bolivia and Colombia to explore its effects on the uses and spatial distribution of public investment, as well as government responsiveness to local needs. In both countries, investment shifted from infrastructure to social services and human capital formation. Resources were rebalanced in favour of poorer districts. In Bolivia, decentralisation made government more responsive by re-directing public investment to areas of greatest need. In Colombia, municipalities increased investment significantly while running costs fell. Six important lessons emerge from the comparison. For decentralisation to work well, (i) local democracy must be transparent, fair and competitive; (ii) local governments must face hard budget constraints; (iii) central government must be scaled back; (iv) significant tax-raising powers must be devolved; and (v) decentralization is composed of distinct, separable components, the sequencing of which is important. Lastly, (vi) what decentralisation achieves, and whether it is advisable, hinge on how central government behaved pre-reform.

Key words: decentralisation, public investment, Latin America, Bolivia, Colombia, local government

1. Introduction

All over the world, developing countries are decentralizing their public administrations in an attempt to make them more efficient, flexible and responsive. Decentralisation is central to the policy agendas of countries as disparate as Mexico, Egypt, Ghana and India. And under the guises of subsidiarity, devolution and federalism, reform is firmly in the foreground of policy discourse in rich countries too. But surprisingly, the empirical literature is unable to agree on what decentralisation's effects on public administration and public finances have been in practice (Kim *et al.* 2005). Advocates (for example Olowu and Wunsch 1990; Putnam 1993; World Bank 1994; UNDP 1993) argue that decentralisation can make government more responsive to the governed by 'tailoring levels of consumption to the preferences of smaller, more homogeneous groups' (Wallis and Oates 1988, 5). Opponents (for example Crook and Sverrisson 1999; Prud'homme 1995; Samoff 1990; Smith 1985; Tanzi 1995) dispute this, arguing that local governments are too susceptible to elite capture, and too lacking in technical, human and financial resources, to produce a range of public services that are varied, efficient and responsive to local demand. But neither side is able to substantiate its arguments convincingly with empirical evidence.

Recent studies in the *Journal of Development Studies* have on balance tended toward the negative camp. In a study of rural water supply in central India, Asthana (2003) finds that decentralisation of water provision decreased efficiency. Operating costs per unit of output were higher in decentralised utilities, and asset utilization was lower. Both differences are statistically significant. Along similar lines, Akin, Hutchinson and Strumpf (2005) analyse a detailed database of Ugandan local government health budgets. Using subjective characterisations of the degree of 'publicness' of different

health activities, they find evidence that local governments are allocating declining proportions of their budgets to public goods, and increasing shares to publicly financed private goods. They attribute this behaviour to free riding by local officials on the health expenditures of their neighbours. Woller and Phillips (1998) test the much broader claim that decentralisation will increase the long-term growth rate by making the public sector more responsive and efficient. Using panel data on 23 developing countries between 1974-1991, they find no strong evidence of any systematic effect of decentralisation on economic growth. Johnson, Deshingkar and Start (2005) buck this negative trend by finding that India's recent decentralisation was associated with positive outcomes for the rural poor in Andhra Pradesh and Madhya Pradesh. But their enthusiasm for decentralisation is nonetheless limited. The pro-poor outcomes achieved, they argue, were due to central and state governments' ability to counterbalance the elite capture that decentralisation tends to spawn, which naturally favours the rich.

The broader literature takes a more positive view of decentralisation, but is ultimately inconclusive. Consider the broadest surveys: Rondinelli, Cheema and Nellis (1983) note that decentralisation has usually disappointed its partisans. Most developing countries implementing decentralisation experienced serious administrative problems. Although few comprehensive evaluations of the benefits and costs of decentralisation efforts have been conducted, those that were attempted indicate limited success in some countries but not others. A decade and a half later, surveys by Piriou-Sall (1998), Manor (1999) and Smoke (2001) are slightly more positive, but with caveats about the strength of the evidence in decentralisation's favour. Manor notes that the evidence, though extensive, is still incomplete, but ends his study with the opinion that 'while

decentralisation ...is no panacea, it has many virtues and is worth pursuing'. Smoke, by contrast, finds the evidence mixed and anecdotal, and asks whether there is empirical justification for pursuing decentralisation at all. Given the sheer size of the literature, the lack of progress is surprising.

This paper examines the effects of decentralisation on: (i) the uses of public resources, (ii) their distribution across space, and (iii) government responsiveness and poverty-orientation, by comparing two recent cases of extensive reform: Bolivia and Colombia. Although these issues are just two of the many dealt with above, they are amongst the most important, and form the core of the theoretical case in favour of decentralisation (Blair 2000; Dillinger 1994; Musgrave 1959; Oates 1972).

Focusing on a pair of broadly similar countries in the same region limits problems of data comparability, and geographic, cultural and historical context. But it is the decentralisation-specific similarities that are most striking, and that make this comparison particularly good. Until reforms began, Bolivia had few elected mayors and Colombia had none. Municipal administrations in both countries had little power and few resources. Both countries were characterised by highly vertical administrations in which authority cascaded down from the President, through ministries and state governments, to local officials in the farthest towns and villages. In such a system, accountability was upwards and not downwards.

Both countries turned to decentralisation in the early 1990s (although Colombia took a few, cautious steps somewhat earlier). In both countries – as we discuss below – reforms were far-reaching. Significantly, both decentralizations gave a prominent role to municipalities, which in both countries are mostly small and rural. Average municipal

population in Bolivia is 20,847, and 36,099 in Colombia, although both figures are biased upwards by the presence of a few very large cities. Fully 82 per cent of municipalities have populations below the average in Bolivia, and 86 per cent in Colombia. The proportion of municipalities with fewer than 10,000 inhabitants is 55 per cent in Bolivia and 40 per cent in Colombia.

Decentralisation is henceforth defined as the devolution by central (that is, national) government of specific functions, with all of the administrative, political and economic attributes that these entail, to democratic local (that is, municipal) governments which are independent of the centre within a legally delimited geographic and functional domain. The rest of the paper is organised as follows. Section 2 reviews the Bolivian and Colombian decentralisation programs, focusing on their legal and budgetary aspects. Section 3 provides summarised analysis of the economic outcomes of decentralisation in each country. Section 4 summarises the effects of reform in Bolivia and Colombia, and teases out policy lessons for other countries contemplating reform.

2. The Bolivian and Colombian Decentralisation Programs

2.1 Popular Participation in Bolivia

The Bolivian revolution of 1952-1953 destroyed an autocratic plutocracy that not only oppressed the indigenous majority but – especially in rural areas – literally enslaved them (Klein 1993). This was replaced with a nationalist project to recast social relations through the active intervention of the state in the nation's social and economic affairs. Revolutionary protagonists sought to transform a poor, backward, extremely unequal country by expropriating the 'commanding heights' of the economy – land and mines – so smashing the power of an entrenched elite. The new government then embarked upon

a state-led modernization strategy in which public corporations and regional governments initiated a concerted drive to break down provincial fiefdoms, transform existing social relations, and create a modern, industrial, egalitarian society (Dunkerley 1984). Revolutionaries deemed direct political control necessary, and so the country quickly acquired one of the most centralised state structures in the region.

Intellectual trends of the subsequent four decades – *Dependencia* theory, Developmentalism, and Import Substitution Industrialization – all contributed to the centralizing tendency, as did the military governments which overthrew elected administrations with increasing frequency from the 1960s onwards (Klein 1993). With political power so little dispersed, there was little point in establishing the legal and political instruments of local governance. As a result, local government existed in Bolivia only in the 30-40 largest and most important cities. Beyond these, municipalities existed at most in name, as a ceremonial institution devoid of both administrative capability and resources. And in most of the country they did not exist at all.

Although the 1994 reform was sprung on an unsuspecting nation, the concept of decentralisation was by no means new. For more than 30 years a decentralisation debate focused on Bolivia's nine departments ebbed and flowed politically – at times taking on burning importance, other times all but forgotten. The issue became caught up in the country's centrifugal tensions, as regional elites in Santa Cruz and Tarija consciously manipulated the threat of secession to Brazil and Argentina respectively – with which each is economically more integrated than La Paz – to extract resources from the centre. The Bolivian paradox of a highly centralised but weak state, and a socially diverse population with weak national identity, meant that such threats were taken seriously by

the political class, which blocked all moves to devolve more power and authority to Bolivia's regions.

What spurred the change of tack? Why then? Two factors stand out. The less important one arises from Bolivia's failure to achieve sustained, healthy growth despite wrenching economic reform overseen by the IMF and World Bank. Fifteen years of near-zero per capita economic growth sapped the credibility of the state and fomented social unrest. The new *Movimiento Nacionalista Revolucionario* (MNR) administration of Pres. Gonzalo Sánchez de Lozada (1993-1997) saw the structure of government itself as an impediment to growth. Decentralisation was an attempt to deepen structural reform in order to make the state more efficient and responsive to the population, and so regain its legitimacy in the voters' eyes.

The more important factor arises from the rise of ethnically-based, populist politics in the 1980s, which undercut the MNR's traditional dominance of the rural vote, and posed a serious challenge to its (self-declared) role as the 'natural party of government'. This rural dominance was itself born out of the MNR's agrarian reforms of the revolution. Hence a party with a tradition of radical reform, which found itself in secular decline, sought a second, re-defining moment. In a typically bold move, it sought to reorganise government, re-cast the relationship between citizens and the state, and so win back the loyalty of Bolivians living outside major cities. To a very important extent, decentralisation was a gambit to capture rural voters for at least another generation.³

Against this background, the Bolivian decentralisation reform was announced in 1994. The Law of Popular Participation, developed almost in secret by a small number of technocrats (Tuchschneider 1997), was announced to the nation to general surprise,

followed by ridicule, followed by determined opposition of large parts of society.⁴ It is notable that opposition to the law, which was fierce for a few months, came principally from the teachers' union, NGOs and other social actors, and not from political parties. Judged by their public declarations, this opposition was an incoherent mix of accusations and fears that denoted a deep suspicion of the government's motives, and not a careful reading of the law. The lack of opposition from parties can largely be attributed to the sweeping reforms that were being enacted by the MNR government at the same time as decentralisation. With privatization of the main state enterprises, education reform, and a comprehensive restructuring of the executive branch all being pushed at once, decentralisation was relegated to the second tier of political parties' concerns. The opposition focused its attention elsewhere, and it never became a fighting point.

First made public in January of that year, the law was promulgated by Congress in April and implemented from July. The scale of the change in resource flows and political power that it brought about were enormous. The core of the law consists of four points (Secretaría Nacional de Participación Popular, 1994):

1. **Resource Allocation.** Funds devolved to municipalities doubled to 20 per cent of all national tax revenue. More importantly, allocation amongst municipalities switched from unsystematic, highly political criteria to a strict per capita basis.
2. **Responsibility for Public Services.** Ownership of local infrastructure in education, health, water & sanitation, irrigation, roads, sports and culture was given to municipalities, with the concomitant responsibility to maintain, equip and administer these facilities, and invest in new ones. But the staffing of this infrastructure, including responsibility for salaries, remained central attributes.

3. **Oversight Committees** (*Comités de Vigilancia*) were established to provide an alternative channel for representing popular demand in the policy-making process. Composed of representatives from local, grass-roots groups, these bodies propose projects and oversee municipal expenditure. Their ability to have disbursements of Popular Participation funds suspended if they find funds are being misused or stolen can paralyze local government, and gives them real power.
4. **Municipalisation.** Existing municipalities were expanded to include suburbs and surrounding rural areas, and 198 new municipalities (out of some 315 in all) were created.

The central agencies previously charged with regional and local investment projects – the regional development corporations – were scaled back as a result. There were relatively few direct transfers of staff to municipalities, although many ‘quasi-transfers’ appear to have operated informally, through the labour market. And a small, complementary program of municipal training and capacity building was established with support from international donors. The Laws of Decentralised Administration (1995), and of Municipalities (1999), followed subsequently, further defining the municipal mandate and locating it in a broader governmental architecture.

The change in local affairs that these measures catalyzed is immense. Before reform local government was absent throughout the vast majority of Bolivian territory, and the broader state present at most in the form of a military garrison, schoolhouse or health post, each reporting to its respective ministry. After reform, elected local governments sprouted throughout the land.

The role of oversight committees (OCs) is worth underlining. These are, in effect, a non-electoral form of representation that operate in parallel to Bolivia's municipal councils and mayors. They are composed of the representatives of grass-root organizations within each municipality. A municipality will typically be divided into four or more regions, each of which nominates one member to the OC from amongst its local grass-roots leaders. OC members elect from amongst themselves a president, whose legal status is comparable to the mayor's. The OC's power lies in its natural moral authority, as well as the ability to suspend disbursements from central to local government if it judges that funds are being misused. Oversight committees thus comprise an additional layer of social representation similar to an upper house of parliament, enforcing accountability on the mayor and municipal council.⁵

2.2 The Decentralisation Process in Colombia

Like Bolivia, Colombia was traditionally a highly centralised country, with mayors and governors directly named by central government. Governors, in particular, were the President's *hombres de confianza*, and carried out his will in the regions. Like Bolivia, a deep and extensive decentralisation program crystallised around the constitutional and legal reforms of 1991-1993. The earlier introduction of a number of piecemeal fiscal and political reforms mean that Colombia's process was not a Bolivian-style 'big bang' reform. But when placed in the international context, the coherent and extensive package of measures that jelled in 1991-1993 should be regarded as a 'fast-track' program.⁶ Taking the long view, Ceballos and Hoyos (2004) identify three broad phases of reform in Colombia:

Phase 1 began in the late 1970s and early 1980s, and included a number of specific fiscal measures aimed at strengthening municipal finances. Most important of these were Law 14 of 1983 and Law 12 of 1986, which assigned to municipalities increased powers of tax collection, including especially sales tax, and established parameters for the investment of these funds.

Phase 2, which began in the mid-1980s, was more concerned with political and administrative matters. Amongst the most important of these measures was Law 11 of 1986, which established the popular election of mayors, and sought to promote popular participation in local public decision-making through *Juntas Administradoras Locales*, amongst others. Reforms enshrined in the 1991 constitution, such as citizens' initiatives, municipal planning councils, open *cabildos*, the ability to revoke mayoral mandates, referenda, and popular consultations, further deepened political decentralisation. The 1991 constitution also established the popular election of governors.

Beginning in 1991, and continuing for most of the decade, **Phase 3** consisted of a number of laws that regulated the new constitution, and other fiscal and administrative reforms of the period. These laws assigned increasing responsibility to municipalities for the planning, financing and provision of public services and social investment, and provided additional resources for the same by increasing central government transfers to local governments gradually but significantly. Over time, municipalities 'certified' as having high administrative capacity were granted greater political autonomy and greater discretion over devolved funds. Automatic transfers to regional governments rose from about 20 per cent to over 40 per cent of total government spending, placing Colombia

first in the region amongst unitary countries, and third overall after the two big federal countries, Brazil and Argentina.⁷

As for Bolivia, the aggregate effect of these reforms was a large increase in the authority and operational independence of Colombia's municipal governments, accompanied by a huge rise in the resources they controlled. Municipalities were allowed to raise and spend significant sums of taxes, central-to-local government transfers increase more than three-fold,⁸ and municipal governments were permitted to issue public debt. Overall municipal expenditures and investments rose five-fold, while running costs remained stable over the period (see figure 7 below). An important difference with Bolivia is that whereas Bolivia implemented fiscal (taxation and expenditure) and political (elections, popular consultations) decentralisation measures at once, Colombia sequenced its reforms, moving forward first with measures to bolster local revenues, and only then turning to local politics. This is an important difference, which we return to below.

What drove decentralisation in Colombia? Ceballos and Hoyos group the motivations into two categories. The first of these is the challenge of political instability. Colombia is a violent country, with a long history of civil conflict, armed rebellion, persistently high levels of 'common' crime, and the use of violence as an explicit tool of political mobilization. The late 1970s saw levels of violence rise again as the internal conflict intensified. At the same time, social protests and pressures from regional groups multiplied, linked to the central state's inability to meet demands for social services and public investment. Secondly, the political hegemony over the instruments of the state of the traditional Liberal and Conservative parties began to be seen more and more as a

liability – less the solution to a previous round of civil violence (*La Violencia*) and more a cause of the next one. Colombians from across the political spectrum became convinced that the inability of the state to respond to society's demands – and its outright absence in many areas (the 'internal frontier'), combined with the waning legitimacy of an arbitrarily restricted democracy,⁹ were leading to public sector inefficiencies, civic discontent, and ultimately armed violence.

Thus from the start decentralisation in Colombia was a multi-faceted tool designed to serve a combination of purposes particular to Colombia's troubled democracy. Through it, policy elites sought to increase the levels of electoral and citizen participation within the existing institutional framework. They sought to open the political system through popular elections at the regional and local levels, where they hoped new political movements would emerge and eventually assume power, so breaking the liberal-conservative hegemony over the resources of the state.

3. The Impacts of Decentralisation

This section compares the allocation of resources across different uses, and across space, by central vs. local government in the two countries. In accordance with the 'big bang' nature of its reform, evidence for Bolivia is presented in stark before-vs.-after terms. By contrast, Colombia's more gradual reform is better suited to a time series approach, and hence that evidence covers the entire period 1993-2002. Ideally this paper would present the same graphs and tables for both countries. Unfortunately, different countries collect data in different ways, and current data availability for Colombia and Bolivia oblige us to present evidence that is similar, but not identical.

3.1 The Impact of Decentralisation in Bolivia

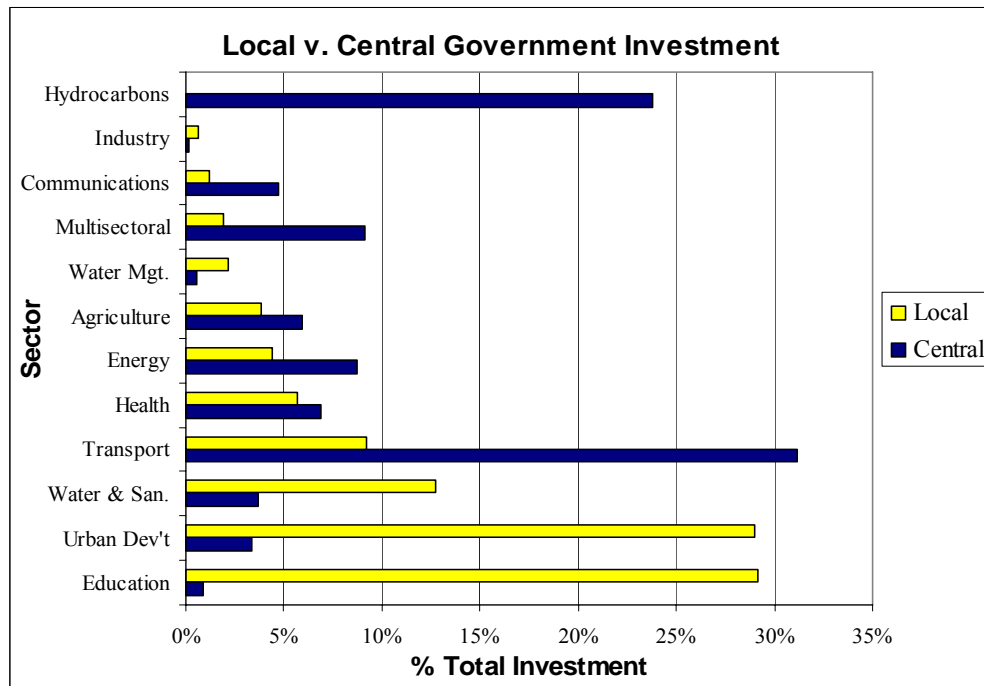
Measuring the effects of decentralisation in a country where $\frac{2}{3}$ of municipalities did not exist before reform presents special methodological problems. The vast majority of public investment in villages and towns before 1994 was undertaken by central government. But financial records of these projects do not include information on which municipality they would eventually belong to. Hence it became necessary to work with local experts in geographic information systems to allocate the thousands of public investment projects in the 1987-1993 Public Sector Investment Budget¹⁰ to Bolivia's municipalities as created or expanded in the 1994 reform. This was carried out under the auspices of a World Bank-funded research project, 'Decentralization and Participatory Planning in Bolivia', which analyzed the effects of the 1994 reform on government responsiveness to objective and subjectively expressed local needs, through a blend of qualitative and quantitative methods. By comparing detailed financial reports from pre-reform investment projects with high-resolution maps of Bolivian towns, villages and geographic features, a small team of Bolivian geographers was able to identify the physical location of the majority of central government investments, and then allocate them to the municipalities defined by the decentralization reform. In this way, we were able to re-construct municipal investment data for a period in which most municipalities did not exist.

The extent of the change is perhaps best appreciated by examining the changes in resource flows decentralisation catalyzed. Before decentralisation, 308 Bolivian municipalities divided amongst them a mere 14 per cent of all centrally devolved funds, while the three main cities took 86 per cent. After decentralisation the shares reversed to

73 per cent and 27 per cent respectively. The per capita criterion resulted in a massive shift of resources away from the richest, most developed urban centres. Amongst smaller, poorer rural districts, resource increases of 50,000 – 100,000 per cent were quite common.

A more important change was to the composition of investment. Figure 1 shows aggregate central government investment during the last three years before decentralisation (1991-1993), divided by sector, compared to aggregate local government investment during the first three years after decentralisation (1994-1996), divided by sector.¹¹ For the sake of a clean comparison, central investment (dark bars) includes only resources controlled by central government agencies, while local investment (pale bars) includes only resources controlled by local governments (that is, municipalities). The differences are large. In the years leading up to reform, central government invested most in transport, hydrocarbons, multisectoral¹² and energy, which together accounted for 73 per cent of public investment during 1991-1993. After decentralisation local governments invest most heavily in education, urban development, and water & sanitation, together accounting for 79 per cent of municipal investment. Of the sectors accounting for roughly $\frac{3}{4}$ of total investment in both cases, central and local government have not even one in common. The evidence implies that local and central government have very different investment priorities. This trend is even stronger when we disaggregate the figures. It is notable that in many municipalities local tax revenues began to rise sharply after 1994, albeit from a very low base. In those districts where local revenues formed a larger share of total investment, the shift to social investment was even stronger.

Figure 1



Source: National Secretariat of Public Investment and External Finance; original calculations.

This pattern is repeated when we sum central and local public investment and look at decentralisation's effects on the total. Figure 2 shows how total investment changed between the same two periods, 1991-1993 and 1994-1996, by sector. We see that decentralisation increased total (central + national) investment in education more than five-fold, more than doubled water and sanitation investment, and led to large increases for water management, transport and health. By contrast, total investment fell most strongly in economic production and infrastructure.

Figure 2

Net Change in National (Central + Local) Public Investment, 1991-93 vs. 1994-96	
Sector	Change (%)
Education	547%
Water & Sanitation	133%
Water Management	77%
Transport	44%
Health	43%
Mining & Metallurgy	34%
Multisectoral	11%
Hydrocarbons	-18%
Energy	-23%
Urban Development	-27%
Agriculture	-34%
Industry & Tourism	-57%
Communication	-59%
TOTAL	16%

Source: National Secretariat of Public Investment and External Finance; original calculations.

It is also instructive to examine how investment was distributed geographically among Bolivia's municipalities before and after decentralisation. Again, we compare central(-only) investment in 1991-1993 with local(-only) investment in 1994-1996. Figures 3-5 show total investment per capita in all Bolivia's municipalities, where each municipality is a dot. An equitable distribution of investment would appear as a narrow band of points. What do the data show? Figure 3 shows that per capita investment before decentralisation was indeed highly unequal, with large investments in three districts and the vast majority at or near zero. Figure 4 corrects for the skewing effect of the highest observations by excluding the upper 12, allowing us to expand the vertical axis and see more detail. Though the distribution now appears less unequal, the density of dots increases steadily as we move downwards. Fully one-half of all observations lie on the horizontal axis. These municipalities received nothing. Closer examination reveals that these are disproportionately Bolivia's small, poor, rural districts.

Figure 3

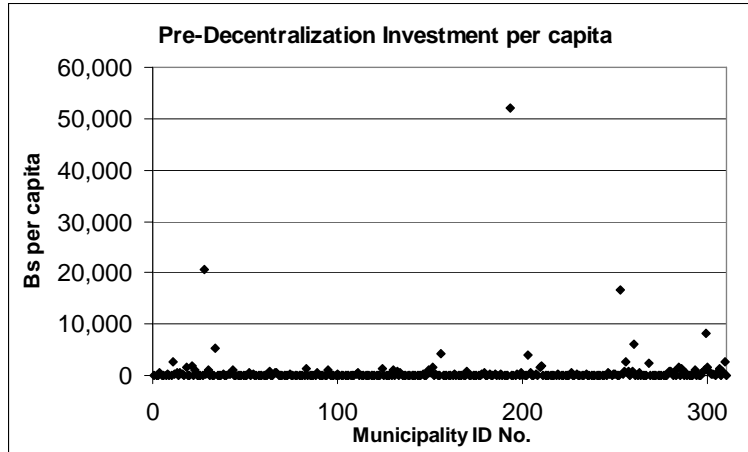
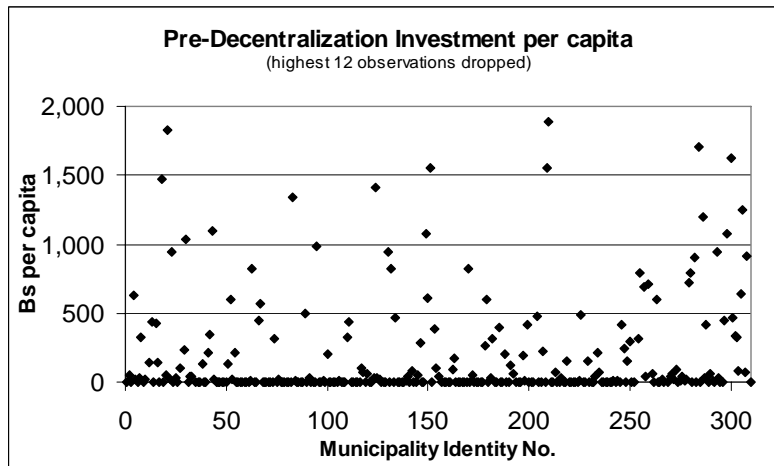


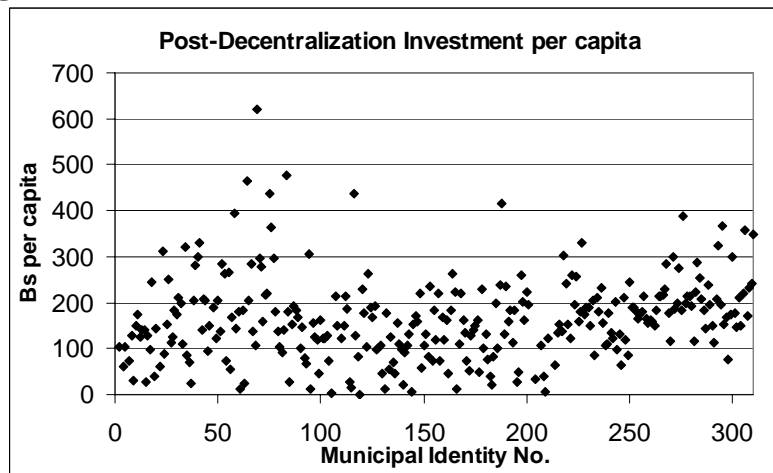
Figure 4



Investment under centralised government was thus hugely skewed in favour of a few municipalities that received enormous sums, a second group where investment was significant, and the unfortunate half of districts which received nothing. Compare this to figure 5, which shows municipal investment after decentralisation. This chart shows no district over Bs.700/capita, a broad band with greatest density between Bs.100-200/capita, and only a few points touching the axis. Average municipal investment for this period is Bs.208/capita, and thus the band contains the mean.¹³ These crude indicators imply that decentralised government distributed public investment much more evenly than centralised government. Equality in per-capita terms is, of course, largely a

result of the design of the reform, as noted in section 2.1, point 1. The *ex-post* result is thus not as surprising as the *ex-ante* one: central government, with a much larger budget and free rein over all of Bolivia's municipalities, consistently chose a highly unequal distribution of investment across space. We return to this point in lesson six below.

Figure 5



Source: National Secretariat of Public Investment and External Finance; original calculations.

Did these changes of allocation across sectors and space lead to any deeper changes in the *quality* of public investment? Ideally we would investigate such a question by comparing quality-adjusted units of public outputs before and after decentralisation. But such information is unfortunately not available for either country (nor, indeed, for most countries). But we can investigate a related question, regarding decentralisation's effects on the responsiveness of public investment to local needs. As noted above, improved responsiveness to local citizens is one of the central – and most disputed – arguments in favour of decentralisation, and hence any evidence in this respect is of particular interest.

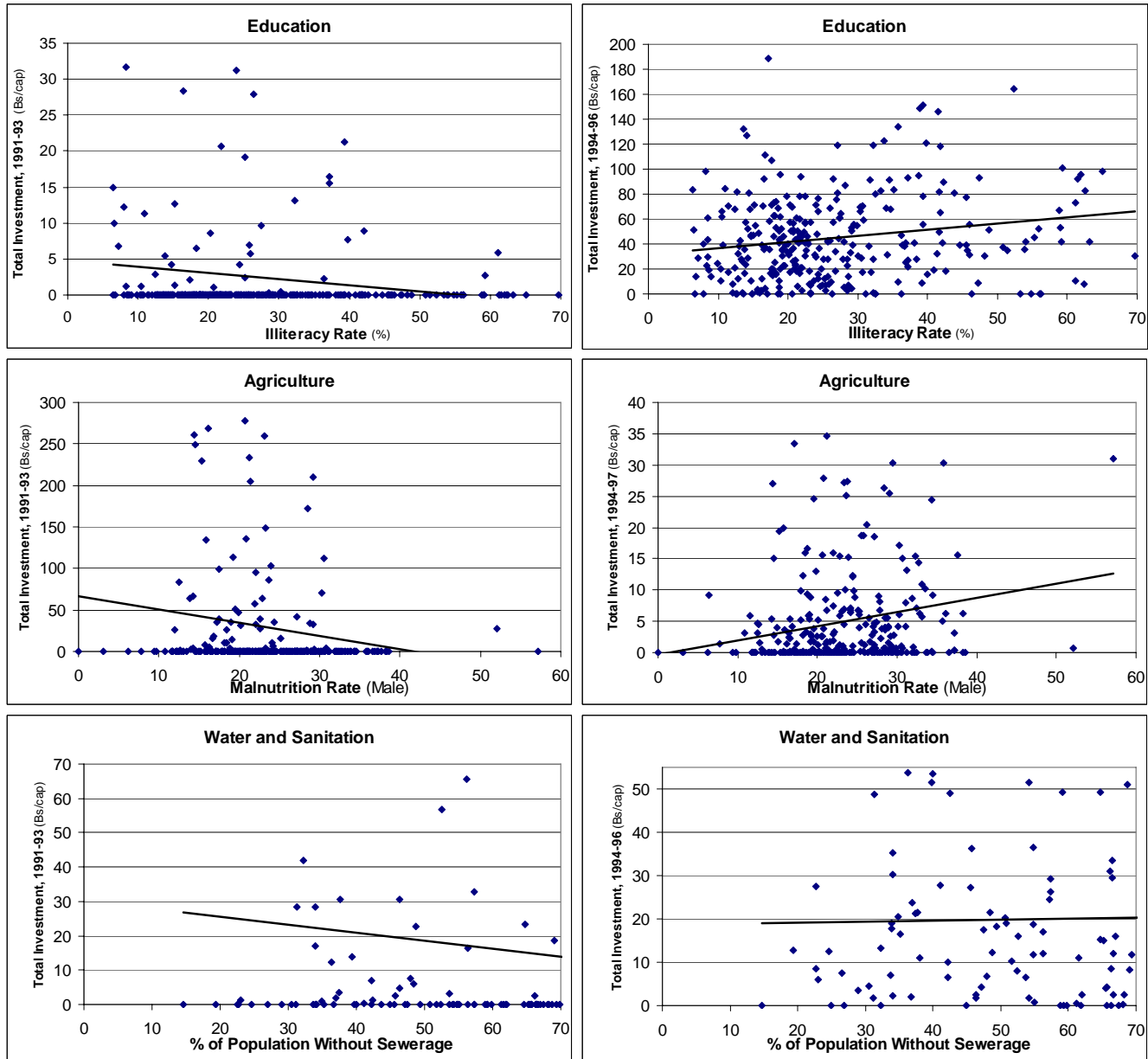
Figure 6 shows scatter plots of central government investment (left-hand side graphs) vs. local government investment (right-hand side graphs) in education, agriculture, water and sanitation, and urban development. The graphs plot central

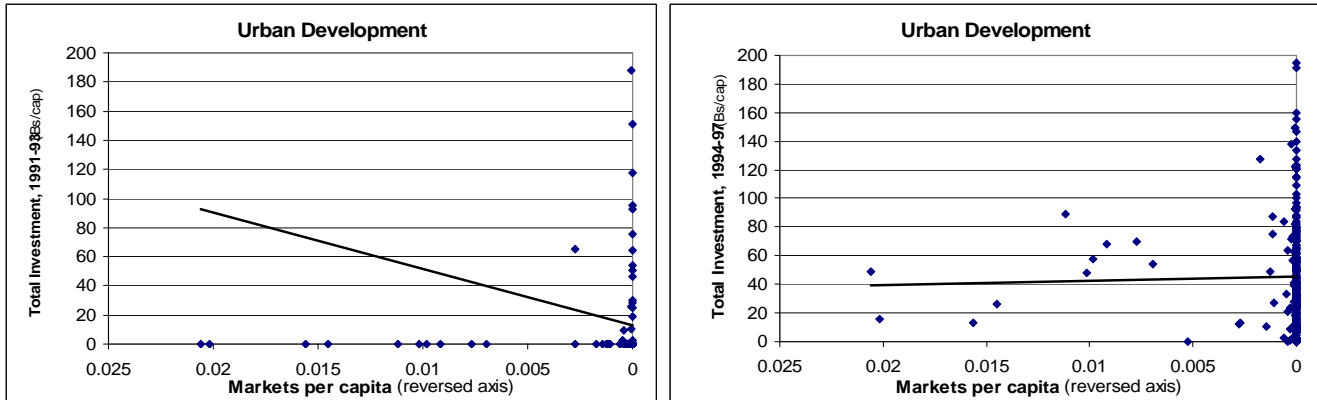
government investment during the last three years before decentralisation vs. local government investment during the first three years after decentralisation, against objective indicators of real local need in each municipality. Each graph includes a regression line summarizing the overall relationship.

The first comparison shows that central education investment fell as the illiteracy rate rose, meaning central government chose to concentrate education resources where literacy was higher. This is the opposite of what we would expect if central government were investing in areas of greatest need. After decentralisation, by contrast, local governments invested progressively more where illiteracy was higher. Both regression lines are statistically significant – at the 5 per cent and 0.1 per cent levels respectively. Note how many municipalities received no education investment at all under centralised rule. The following two graphs show a similar pattern for agriculture. Central government invested less where malnutrition rates were higher, whereas local governments invested more where malnutrition was higher. Both of these regression lines are significant at the 5 per cent level. The pattern is similar, though less dramatic, for water and sanitation, and urban development.¹⁴ In both sectors, strong tendencies to concentrate investment where it was least needed were reversed with decentralisation, although in both cases local governments' progressiveness is weak and statistically not significant. But even if we assume both decentralised regression lines have a slope of zero, this marks a significant change from central investment that increased where need was lower.

Figure 6
Central Gov't Investment, by Municipality

Local Gov't Investment, by Municipality





Sources: National Institute of Statistics, National Secretariat of Popular Participation, National Secretariat of Public Investment and External Finance; original calculations.

These graphs imply that decentralisation increased government responsiveness to real local needs. After 1994, investment in education, agriculture, and water and sanitation was higher where illiteracy rates, malnutrition rates, and sewerage non-connection rates were higher; and urban development investment was higher in places where public infrastructure such as marketplaces was more scarce. That is to say, although median investment in these sectors increased throughout Bolivia after decentralisation, the increases were even higher in those districts where the objective need for such services was greatest. These changes were driven by the actions of Bolivia’s 250 smallest, poorest, mostly rural municipalities investing newly devolved public funds in their highest-priority projects. This evidence supports the findings of Faguet (2004), which investigates a similar question.

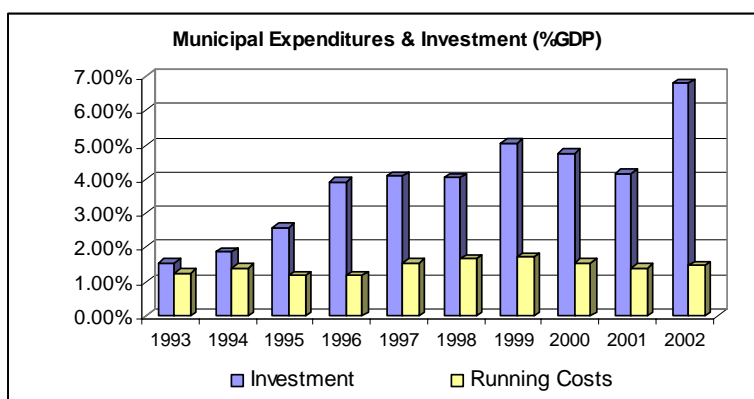
3.2 The Impact of Decentralisation in Colombia

Our Colombia dataset comprises 950 municipalities – 80 per cent of the universe – for the decade 1993-2002. For the purposes of this paper, 1993 is the base year, after which decentralisation was progressively implemented throughout the country. This view takes account of the piecemeal nature of Colombia’s earliest decentralisation measures in

the 1970s and 1980s, and considers that ‘real’ decentralisation did not begin until the raft of reforms included in the new constitution, plus accompanying regulatory laws (1991-1993), were promulgated. We thus consider 1993, the beginning of the full decentralisation process, to be a year with relatively high *centralization*, and 2002, at the other end of a decade of reform, as a year with relatively high *decentralisation*. Focusing on the changes that occurred throughout this decade allows us to examine the full implications of these deep reforms as they took hold.

As for Bolivia, statistics from Colombia tell an eloquent story. Figure 7 plots municipal investment and running costs as a percentage of GDP. While invested sums rose to some five times their initial values, personnel costs remained essentially constant. This contradicts critics who claim that decentralisation leads to increased bureaucracy at the expense of productive investment. It also contradicts those who say that inexperienced or politically captured local governments will go on a hiring spree, so wasting scarce resources. The numbers tell the opposite tale – as decentralisation advanced and reform deepened, municipalities dedicated more and more of their resources to public investment, and less and less to operating costs.

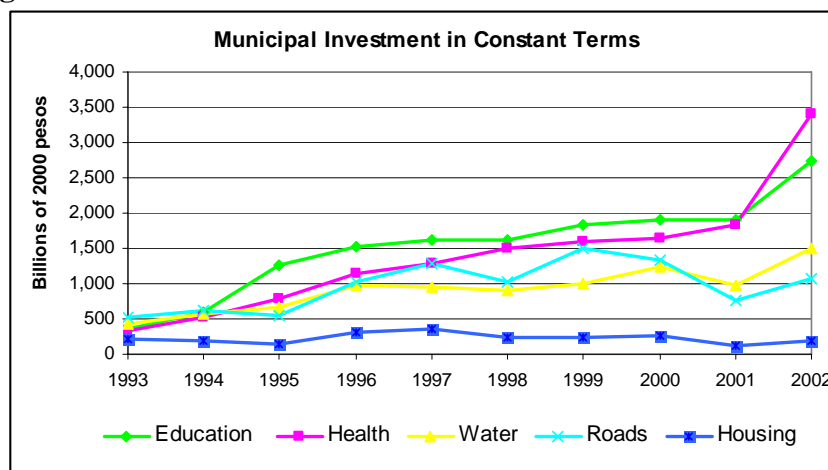
Figure 7



Source: Ministry of Finance, National Planning Department; original calculations.

How was this increasing investment budget spent? Figure 8 shows investment by sector in billions of constant 2000 pesos, and allows us to compare social investment (that is, human capital formation) with investment in physical infrastructure. We see that education, health and water investment rose between three and seven times in constant peso terms, while investment in roads doubled and housing remained broadly stable. Decentralisation thus significantly increased investment in social services and human capital formation at the expense of physical infrastructure, again the opposite of what many of decentralisation's critics contend. As in Bolivia, local tax revenues rose strongly with decentralisation, although from a much higher base, so that local revenues were a much larger share of total municipal resources in Colombia. And also like Bolivia, the trend towards social and human capital investment was stronger in those municipalities where local revenues were a larger share of the total. These facts contradict those who claim that local government is too ignorant, corrupt, or inept to invest in basic social services, which should be left instead to a wiser and more technocratic central government. Decentralisation coincided with an increase in social investment locally, and as decentralisation deepened the trend accelerated.

Figure 8



Source: Ministry of Finance, National Planning Department; original calculations.

Did decentralisation change the distribution of resources across space? Figures 9 and 10 compare central government investment in 1994 with local government investment in 2003, measured in constant 2002 pesos/capita. For the sake of comparability with Bolivia, figure 9 includes only resources controlled by the centre, and figure 10 includes only resources controlled by municipalities. Each dot represents a municipality. Moving from figure 9 to figure 10, we see that the dots become more dispersed after reform. Hence public investment became more unequal, the opposite of what happened in Bolivia. Under centralization most municipalities were concentrated in a band between 100,000–200,000 pesos/capita, and there was a small number of ‘winner’ municipalities that received more than 300,000 pesos/capita. By the end of the period, by contrast, density in the 100,000–200,000 pesos/capita band had fallen, and there were five times more ‘winners’. These changes are far less dramatic than in Bolivia, mostly because centralised government in Colombia invested much more equitably across space. Indeed, mean public investment by central vs. local government is almost identical.¹⁵ But more detailed examination of the data shows that central resource transfers to the smallest, poorest, most rural municipalities were higher after decentralisation than before.

Figure 9

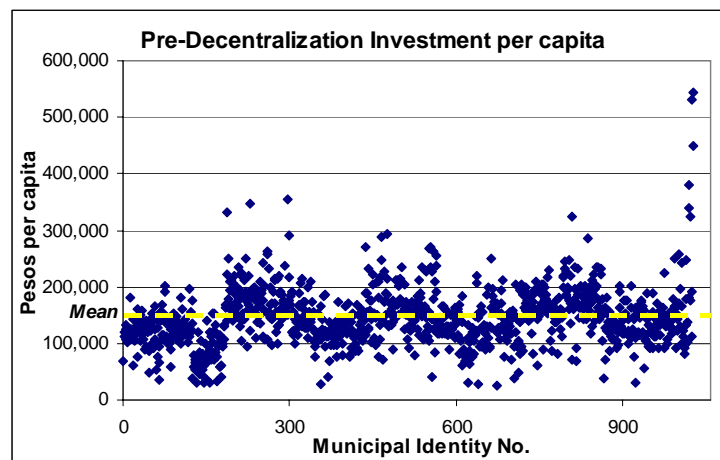
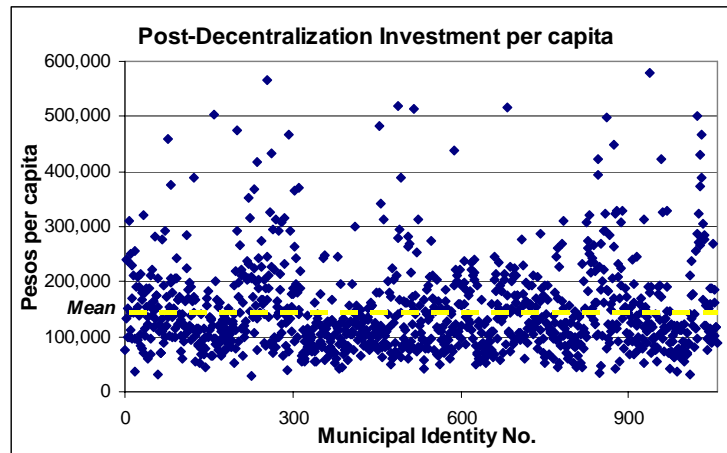


Figure 10



Source: Ministry of Finance, National Planning Department; original calculations.

These statistics paint a rosy picture of Colombian reform. But decentralisation was not entirely trouble-free for Colombia. During the period in question, Colombia's stock of public debt doubled and interest payments tripled. This formed part of a deteriorating fiscal performance from the mid-1990s onwards, which led Colombia to sign a formal agreement with the IMF for the first time in its history in an attempt to stem capital flight and ease pressure on the peso. Colombia suffered its most serious recession in three generations. Alesina *et al.* (2000) and others have blamed this fiscal deterioration largely on unbalanced local-central government fiscal relationships. Did decentralisation lead to macroeconomic instability in Colombia, per de Mello (2000)?

It is a matter of record that decentralisation was followed by significant borrowing by sub-national governments, and then a string of bankruptcies, which ultimately cost the national treasury dear. It is also true that fiscal imbalances between central and state governments in Argentina and Brazil, including especially an implicit political guarantee of sub-sovereign debt, contributed significantly to the recent Argentine economic collapse, and to Brazilian financial instability in the late 1990s. But is important to remember that in Colombia the economic events in question occurred during an

extraordinary period. Pres. Ernesto Samper (1994-1998) stood accused by the United States of having been elected with drug money. As American economic sanctions took their toll and Colombians demonstrated in the streets against their government, the administration undertook a comprehensive campaign to win the support of political and regional elites. Rather than scaling back the central state, as the very word ‘decentralisation’ implies, its headcount rose; national borrowing increased as the administration sought to expand its base of support and survive the political storm. The costs of this campaign were considerable, and added significantly to Colombia’s fiscal woes. Disentangling the effects of this crisis in legitimacy from those of decentralisation *per se* is a complex task. Suffice it to say that a decentralisation program with built-in, unnecessary fiscal imbalances contributed to Colombia’s fiscal problems of the late 1990s, but is not solely responsible for them.

4. Conclusions and Policy Lessons

Figure 11 summarises the key outcomes of decentralisation in both countries.

Figure 11

Summary of Key Outcomes		
<i>Decentralization...</i>	Bolivia	Colombia
1 shifted public investment into social services and human capital formation, at the expense of physical infrastructure	✓✓✓	✓✓
2 shifted resources to smaller, poorer, rural districts	✓✓✓	✓
3 distributed investment more equally across space	✓✓✓	X
4 made investment more responsive to local needs	✓	<i>i.i.</i>
5 increased local investment while holding running costs steady	<i>i.i.</i>	✓✓
6 increased local tax revenues	✓	✓✓

✓✓✓=Yes, very strongly, ✓✓=Yes, strongly, ✓=Yes, modestly, X=No, i.i.=insufficient information

The experiences of Bolivia and Colombia lend credence to some of the central claims in favour of decentralisation. Investment in basic social services and human capital

formation rose strongly in both countries. In both countries, shifts in national investment aggregates were driven by the smallest, poorest municipalities investing newly-devolved resources in their preferred projects. By shifting resources towards poorer districts, decentralisation made investment much more equitable across space in Bolivia.

Decentralisation made government more responsive by re-directing public investment to areas of greatest need – for example, Bolivian investment in education and water & sanitation rose after 1994 where illiteracy rates were higher and water and sewerage connection rates lower, respectively. In Colombia, municipal investment rose fivefold with no increase in running costs. In both countries local tax revenues increased strongly, although more so in Colombia.

But decentralisation is no panacea. It can be done badly, and across many nations probably has been. It is here that the country comparison is most informative. In Bolivia, the vote was in practice more restricted than Colombia. Bolivia had further to go to make decentralisation – and indeed democracy – work. Fortunately, a number of systemic reforms were enacted in the 1980s and 1990s which paved the way to a well-ordered municipal system. These increased transparency in the vote count, ensured voting secrecy, provided for independent oversight of the voting process, and increased the number of polling stations in rural areas. But they also included non-electoral reforms, such as a new, efficient citizen registration process (which in turn permitted voter registration), and the extension of rural literacy programs (especially amongst women). Their collective effects were broad increases in voter registration and participation.

But the secret to the success of these reforms lay in large part with the design of the decentralisation program itself. The LPP brought rural areas into the municipal

system, and then devolved significant authority and political responsibility to them. Whereas before rural dwellers voted, if at all, for cantonal officials who had neither resources nor political power, now fully-fledged municipal governments with real resources and legislative authority were at stake. The prospect of gaining control over these drove political parties into the countryside in search of rural votes. The prospect of benefiting from them pushed villagers and farmers into municipal politics and into the voting booth.

As evidence, consider the number of valid votes cast in municipal elections in Bolivia. These rose by 39 per cent between 1993 and 1995, while absenteeism fell by 14 per cent. This implies two effects: while decentralization (1) gave registered voters a greater incentive to participate, the dominant effect came through (2) registering new voters, and hence including a large, new group of citizens in the political process. In this way, the concerns and opinions of a previously ignored sector of the population were brought into the political mainstream, as electoral politics penetrated deeper and deeper into the hinterland. This, then, is the **first lesson**: democracy and decentralisation are deeply complementary, and in order for the latter to work well, the former must be locally free, fair, transparent and competitive.

The experience of both countries – and in particular the key outcomes cited above – imply that elite capture did not dominate the post-reform experience in either.¹⁶ Why is this the case? The first thing to note is that there is abundant anecdotal evidence from both countries of municipalities that *were* captured by elites, including in Colombia by guerrilla and paramilitary forces. Hence the question can be re-phrased as: why were captured municipalities in the minority? Why did capture, and the effects of capture, not

dominate the post-decentralization experience? Our comparison implies that the electoral-systemic reforms described above were complemented in both countries by additional measures of consultation and representation – OCs in Bolivia, and citizens’ initiatives, *cabildos*, and *Juntas Administradoras* in Colombia. Together, systemic reforms and complementary consultation mechanisms comprised a robust system of citizen accountability and control of local authorities that promoted pro-poor outcomes and curbed elite capture.

The **second lesson** is a negative one, best illustrated in the Colombian experience. In order for decentralisation to work well, sub-national governments must face hard budget constraints. Reform programs featuring central guarantees of sub-national debt – whether legally explicit or politically implicit – lead to fiscal imbalances that can ultimately threaten economic stability. Colombia is a good example of this. Bolivia, by contrast, shows that this problem can be overcome through good institutional design. There, central government refused to guarantee municipal debt, a threat made credible by the centre’s weak finances, and those few cities able to borrow were left to sink or swim by their own devices; several sank.

To a large extent, hard budget constraints are implicit in the very definition of decentralisation. By contrast, debt guarantees imply a continuing central intervention in local affairs that violates the functional independence that decentralisation presupposes. Alesina *et al.* suggest simply banning sub-national governments from taking on debt, allowing them only to ‘borrow’ against future Treasury disbursements. Another solution could be strict limits on borrowing levels and maturities; a third would be for the centre to simply refuse to bail out local governments. This last option has proved politically

extremely difficult in many countries, some of which have devised creative alternatives (Ter-Minassian 1997). In Hungary (Singh and Plekhanov 2005) and Poland (Swianiewicz 2004), for example, implicit guarantees of local debt are combined with legal limits on debt levels, and strong internal controls and auditing by the centre. The result has been few problems with local bailouts, and a pattern of timely repayment. Singh and Plekhanov find corroborating evidence from an analysis of data from 44 countries. The precise form of limits and restrictions is less important than the principle – decentralisation requires hard budget constraints.

The **third lesson** follows on from the second. If decentralisation means devolving resources, responsibility and authority from higher to lower levels of government, then it also implies that the higher levels must be scaled back. The central headcount must be reduced, as officials are transferred to regional and local governments, or simply fired. Bolivia did this, slashing the budgets and headcounts of its regional development corporations, while Colombia did not. The consequences for Colombia were dire. Why did Colombia fail where Bolivia succeeded? The principal reason behind Bolivia's behaviour is the historical weakness of its fiscal position. With a very tight budget and only limited access to international debt markets, Bolivia simply could not expand local spending without reducing it elsewhere. This is not true of Colombia, where the state is better resourced, and the treasury has a long history of tapping international markets.

Other deeper historical and economic differences between the two countries most likely play a role. But their identification must await future research into longer time-spans. This is because for the period in question, such factors are overwhelmed by the presence of a deep crisis of legitimacy in Colombia, and its absence in Bolivia. As

mentioned above, the logic of securing political support for an embattled administration precluded scaling back central government spending, and so the Colombian state expanded at all levels for several years, provoking fiscal crisis. In Bolivia, meanwhile, decentralization proceeded in relative calm.

The **fourth lesson** concerns the importance of devolving significant tax-raising powers. The point is well illustrated by Colombia, where local revenues have increased much faster than Bolivia. Local taxes are important, firstly, because they provide more resources for local services. Secondly, to the extent that public expenditure implies a direct cost to the local economy, local policy debates will weigh competing options more carefully, and better decisions will be made. If local budgets come entirely from central transfers, by contrast, citizens may feel less ownership over municipal resources, and accordingly less interest in how they are spent. This translates into less interest in local government, and less oversight and accountability.

But *how* powers and responsibilities are devolved is also important. The reason that Colombia has made more progress increasing local revenues is probably related to the sequencing of reforms. Combining both political and fiscal decentralization in a single, ‘shock therapy’ treatment, as Bolivia did, risks overwhelming smaller, administratively weaker municipalities. In learning their new roles and responsibilities, public officials in such places naturally focus on some parts of the reform, such as the investment budget, or elections and consultations, and ignore others, such as local tax revenues. This, broadly, is the story of Bolivia. Contrast with Colombia, where fiscal reforms that emphasized local tax revenues came first, followed by political reforms, and then further fiscal and administrative reforms. Sequencing gave Colombia’s local

officials time to focus on one aspect of a complex package, often under direct central government tutelage, before being confronted with another. The **fifth lesson**, then, is that decentralization is not so much a policy package as a dynamic process. It *can* be broken down into discrete steps – for example fiscal, political and administrative. The sequencing of these steps is important, and paying careful attention to that sequence improves outcomes. The ‘optimal’ sequence of reforms, however, is likely to differ country-by-country, depending on history and initial conditions.

One last, **sixth lesson** arises from the observation that the central government invested far more equitably across space in Colombia than Bolivia. Decentralisation’s effects depend very much upon the character of the centralised regime preceding reform. In both countries, decentralisation was designed to favour poorer rural municipalities. In Colombia, this resulted in a modest re-allocation away from major cities, whereas in Bolivia the effect was a huge fiscal equalization shock. Where central government allocates resources is very unequally, or very inefficiently, a decentralisation that re-allocates resources more neutrally will tend to have dramatic consequences. But where the centre was equitable and efficient, such effects will be smaller. Where central government is highly efficient and competent, the economic case for decentralisation (based on how resources are allocated) may well vanish entirely.

Getting these lessons right is of seminal importance to any decentralisation program. Done badly, it can make government more costly and bureaucratic with little or no offsetting gain. But under the right circumstances, decentralizing resources and political authority can generate real accountability where none existed before, and improve the quality of government a society achieves.

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³ At the time MNR strategists gleefully predicted such a result. They proved wrong.

⁴ “Injertos Tramposos en ‘Participación Popular’”, *Hoy*, 19 January 1994; “La Declaratoria de Guerra del Primer Mandatario”, *La Razon*, 27 January 1994; and “Arrogancia Insultante”, *Presencia*, 27 February 1994 are only three of the many articles which appeared in the Bolivian press documenting popular reaction to the “Damned Law”. These are documented in Unidad de Comunicación (1995).

⁵ I am indebted to Dr. Teddy Brett for this apt analogy.

⁶ I am indebted to an anonymous reviewer for this point.

⁷ Alesina *et al.*, 2000. The regional average is 15 per cent.

⁸ Sánchez *et al.*, 2000, show that central transfers grew from 2 per cent of GDP in 1990 to almost 7 per cent in 1997.

⁹ The *Frente Nacional* (1957-1974) quelled *La Violencia* by sharing out the fruits of power equally between Liberals and Conservatives, and restricting electoral competition to those two parties.

¹⁰ Source: Ministry of Finance, National Secretariat of Public Investment and External Finance.

¹¹ In both Bolivia and Colombia, “local investment” refers to construction and maintenance of capital facilities, and equipment and supplies for the same. In Colombia it also includes salaries of the staff directly involved in providing those services. In Bolivia, by contrast, salaries, staff selection and retention remained core central government responsibilities.

¹² A hodgepodge, including feasibility studies, technical assistance and emergency relief, that is difficult to categorise.

¹³ Investment sums here are much lower because they exclude central government funds.

¹⁴ Note that the x-axis is reversed for urban development, for comparability. This is because the dependent variable used here is a positive, and not negative, concept.

¹⁵ Under central government mean investment was \$144,876/capita, s.d. = \$51,093/capita. Under local government mean investment was \$145,878/capita, s.d. = \$79,998/capita.

¹⁶ I am indebted to an anonymous reviewer for pointing this out.

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