



# SOCIAL FUNDS INNOVATIONS NOTES

## Integrating Social Funds into Local Development Strategies

### FIVE STORIES FROM LATIN AMERICA

RODRIGO SERRANO

The steady movement towards decentralization that Latin America has experienced in the last decade, often referred to as the “quiet revolution” has led governments and donors to rethink the role that Social Funds (SFs) should play in promoting local development. While SFs had been relatively successful in building local infrastructure, insufficient integration with public sector systems (both national and local) had raised well founded concerns about institutional and investment sustainability. The challenge for governments going through the process of decentralization was to decide whether to institutionalize SFs as a long-term instrument for promoting local development or to disband these institutions.

A quick survey of the regional experience reveals three broad kinds of responses to this challenge. Some governments have opted to close down SFs, transforming them into pure fiscal transfers. Mexico, for instance, abandoned PRONASOL and put in place formula-driven, earmarked transfers to municipalities known as Ramo 33. Others have opted to ignore this challenge. Until recently, for instance, Guatemala had multiple overlapping SFs that coexisted in an environment of patronage and

clientelism. The new government is seeking ways to revert this. Finally, many governments in the region are reforming SFs into instruments that support local development.

This Note gives a quick overview of how these reforms are unfolding in five SFs in Latin America (see Table 1) and highlights some features of the emerging models. **It shows that many SFs are working closely with local governments. For these SFs the challenge is no longer whether they undermine local governments or not but rather how they can become an effective instrument of the country’s decentralization policy**—i.e., how their interactions with local governments, communities, and sectoral agencies advance the decentralization policy objectives and a more balanced approach to local development.

While the enabling environment for decentralization in these five countries has significant room for improvement (e.g., clarifying responsibilities across levels of government), when compared to most countries in Africa and Asia we see that basic building blocks are already in place. In all five countries local governments have elected authorities,

**Table 1. Five SFs in Latin America Working with Local Governments**

<b>Nicaragua</b>	Fondo de Inversión Social de Emergencia (FISE)
<b>Honduras</b>	Fondo Hondureño de Inversión Social
<b>El Salvador</b>	Fondo de Inversión Social para el Desarrollo Local (FISDL)
<b>Bolivia</b>	Fondo Nacional de Inversión Productiva y Social (FPS)
<b>Peru</b>	Fondo Nacional de Compensación y Desarrollo Social (FONCODES)

## Box I. Bolivia: Social Funds as an Instrument for Managing Conditional Transfers to Local Governments

In 2000, the government of Bolivia merged the earlier social investment funds into the FPS which became the single window for channeling matching grant resources to municipal governments. FPS was the main instrument to implement the central government's anti-poverty policy called National Compensation Policy (NCP). The NCP aimed to rationalize fiscal transfers to municipalities from government and donors, to introduce progressive criteria and a pro-poor bias to intergovernmental finances and to establish a mechanism to reconcile local demands with national priorities through a matching grant system of "relative prices." Government created the Unified Directorate of Funds (DUF) to approve and oversee the plans and budgets of the FPS and the municipal credit fund (FNDR), and to promote synergies and coordination among these two funds and with the rest of the public administration.

While these reforms suffered from a number of design and implementation problems, the overall assessment is that both the creation of FPS and DUF moved the system in the right direction in terms of rationalizing the government's investment policy. One lesson that comes out of this experience is the need to plan the merger processes better—while FPS was able to go back recently to the funds' previous level of administrative efficiency, during the transition the "internal processes used by the FPS became so complicated that the number of days that it took from the moment of submitting a subproject to the start of its execution grew to 490 days." (see PAD Bolivia-PSAC for Decentralization II).

and access to a local tax revenue base as well as to a general purpose transfers from the central government. In all countries there are ongoing reforms to empower citizens in local governance and service provision, as well as awareness that decentralization should proceed in a context of fiscal responsibility.

The increased commitment to decentralization in these five countries has signaled the end of SFs as ad-hoc structures for financing and managing local infrastructure investments. Through different reform strategies governments are integrating SFs into the institutions supporting the governance and provision of services at the local level. These reforms—which involved either mergers of funds, absorption by line ministries, or the institutionalization of SFs as permanent agencies with clearer and permanent mandates—are ongoing and unfinished. However, there is a convergence in the roles that are being assigned to SFs:

- First, to gradually transform these funds into conditional, matching grant mechanisms that leverage municipal investments toward

national priorities. Bolivia and El Salvador were the first examples of this trend, and the other three countries are moving in a similar direction. (see Box 1)

- Second, to be the implementation arm of a local investment national program for poverty reduction, focused on strengthening local government and community capacities for planning, financing, and managing local infrastructure services in a participatory and accountable manner. (see Table 2)

This Note highlights selected aspects of the experience of these five SFs in supporting the planning, financing, and implementation of local investments (see Table 2 for a summary).

### PARTICIPATORY MUNICIPAL PLANNING

All five countries have developed statutory regulations mandating Participatory Municipal Planning (PMP) processes, and in all countries Social Funds only finance investments that come out of such plans. This is a major change from the previous sit-

**Table 2. Social Funds Support to Local Development in Five Countries in Latin America**

Country	Planning		Financing		Implementation	
	Do projects come from Participatory Municipal Plans?	Statutory Guidelines for PMP	Do LG manage the funds?	Allocation Mechanism	Who has the main responsibility for implementation (contracting, supervising, etc)?	Are LG and communities involved in maintenance?
<b>Honduras FHIS</b>	Yes	Yes. Municipal Development Strategic Plans	Only accredited LG  Some LG also transfer to Comm groups	Formula based, (Poverty Map)	Accredited (LG, Municipal Associations)  Non-accredited (SF)	Yes. Municipal Maintenance Plans, Community Maintenance Organizations
<b>Nicaragua FISE</b>	Yes	Yes. Municipal Planning System	Only accredited LG  Some LG also transfer to Comm groups	Formula based (Poverty Map). Transitioning to matching grants reflecting sectoral priorities.	Accredited (LG).  Non accredited (SF)	Yes. Preventive Maintenance Fund Community Maintenance Organizations
<b>Peru FONCODES</b>	Yes	Yes. Participatory Budgeting Law	Only accredited LG	Formula-based (Poverty Map)	LG or Joint Community-LG Teams	Yes
<b>El Salvador FISDL</b>	Yes	Yes. Minimum Criteria guidelines	All LG that win	Competitive Biddings	LG	Yes
<b>Bolivia FPS</b>	Yes	Yes. Popular Participation Law	LG approves payment and FPS pays contractors	Formula based, indicative municipal allocation (poverty map). Matching grant reflecting sectoral priorities	LG	Yes. Also there is a 25% reduction in counterpart as a reward for good O&M (it has not been used yet)

LG: Local Governments

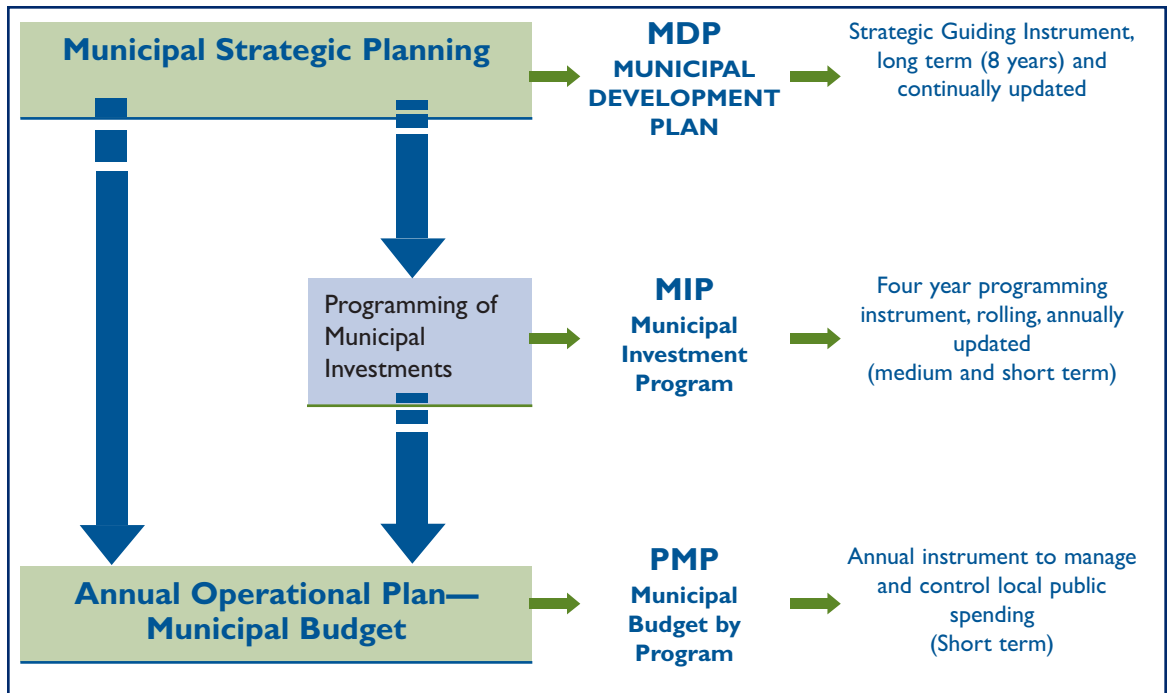
uation in which SF financed isolated projects presented mostly by individual communities and approved centrally by the Social Fund. This previous approach was criticized because of its potential to undermine local governments, and its lack of transparency and downward accountability.

While in Bolivia and Peru Social Funds changed their project selection in response to the passing of new national laws regulating municipal planning (e.g. the Law of Participatory Budgeting in Peru), in the three Central American countries the new

national regulations were largely influenced by the experience of the Social Funds with PMP processes. The almost decade-long experiment of these three Social Funds with participatory planning methodologies suggests the following lessons:

- In contexts where local governments are elected, autonomous entities, social funds should strive to finance projects that come out of participatory municipal plans rather than isolated community demands. While initial conditions in some countries may be adverse to institutionalizing PMP, its potential benefits

**Graph I. The Municipal Planning System in Nicaragua<sup>1</sup>**



(in terms of allocative efficiency, inclusiveness, and accountability) make it worthwhile to take gradual steps towards its adoption.

- If municipalities lack such plans, and there are no statutory instruments on PMP, social funds can contribute by developing PMP methodologies and jumpstarting the interest on the issue. The more these instruments are designed based on the “municipal” rather than the “social fund” perspective, the more likely it will be that they are adopted as part of the normative framework regulating PMP.
- Once the government has passed the statutory regulations for PMP social funds can play an important role as the implementing agency managing the process through which assistance is provided to LG and communities to develop these plans.
- There are different strategies for developing a normative PMP framework. Some countries, like Nicaragua, chose to develop a framework that details processes, instruments, and institutions (see Graph I). Other countries, like El

Salvador, have guidelines establishing a set of minimum criteria that municipal plans should meet but without specifying a unique methodology for fulfilling them. FISDL provides simple and comparative information on municipal performance for each criteria as benchmarks for municipalities to identify where they need to improve.

## FINANCING

Until a couple of years ago most of the SF funding was managed centrally by the SF. Currently these five SF are transferring all or a substantial portion of their resources directly to local governments. In Honduras and Nicaragua some LG are transferring funds even further down to community groups. Different contexts and policy objectives have led these five social funds to develop different rules for allocating and accessing these transfers.

Bolivia’s National Compensation Policy, implemented through the FPS, has two objectives. To

<sup>1</sup> INIFOM y AMUNIC (2002). Sistema de Planificación Municipal. Guía Ilustrada. Managua: INIFOM.

## Box 2. FISDL's Program to Mobilize Financial Support from Associations of Salvadoreans Abroad

Over the last couple of years, FISDL has been working to stimulate the contribution of associations of Salvadorans living abroad for financing of local development projects. The goals have been to:

- Recognize and support the social commitment of Salvadorans living abroad, strengthening the communication links between them and the different private and public national actors.
- Develop a program that strengthens the contribution of Salvadoran communities abroad for local development works in their communities of origin.
- Strengthen the institutional structure that works with Salvadoran communities abroad.

Associations of Salvadorans can participate not only in the general Competitive Biddings window that FISDL uses to finance projects, but more recently they can also participate in a specific financing window where FISDL allocates 1 million dollars per bidding to co-finance projects where these Associations participate.

Since September of 2,000, about 30 Associations of Salvadorans abroad have mobilized US\$2.13 million or about 19% of the US\$11.45 million invested in 45 development projects. Another US\$2.28 million was leveraged from municipal governments, US\$ 6.9 million from FISDL, and US\$115,000 from Ministries.

compensate for differences in poverty levels across municipalities, FPS defines indicative municipal allocations following a poverty and population-based formula. To gear local investments towards national sectoral priorities for poverty reduction, FPS finances projects following a system of “relative prices” in which the co-financing rate is lower for sectoral investments that are a central government priority and for poorer municipalities. Some lessons on the performance of these two objectives so far are:

- While poorer municipalities have received a larger share of FPS resources than their richer counterparts, it has been less than what was expected according to the indicative allocation formula. The lower capacity to manage investments (and the absence of mechanisms to compensate for them) hindered poorer municipalities from fully executing their indicative allocation<sup>2</sup>
- While the analysis that is available makes it impossible to verify whether the FPS has been

effective in influencing municipal priorities, changes in sectoral investment allocations at the municipal and FPS levels show different directions (eg, education went from 51% to 12% in 2002–2004 in FPS, and from 17% to 23% in 1999–2003 in municipalities) (Frank 2004). Part of the problem appears to be the resistance of donors and departmental governments (prefecturas) to honor the National Compensation Policy, establishing parallel financing mechanisms that undermine the NCP.

El Salvador's FISDL has a competitive bidding allocation mechanism that uses the share of counterpart funding as the main criteria for prioritizing investments in each bidding round. FISDL finances only municipal infrastructure projects above US\$50,000 as a way of complementing the focus on small-scale projects that LG tended to finance with their own resources. Contrary to what some feared, the process did

<sup>2</sup> Aguilar Perales, Javier and Fernando Ruiz Mier (2004). *Hacia Una Nueva Política de Transferencias Condicionadas a Gobiernos Municipales*. Draft. La Paz.

not discriminate against poorer and smaller municipalities—89% of the funds were awarded to municipalities in the poorest three quintiles. As an incentive for good municipal practices, LG have to fulfill a set of conditions (related to participatory planning, investment efficiency and transparency) to be eligible to participate in the bidding. During the last few years, FISDL has placed a special emphasis in stimulating associations of Salvadorans living abroad to partner with municipal governments in funding local development projects (Box 2).

Similarly to Bolivia, the other three SF also make municipal allocations on the basis of a formula incorporating population and poverty indicators. While so far they do not have clear mechanisms to influence the sectoral allocations at the municipal level, this appears to be changing. In Nicaragua, for instance, the gradual increase in general purpose transfer to municipal governments in a context of unclear transfer of responsibilities and concern for fiscal neutrality is leading government to convert FISE into a matching grant scheme that links local spending decisions with the national poverty reduction goals. All three SF have in place some

form of accreditation system establishing the ex-ante conditions that LG need to fulfill in order to receive the transfer (see below).

Some social funds have experiencing with new instruments to bring greater transparency and efficiency in their financial transactions with LG. In Honduras, for instance, FHIS is piloting a Trust Fund (Fideicomiso) with a national private bank which is responsible for making all the financial transactions through its extensive branch network.

### INVESTMENT MANAGEMENT CAPACITIES

While the rationale for decentralizing resources through SF in countries like Bolivia or El Salvador was to influence local spending decisions, in countries like Nicaragua and Honduras the main rationale was to gain allocative and productive efficiency by delegating resources and decision-making power to local actors. In the latter cases, SF entered into temporary principal-agent arrangements with local governments under the assumption that relying on local capacities would produce services in a cheaper, faster, and more responsive

### Box 3. Efficiency and Accountability Gains of the Decentralized Approach in Nicaragua

An evaluation of FISE's Pilot<sup>3</sup> concluded that the decentralized approach to investment management performed better than the centralized model in terms of efficiency, effectiveness, and transparency.

- The pace and volume for infrastructure building was much higher than the historical record in the same municipalities as well as in comparable municipalities during the same period.
- Project Beneficiary Committees were able to participate in local government's bidding process, something which was absent in the centralized model.
- Contracting and procurement was 40% faster and 7% cheaper. The latter was a result of greater competition among contractors in the decentralized model.
- While real costs in the decentralized model were 4% lower than estimated costs, in the centralized model real costs for similar projects were 6% higher than estimated ones. Construction times for similar projects were 40% faster in the decentralized than in the centralized model. In general, the decentralized model compares favorably in terms of number of fines, renegotiation of costs, and timeframes for project completions.

<sup>3</sup> Grun, Stephen (2002). Evaluación del Programa de Descentralización de Gestión y Manejo del Ciclo de Proyectos del Fondo de Inversión Social de Emergencia (FISE). Managua.

#### **Box 4. Fostering “Mancomunidades” (Municipal Associations) to Reach Municipalities with Weak Capacities**

Frustrated by the difficulty to decentralize its project cycle to a larger number of municipalities due to their weak managerial capacities, in 2002 and in partnership with KfW and GTZ, FHIS began a pilot with the Municipal Association of CAFEG. CAFEG which groups 7 of the poorest municipalities in the country located in the Lempira Department, was an attempt by these municipalities to share the costs of technical assistance by jointly financing a technical unit serving all seven municipalities.

After the first year, in which FHIS subsidized the unit's expenses, municipalities have honored their initial commitment to fully cover the Unit's costs out of their transfers. So far, CAFEG has successfully managed 31 investment projects for a total of approximately US\$800,000. It has a lower overhead than FHIS (6.7% instead of 10%). The technical unit has 4 employees (1 civil engineer, 1 administrator, and 2 social promoters) in addition to equipment, an office, and transportation.

Encouraged by the success with CAFEG, FHIS has already signed agreements with 19 Municipal Associations (known in Honduras as *Mancomunidades*). Similar experiences are taking place in many other countries in the Region.

and accountable manner. Preliminary evidence of the experience in Nicaragua supports these arguments (Box 3).

Decentralizing the project cycle is not an easy task given that most local governments have weak managerial capacities. This is why some SF (in Peru, Honduras, Nicaragua) have followed a gradual approach where municipalities have to prove that they have the minimum capacities for managing investments before assuming their new responsibilities. While in Peru the accreditation system is binomial (in or out) social funds in Honduras and Nicaragua have a multi-tier graduation system that allows municipalities to take on more or less investments responsibilities according to their managerial capacities. For municipalities with low capacities, social funds are supporting the formation of Municipal Associations which allow several municipalities to afford the shared provision of technical services (Box 4). In the municipalities that have not been accredited, the social fund manages investments in its traditional way (either through contractors or community groups).

Not all countries, however, have a gradual transfer strategy. Both El Salvador and Bolivia have delegated the project cycle to all local governments irrespective of their capacities. While in El Salvador this approach does not seem to have penalized poorer municipalities in Bolivia it does. Comparing these approaches should provide useful lessons.

One of the key roles that SF play under the decentralized model is to develop local government and community capacities to manage local investments. Two of the areas where social funds usually have a comparative advantage are, first, in developing and assisting in the implementation of systems and procedures for local investment management. The main challenge here has been to design a system that is not social fund-specific but instead general and applicable to all municipal clients. In Nicaragua, the pilot phase revealed that local governments had different project management systems for each donor or public agency, and that FISE's system was only adding to that fragmentation. To fix this problem, and at the request of the municipal development agency, FISE has developed a generic “municipal” investment management system.

Another system-wide innovation that FISE has brought to managing local investments is the establishment of a Preventive Maintenance Fund<sup>4</sup>.

A second innovation has to do with bringing CDD practices in the repertoire of local government management tools. SF are trying different variations of the same idea of having local governments and communities be jointly responsible for the construction and operation and maintenance of local infrastructure. In cases like Honduras this means that the local government subcontracts and supervises the Community Project Committee which manages the resources for project implementation. In cases like Peru it means having a mixed project committee formed by three representatives from the community (president, secretary, treasurer) and one from the municipality (fiscal).

## A LEARNING AGENDA

As decentralization processes deepen in Latin America, governments are confronted with the need to either reform social funds or to shut them down. The experience of the five social funds reviewed here shows that the trend has been towards reforming them to play a clearer role in the overall decentralization policy. Because more and more countries are facing the same challenge these ongoing reforms provide us with an opportunity to learn about what works and what does not. Some of the pending questions are:

- *Institutionalization.* What kind of reforms work better to integrate social funds into public sector systems? What lessons do mechanisms like the Directorate of SFs tried by Bolivia (and now being emulated by Guatemala) leave about the effectiveness of such mechanisms?

In cases of program mergers, what transition strategies can minimize the risks of institutional paralysis?

- *Municipal Matching grants.* How to design matching grant systems that ensure the poverty focus of municipal investments? What kind of M&E system is needed to measure their effectiveness in influencing municipal priorities?
- *Planning.* What systems and procedures allow governments to reconcile local participatory planning with sectoral planning? And within local planning, to resolve the tensions between popular preferences and technical knowledge? How can national governments ensure that local participatory processes include the poorest and the most vulnerable groups?
- *Accreditation and capacity building.* What was the performance in those Social Funds that followed a gradual approach to delegation of responsibilities versus those that delegated to all LG at the same time? Why, among the latter, some instruments seem to penalize poorer LG (Bolivia) while others do not (El Salvador)?
- *LG-Community Partnerships in implementation.* With local governments assuming a more central role in the provision of services, the challenge becomes how to prevent them from repeating the centralist tendencies that have plagued national agencies. Partly to address this risk, SFs are giving incentives for LG-community partnerships for the implementation of small-scale investments. Do these partnerships produce better outcomes than without them? Do differences in their design matter?
- *Social Capital.* How to prevent that the social capital created or strengthened by social funds is not project-specific but can be used toward broader developmental purposes?

<sup>4</sup> For more information see Serrano and Warren (2003). Re-engineering SFs for Local Governance: The Central American Experience. *Spectrum* (Fall Issue).

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