LOCAL DEVELOPMENT AND FISCAL ACCOUNTABILITY PROGRAM

(BO-0180)

EXECUTIVE SUMMARY

Borrower and guarantor: Republic of Bolivia

Executing agency: Ministry of Finance, through the National Regional Development Fund [Fondo Nacional de Desarrollo Regional] (FNDR) and the National Fund for Productive Social Investment [Fondo Nacional de Inversión Productiva y Social (FPS)

Loan modality: Multiphase (first phase up to five years)

Amount and source:

(in US$ millions)

	Phase I (FSO)	Phase II	Total
IDB:	47.0	40.3[1]	87.3
Local:	7.6	5.6	13.2
Total:	54.6	45.9	100.5

Financial terms and conditions:

Amortization period:	40 years
Grace period:	10 years
Commitment period:	4 years
Disbursement (first phase):	5 years
Interest rate:	1% Grace period 2% Amortization period
Inspection and supervision:	1%
Credit fee:	0.75%

Objectives: The objective of the program is to support Bolivia's policy for increasing municipal management efficiency in an effort to expand and improve the quality of the services that local governments provide to their communities. The contribution toward this effort will be made through direct support for municipal investment by means of *financing local development projects,* and by contributing to *improving the institutional and financial framework of the municipal sector*, particularly in terms of: (i) fiscal relations and the distribution of responsibilities among the various levels of government; (ii) approval of responsible municipal fiscal administration practices;

[1] Subject to the availability of FSO funding for Bolivia.

and (iii) the financing mechanisms (by credits and/or transfers) and control of local public spending.

The studies, discussion, and legal processing involved in assigning responsibilities, consultations, and preparation of the financing conditions are expected to take more than one political cycle to be fully completed. Also, approval of responsible practices in municipal fiscal management and fulfillment of the conditions by the municipality call for a monitoring period of at least three years to ensure that sustainable physical investment rest on a sound footing. The deepening of the financial market and its more competitive position for the municipalities requires actions and regulations to ensure that the opening up of the municipal sector to commercial bank financing takes place in a setting of sound credit and adequate guarantees to cover the different types of risk that the sector may face.

Description: Given the broad scope of the program's institutional objectives, the time required for consolidating fiscal and financial reforms and the reform of functions within the municipal sector, and for strengthening the municipalities themselves, the government and the Bank have agreed to view this as a multiphase operation: the first phase, with a loan of US$47 million and a duration of up to five years, and the second phase, with a loan of approximately US$40 million and a duration of an additional five years.

The components of the program are as follows:

1. **Municipal investments (US$40 million)**: Investments by means of credits and transfers will be made in urban and social development projects that correspond to the socioeconomic development priorities of the municipalities. Through credits, projects will be eligible in the traditional urban investment sectors of the FNDR (such as urban road systems, storm drains, erosion and flood protection, city services such as solid waste collection and disposal, public lighting; transportation terminals, markets, and other urban facilities, environmental protection, parks, and green spaces). Through transfers, projects are eligible in sectors defined as priorities in the national dialogue process, such as rural development (local roads, irrigation, and other sectors), education, health, micro and macro drainage projects, basic sanitation, rural energy, the environment and natural resources, institutional strengthening, and production infrastructure.

   Physical investments will be made with program funds provided that the goals agreed upon in the institutional adjustment plans (IAP) worked out with each municipality have been met.

2. Institutional strengthening (US$11.0 million)

2.1 **Municipal adjustment projects (US$3.8 million)** will support implementation of institutional strengthening programs in municipalities. The intent of these programs is to produce prudent financial management, verified by performance indicators established and agreed upon in agreements with the municipalities. These agreements are the outcome of comprehensive analyses to be undertaken in each municipality, which will identify the means for institutional improvement that will be supported in each case by means of credits and/or transfers. The adjustment projects will be concentrated in the following sectors: (i) integrated tax and financial administration; (ii) information and internal management control systems; (iii) human resources management systems; and (iv) means to increase the efficiency of public services (public cleaning, roadway maintenance, social and other services), by transferring or privatizing those services, or improving their management.

2.2 **Property registers (US$5.5 million)**. Financing with credits and/or transfers of at least 10 municipal property registers, in light of existing weaknesses in this area and their importance to strengthening fiscal responsibility. The property register activities and the timetable for implementing them will be established in the agreements specified in the institutional adjustment programs which will also determine the credit-transfer financing "mix" for each beneficiary municipality. The major milestones in establishing the new property registers and their functioning will be verified in the monitoring of the IAP agreed on with each municipality.

2.3 **Sector development (US$1.7 million)** consists in designing and implementing strategies for the development of municipal management, with a focus on: (i) ***Intergovernmental relations***: review of the allocation of responsibilities among the various levels of government and of the system for intergovernmental transfers; and a review of the current legislation, so that adjustments may be made to the requirements of the new institutional framework for subnational governments; (ii) ***Sector financing***: supports new financing modalities for municipalities, including the promotion of private financing for the sector, including the possibility of private members in the FNDR that will contribute to municipal financing; and (iii) ***Fiscal management***: which will support the creation and maintenance of updated databases on finances and the performance of periodic risk assessments for the municipalities, by private firms.

3. **Program administration and supervision (US$3.1 million)**

The program's administrative costs include (i) the administrative costs of program management by the DUF and the operating costs of the coordinating unit; and (ii) the costs of implementing computerized operations control systems which will serve the two funds and the DUF. The Support for Execution and Monitoring category will finance: (i) the costs of preparing the institutional assessments of the municipalities and prefectures; (ii) the promotion and dissemination of the program within municipalities throughout the country; (iii) the cost of hiring participative evaluation services and monitoring program results, based on the benchmarks in the logical framework; and (iv) the independent audit of the program, which will include concurrent audits for the FNDR and the FPS.

The Bank's country and sector strategy: The main objective of the Bank's strategy in Bolivia, which is the fight against poverty, follows three lines of action which, in turn, are consistent with three of the four *pillars* of the government's Operating Action Plan strategy for 1997-2002: (i) economic growth and the creation of opportunities, which includes the environment (*opportunity* pillar); (ii) human capital development and access to basic social services (*equity* pillar); and (iii) good governance and consolidation of reforms (*institutionality* pillar). The three lines of action in this operation are consistent with the above-mentioned strategy; the operation supports the results of the national dialogue with regard to the objectives of strengthening the decentralization process, economic growth, and the social development of the urban population, particularly for low-income groups.

Environmental and social review: The Committee on Environment and Social impact (CESI) approved the environmental and social protection procedures and the means for affected communities to participate. The urban and social development projects will have a positive impact on the beneficiary population and the environment. The municipalities environmental management capacity will be strengthened (see paragraphs 4.12 through 4.18).

Benefits: On the basis of its review of the sector's institutional framework, the program will help introduce efficiency criteria in intergovernmental transfers to municipal governments, providing incentives for better use of their local fiscal potential, increasing net fiscal savings, and rationalizing spending at the various levels of government. Preparation of the IAPs will also bring about responsible fiscal behavior, promoting standards of prudent borrowing and maintaining the municipalities' fiscal balance. As a result, the municipalities will be able to increase their savings capacity and generate resources for investment and for maintaining their public services, particularly services for low-income groups.

The program will create the conditions and will provide incentives for mobilizing private funds for the municipal sector, making the sector's financing more competitive. These additional resources are vital and important for the financing of income-producing projects and to promote responsible financial management in municipalities.

The modernization of management and the expansion of the range of municipal public services, supported by the program, will provide significant advantages for their users, and improve the quality of urban life. The rural development projects, financed by means of transfers, will help improve the quality of life of poor rural communities.

Risks: However, the country is undergoing a period of consolidation in municipal sector institutions, at the local and central levels. In attempting to modernize this framework, the program will propose changes of a legal nature that depend on broad political consensus. This poses a potential risk to achieving some of the program's sector reform objectives, but this risk is mitigated by their dynamic nature and the adjustments to policies that the multiphase modality offers.

Attaining the program's development objectives and improving the institutional performance of the municipalities also depends on the proper functioning and implementation of the government's compensation policy. The new system makes the use of transfers more transparent, requiring that the projects submitted be decided upon with the participation of the communities. The challenge lies in the response capacity of small communities and the willingness of government agents to support them. The program seeks to mitigate this risk by financing promotional and project preparation activities, and by requiring that the funds meet goals relating to their response to municipal requests. On the other hand, by adopting a multiphase loan modality and through the methodology of institutional adjustment plans that may run for up to three years, a closer relationship will be established and more frequent monitoring will be performed with regard to the actions undertaken by the municipalities, particularly with respect to the management changes that are planned, so that the necessary adjustments will be facilitated and the requisite technical support may be provided.

Special contractual clauses: The following are conditions precedent to the first disbursement of financing: (i) the government must demonstrate that it has created the program coordinating unit (PCU) and hired a coordinator and an accountant as agreed with the Bank (see paragraph 3.8); (ii) the Operating Regulations must be approved (see paragraph 3.16); (iii) subsidiary agreements must be signed between the Ministry of Finance and the investment funds for transfer of the financing (see paragraph 3.14); (iv) the FNDR and FPS internal procedures manuals

prepared in accordance with the technical and administrative requirements agreed on in advance with the Bank must have been approved (see paragraph 3.6); and (v) drafts of the agreements signed between FNDR and FPS and each of the municipal governments concerning participation by the latter in the program must have been submitted to the Bank for approval (see paragraph 3.15).

Conditions precedent to financing for nonreimbursable transfers to municipal governments are that: (i) the government submit to the Bank the formula established for granting such transfers and the indicative allocation of those transfers to the municipalities for the initial two-year period in accordance with the technical criteria agreed on with the Bank (see paragraph 3.4); and (ii) the borrower must demonstrate that the FPS has started financing one municipal project, as established in its procedures manual (see paragraph 3.7).

As a condition precedent to disbursement of the financing for lending to municipal governments, the borrower must demonstrate that the FNDR and the FPS have formed an Approval Committee for Institutional Adjustment Plans (IAPs) (see paragraph 3.17).

The loan contract will contain three special clauses concerning the establishment of more equitable regulations that will permit the supply of municipal credit to be expanded and a suitable control structure in fund and municipalities to be assured: (i) during the period of the loan, the borrower must submit proof to the Bank each year that the FNDR is complying with the standards of the Supervisory Authority of Banks and Financial Institutions; (ii) the government will authorize Nacional Financiera de Bolivia (NAFIBO) to open a line of financing for municipal credit to be effective by month 18 after the effective date of the loan contract (see paragraph 3.11); and (iii) the outside audit of the program will include specific semiannual reports on the results of the internal control structure assessment and the review of procedures and activities relating to procurement and disbursements made by the FPS, FNDR, and municipalities, in accordance with the benchmarks agreed upon with the Bank (see paragraph 3.47).

Poverty-targeting and social sector classification:

This operation qualifies as a social equity-enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704).

Furthermore, this operation qualifies as a poverty-targeted investment (PTI) (see paragraphs 4.19 through 4.21).

The borrowing country will be using the 10 percentage points in additional financing (see paragraph 4.23).

Exceptions to Bank policy: None.

Procurement: Contracting will be done in conformity with Bank procedures for construction work, procurement, and hiring of consulting services. International competitive bidding will be used for construction work in amounts equal to or greater than US$2 million and procurement in amounts equal to or greater than US$350,000, in the case of goods and US$200,000, in the case of consulting services. The Bank's Country Office will perform an ex ante review of the first processes of each modality for each of the funds. Depending on its evaluation, the Country Office may grant the FNDR and/or FPS authorization for ex post implementation of the procedure in the future. Given the amount of contracting that the program involves, the FNDR and the FPS will act as supervisors of procurement procedures that will be carried out by the municipal governments themselves, based on the standard bidding documents of the program's Procurement Regulations (Annex III-1).

I. BACKGROUND

A. Local urban context

1.1 Bolivia has been undergoing a process of urbanization, the result of which is that some 64% of the total population of 8.3 million in 2000 is an urban population. Migration from rural and economically depressed areas has created serious shortfalls in public services and infrastructure in areas receiving this influx, which also tends to concentrate poverty in the periurban areas of Bolivia's large cities. Presently, more than 50% of the population below the poverty line is living in urban areas, many of them with limited or no access to basic services. Accelerated urban growth, in turn, presents a challenge for local governments, adding further complexity to their weak management capacity. The annual urban growth rate of 4.2%, as indicated in Table I-1, means that some of the largest cities are growing at a rate of 6% to 7% per year. There are now eight cities with populations in excess of 100,000 inhabitants, twice what they were a decade ago.

Table I-1. Bolivia-Urban and Rural Population 1975-2000 (in thousands)

Year	Rural Population	Urban Population	Total Population
1975	2,600	1,900	4,500
1990	3,000	3,600	6,600
2000	3,000	5,300	8,300
1975-1990	+400	+1,700	+2,100
1990-2000	0	+1,800	+1,700
Annual growth (1975-2000)	**+0.6%**	**+4.2%**	**+2.5%**

Source: UDAPE 1999

1.2 Urban poverty affects 47% of the inhabitants of the major cities, i.e. 2.7 million of the 5.2 million poor people nationwide. Of the nine major cities in Bolivia, six have poverty rates in excess of 50%, and two, Potosí and El Alto, have rates of 66% and 60% respectively.

1.3 These factors explain, in part, the heterogeneity of Bolivia's municipal sector, which is characterized by a great diversity of geographical, economic, social, and cultural situations.

Table I-2. Municipal Socioeconomic Indicators (1996)

Municipality size	Mean population 1992 (thousands)	Per capita income US$ year	BNI 1/	HDI 2/	Sanitation Coverage	Commercial establishments (x 1000 inhabitants)
>50 thousand	216.7	1,891.2	62.3	53.5	41.4	26.9
>15 to 50 thousand	24.2	1,272.4	85.8	41.7	25.2	4.8
>5 to 15 thousand	9.5	1,145.7	92.7	39.5	29.7	4.1
Up to 5 thousand	2.4	1,117.0	94.8	40.6	21.8	6.1
Average	**20.6**	**1,201.7**	**90.3**	**41.0**	**26.8**	**6.0**

1/ BNI = Index of unmet basic needs
2/ HDI = Human development index

1.4 This diversity is also reflected in diverse conditions with regard to technical and public management capacities. The administration of many municipalities is weak and falls within a political system characterized by high turnover rates. This does not provide motivation for training or retaining a specialized bureaucracy.

Table I-3. Municipal Management Indicators (1996)

Municipality Size	Employees Per thousand inhabitants	Personnel Training (%)	Current Savings	Investment/ Inhabitant 1997 Bolivianos	Taxes/x Inhabitant 1997 Bolivianos
>50 thousand	3.3	10.3	61.0	241.6	85.1
>15 to 50 thousand	1.6	14.3	77.7	139.9	19.8
>5 to 15 thousand	1.4	11.9	80.0	127.8	9.8
Up to 5 thousand	4.7	10.9	81.5	154.6	4.9
Average	**2.6**	**12.0**	**78.9**	**144.4**	**14.1**

Source: Municipal Census and Government General Accounting Office

B. The municipal development institutional framework

1. Political and administrative context

Box I-1. The Political and Administrative Context of Decentralization

The territory of the Republic of Bolivia is divided into nine regions called *departments*, and presently into 314 geographical continuous municipalities.
The **municipality**, the existence of which dates back to the colonial period, has locally elected municipal councils and mayors. Municipal councils have from five members in municipalities with fewer than 50,000 inhabitants to 11 members in cities that are the capitals of departments. Municipalities have their own sources of tax revenues, and receive block transfers called "revenue share-outs".
The **Grassroots Territorial Organizations [Organizaciones Territoriales de Base] (OTBs)** represent the people and are invested with responsibilities and rights that relate to municipal management. There are approximately 14,000 of them throughout the country. The Vigilance Committees [Comités de Vigilancia] (CV) are composed of representatives of the OTBs. The OTBs and the CVs are invested with responsibilities and rights that relate to municipal management.
The **prefecture [prefectura]** is the decentralized administrative political entity responsible for the department. The President of the Republic appoints the prefects, who represent him in the department, but there is also an elected Departmental Council with the power, for example, to accept or reject the prefecture's budget.

1.5 Until 1994, Bolivia maintained a high level of centralization in its public administration. The transition to an efficient decentralized scheme is obviously a long and difficult process. Nonetheless, after only six years of effort, Bolivia has made significant advances in the decentralization process. The municipal institution has taken root; mayors are playing an important political role, and they are sometime more popular than the ministers at the national level. In many cases, public resources have been allocated more efficiently, and with greater geographical equity.

1.6 The decentralization process in Bolivia is based on the 1985 General Law of Municipalities (and its later amendment), which grant political autonomy to municipal governments. Subsequently, the Constitutional Reform of 1995, the Popular Participation Act (LPP) of 1994, the Administrative Decentralization Act (LDA) of 1996, and the Executive Powers Act of 1997 expanded the process in the municipal sphere, and constitute the current legal framework for decentralization in Bolivia.

1.7 The Popular Participation Act of 1994 (LPP) marked the beginning of a decisive decentralization policy, with an emphasis on strengthening local autonomy and accountability through participative mechanisms. It also increased the responsibilities of municipal governments, delegating to them the administration of infrastructure relating to health, education, culture, sports, local roads, and micro irrigation services; the maintenance and expansion of that infrastructure, and gave them responsibility for local services in general. At the same time, the municipalities were granted resource transfers as well as the authority to collect

local taxes. The LPP extends municipal jurisdictions so that they cover the entire territory of Bolivia[1].

1.8 The LDA defines the prefectures as deconcentrated entities and regional links between the central and municipal levels, with the major responsibility of coordinating the implementation of national priority policies at the local level. The prefectures are responsible for pursuing regional development, maintaining law and order, strengthening municipal governments, administering certain public services not delegated to the municipalities, carrying out investment programs for roads, rural electrification, irrigation, and tourism, and administering education and health personnel.

1.9 Table I-4 summarizes the allocation of responsibilities among the thee levels of government.

Table I-4. Allocation of responsibilities among the various levels of government

Responsibilities	National Government	Prefectures	Municipalities
Primary and secondary education	Standards	Personnel management	Operational infrastructure
Health	Standards	Personnel management	Infrastructure/equipment
Roads	National roads	Departmental roads	Local roads/city streets
Urban infrastructure, water and sanitation	---	Technical and financial assistance to municipalities	Construction and maintenance
Local services: trash collection, slaughter houses, markets, cemeteries, parks and gardens	---	---	Supply and maintenance
Environment	Standards	Standards, implementation	Implementation, supervision
Support for economic activities	Standards, activities at the national level	Coordination of municipal plans	Local projects
Cultural and historic heritage	Standards and national heritage	Protection of departmental Heritage	Protection of municipal heritage

1.10 With the exception of basic urban services, and those services in which coordination has clearly been established, the allocation of responsibilities among the prefectures and municipalities is unclear. The division of responsibilities does not clearly distinguish between broad services assigned to departments, and local services. Both levels operate in the same areas, and have competing or shared responsibilities, for example in terms of sports or social, cultural, and tourism

1 In 1994, under the LPP, 310 municipalities were established. Presently, the number of municipalities stands at 316, many of which received political and administrative autonomy without prior management experience.

activities, while the prefectures have a mandate to complement municipal actions. This leads to problems with regard to efficient allocation of resources, and determining specific responsibilities. One example of this is the allocation of responsibilities in education and health, sectors in which a division of responsibilities has taken shape, with operating and investment costs paid by the municipalities, while salaries, in terms of financial management, remain at the central level.

2. Aspects of decentralized fiscal management

a. Financial resources

1.11 Local governments have three main categories of resources: their own funds, transfers, and borrowing. With regard to the interactions among them, these resources and the system's incentives must be analyzed as a whole, in terms of the municipalities' responsibilities and the objectives of national policies.

(i) Own funds

1.12 The economic basis of the municipalities must be their own funds, ensuring the expansion and sustainability of services. In Bolivia, these revenues include the tax on real estate and vehicle ownership, the municipal tax on transfers of real estate and vehicles, special taxes for improvements, licenses, charges and fees for administrative services and processing.

1.13 The share of municipalities' own funds with respect to total revenues varies significantly depending on the size of the municipality. In those with more than 50,000 inhabitants, the proportion is 50% of total revenues, while in those with up to 15,000 inhabitants, the proportion does not exceed 5%. This indicates a nearly complete dependence on revenue share-outs for funds, and also reflects both the disparity among municipal tax bases and the lack of incentives to mobilize their own funds. While there are communities where collections are high, there are others where collections remain low. In fact, 70% of all local revenues are collected in 10 municipalities.

Table I-5. Indicators of Fiscal Independence (%) (1997)

Municipality Size	Own funds/Total revenues	Taxes/ Total revenues	Revenue share-outs, Current Revenues
> 50 thousand	50.2	31.5	48.3
>15 to 50 thousand	9.9	8.2	78.9
>5 to 15 thousand	4.5	3.9	89.3
Up to 5 thousand	2.5	2.0	92.3
Average	**7.4**	**11.4**	**72.2**

Source: Government General Accounting Office.

1.14 Most municipal revenue categories do not seem to provide significant collections, with real estate and vehicle ownership taxes supplying municipal treasuries with the bulk of their revenues. In 1998, real estate taxes accounted for 38.3% of all

collections by municipal governments (Bol. 279,809,689), followed by other nontax income at 23.5%, indirect taxes at 18.1%, and vehicle licenses at 12%.

1.15 The distribution of taxes among the various levels of government must seek to maximize the efficiency of fiscal administration as a whole. The current distribution of taxes at the local and central levels in Bolivia is not in contradiction with theoretical recommendations[2]. The limitations that have been identified mainly have to do with the weakness of tax administration systems. Tax rates are set at the central level, and municipal governments are responsible for determining the tax base and collecting local taxes. In general, appraisal and collection rates are low, both aspects under the control of the municipal government. With regard to tax administration, there is a great disparity of capacities within the municipalities. While the larger mayoralties are developing modern systems for assessing and collecting taxes, most of them have adopted a more passive stance, and their finances depend greatly on revenue share-out transfers.

1.16 The potential for increasing municipalities' own revenues is important. Current real estate tax collections are estimated to be less than half the potential tax base. Other sources of revenues are also believed to be underutilized. Finally, some municipalities do not have the human and material resources needed for the task of collecting taxes with a certain degree of efficiency.

(ii) **The system of transfers**

1.17 Intergovernmental relations in Bolivia are characterized by a high degree of vertical imbalance, the result of insufficient tax efforts at the subnational level and the shifting of significant responsibilities to prefectures and municipalities. Bolivia is seeking to reduce these vertical imbalances by means of a system of two types of transfers: systematic and non-systematic transfers.

1.18 *Systematic transfers:* these occur at the municipality and prefecture level. Municipal governments receive revenue share-out funds equivalent to 20% of the central government's national revenues[3]. In 1999, tax revenue share-outs were estimated at US$180 million, approximately 2% of GDP. Tax revenues are distributed in accordance with the size of the population, based on data from the 1992 national census. Municipal governments are not subject to any sector restrictions with regard to the use of these resources; there is only one condition: that the governments must spend at least 85% of the revenues on investments.

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2 Mobile-based taxes, with the potential for export to other areas or potential efficiencies of scale at the national level go to the central government. Fixed-base taxes relating to a local geographical area are allocated to the sub-national governments.

3 National revenue is defined as the Value-Added Tax (VAT), the Complimentary Regime to the VAT (RV-IVA), the Tax on Company Profits (IRPE), the Transaction Tax (IT), the Excise Tax (ICE), the Consolidated Customs Levies (GAC), the Inheritance Tax, and export taxes. Neither taxes on petroleum and natural gas nor royalties are part of national revenues.

Given the nature of social spending, this high requirement is achieved in practice by recording for accounting purposes as investments some specific operating expenses incurred in connection with social investment projects as previously agreed with the funds.

1.19 One advantage of the present formula for distributing tax revenue share-outs to municipalities, using population as the sole indicator, is its simplicity; yet the system does have weaknesses. First, the lack of updated population data results in penalizing areas experiencing greater demographic growth. Secondly, the distribution of the resulting resources only slightly decreased regional disparities, and did not manage to set the municipalities on equal footing in terms of providing public services. Finally, there is no relationship between revenue share-outs and the tax efforts of local governments. If transfers are not linked to local fiscal efforts, incentives for efficient spending are reduced because the citizens do not perceive the real cost of services.

1.20 Transfers from the central government are the major sources of funds for the prefectures. These transfers are the royalties and share of the Departmental Royalties Compensatory Fund [Fondo Compensatorio Departamental de Regalías] (FCDR) and the Special Tax on Hydrocarbons and their Derivatives [Impuesto Especial a los Hidrocarburos y sus Derivados] (IEHD). Royalties are central taxes channeled to the point of origin of the exploitation of the natural resource. The Compensatory Fund enables departments with per capita royalties below the national average to attain that average. Finally, 25% of IEHD collections are transferred to the prefectures. In 1999, the IEHD totaled approximately US$54.4 million, while mining and hydrocarbon royalties totaled US$8.0 million and US$120 million, respectively.

1.21 *Non-systematic transfers* are channeled mainly through the investment funds[4], the activities of which aim to support policy priorities concerning the fight against poverty, and provide support for production through cofinancing of investment projects. In theory, these funds finance projects as a function of the relative needs of the municipalities, and should therefore result in equalizing transfers. It is estimated that 30% of municipal investment is financed by resources that have outside aid as their principal source of funds.

1.22 In 1998, the funds executed 18% of public investment resources, or US$93 million[5], and allocated them for education, health, basic sanitation, and urban planning. Additionally, one of the major functions of the funds is to provide

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[4] The main transfers are made through grants from the Social Investment Fund [Fondo de Inversión Social] (FIS), the Campesino Development Fund [Fondo de Desarrollo Campesino] (FDC) and credits combined with transfers from the National Regional Development Fund [Fondo Nacional de Desarrollo Regional] (FNDR).

[5] FNDR 11%, FIS 5.5%, and FDC 1.7%.

technical assistance to local governments that are beneficiaries of investment projects.

1.23 The following points should be noted with regard to transfers through the funds: (i) they have favored social investment over productive investment[6]; (ii) in general, they do not operate in a way that strengthens the capacity of municipal governments, since investments are executed directly by the funds at all stages; (iii) these transfers exhibit an anti-urban bias that has led to over-investment in rural areas and under-investment in periurban areas; and (iv) the allocation criteria and procedures are not always transparent.

1.24 In summary, it is extremely difficult to assess the equalizing impact of transfers, since it is unclear whether the combined effect of systematic and non-systematic transfers to municipalities and prefectures actually results in greater equity. The clear and significant differences in revenues at the departmental level, and the lack of transparency in the criteria for allocating cofinancing resources seem inconsistent with the objective of ensuring uniformity in providing services in the various regions of Bolivia.

(iii) Municipal borrowing

1.25 Municipalities and prefectures finance part of their spending through borrowing. The FNDR is the most important source of long-term funding. Additionally, they turn to the national financial system, trade creditors, and de facto to generating credits by not paying socials security benefits and other obligations.

Table I-6. Status of municipal governments public debt
(Department capitals, as of 30 November 1999)
(US$ millions)

Municipal Government	Current Revenues	Debt Service	VP of Total Debt	DS/CR	VPD/CR
Sucre	10.05	1.54	6.39	15.3%	63.6%
La Paz *	60.24	14.70	109.27	24.4%	181.4%
Cochabamba	31.63	6.24	49.93	19.7%	157.9%
Oruro	9.09	1.77	18.13	19.5%	199.4%
Potosí*	15.80	1.74	3.07	11.0%	19.4%
Tarija	5.80	1.18	7.33	20.3%	126.4%
Santa Cruz	47.74	18.74	72.60	39.3%	152.1%
Trinidad*	1.85	0.88	2.20	47.6%	118.9%
Cobija	0.46	0.21	1.30	45.7%	282.6%
TOTAL	**182.66**	**47.00**	**270.22**	**25.7%**	**147.9%**

* Information as of 31 December 1998.
Source: Office of Public Credit – Ministry of the Treasury.

[6] The education, health, and sanitation sectors account for two thirds of the Funds' investments from 1995 to 1998.

1.26 The systematic lack of a significant effort to generate current savings means that many municipalities are overusing their borrowing capacity. Preliminary data suggest that the situation is particularly acute in the large municipalities, such as La Paz and Santa Cruz. This fact is of concern to the economic authorities, since it affects the capacity of these municipalities to increase spending to meet growing needs, and indicates the urgency not only of establishing and implementing prudent borrowing standards, but of adopting means for the financial reorganization of those municipalities that are in the worst condition, in order to ensure that they are managed within strict parameters of fiscal discipline.

1.27 There is a series of problems relating to municipal borrowing. There are significant gaps in the legal framework for municipal borrowing, since the law only imposes limits on debt service and stock, but neither is a good measure of borrowing capacity. There is no comprehensive system for recording and monitoring debt; there is no transparency in the information about or monitoring and evaluation of municipal fiscal and financial administration; the negative incentives inherent in the existing credit system, which does not channel funds in a transparent manner, means that financing is granted to municipalities that should not be credit recipients. The FNDR, the entity responsible for channeling credit to local governments, does not contend with credit risk because it has privileged access to guarantees in that the Central Bank withholds municipal revenue share-outs (automatic debit) in cases of insolvency. This privileged guarantee overlooks borrowing regulations, does not promote the introduction of risk assessments, and prevents greater involvement on the part of private banks. Recently, the Ministry of the Treasury set limits for municipal borrowing, and established prerequisite "borrowing certificates" in order for municipalities to obtain credit from the banking system. The Office of Banking Supervision issued a regulation concerning the establishment of reserves related to the existence of such a certificate[7].

b. Municipal spending

1.28 In 1998, current municipal spending amounted to 37.7% of their overall spending, and the cost of capital, including investments and debt service, totaled 62.3%. These investments are primarily in education and health, and to a lesser extent in rural roads. That these investments are being made shows the progress of decentralization with regard to transferring greater responsibility to local entities. In 1994, only 35% of investment was decentralized, whereas in 1999 47% of public-sector investments were realized by local entities (prefectures, municipalities, and regional and local enterprises), and 19% through regional cofinancing from the investment and development funds. Only 15% of investments were made through the ministries of the central administration, 14% through the National Highway Department (SNC), and less than 1% by national public enterprises.

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7 Although well intentioned, this type of certificate may create a "moral risk" since it could be interpreted as an implicit guarantee by the national government.

C. Problems in the sector

1.29 *Inadequate allocation of responsibilities among the levels of government.* The problem of allocating responsibilities is a fundamental issue in a decentralized system, inasmuch as it affects the effective provision of services. There are discrepancies between activities accomplished by the three levels of government and the division of responsibilities originally established by law. These competing responsibilities may result in a duplication or an absence of services. The present situation of competing or shared responsibilities must be changed; clear responsibilities must be established in order to increase transparency and efficiency.

1.30 *The system of intergovernmental transfers does not meet all efficiency and equity criteria.* In order for local governments to be able to provide the services that are their responsibility, they must have access to adequate financing. Transfers must not take the place of local collection efforts, nor distort local spending priorities, while providing for horizontal equalization. The system should promote the mobilization of regional and local resources to reflect the priorities and willingness of local communities to pay taxes. The transfer system as a whole can be improved, with a focus on criteria of efficiency and equity. The formula for systematic transfers must observe the principle of equity and simplicity, in order to maintain the transparency needed so that the municipalities will understand the adopted criteria. The fiscal effort criterion must not penalize the indigenous population that has low fiscal potential. Non-systematic transfers from the funds or prefectures mean that significant investment resources are channeled in a discretionary manner. Owing to the lack of harmonization, the overall impact of the various mechanisms for financing spending on poverty reduction and regional equality is unclear. Furthermore, the combination of these mechanisms sends confusing signals.

1.31 *Lack of fiscal discipline and inadequate monitoring of municipal borrowing.* Financial information systems are a key element in public finances. Sound financial management cannot take place in the absence of proper procedures for recording and reporting on economic operations. Municipal information systems have weaknesses in their records. They are based on different budgetary and reporting structures and there are delays in providing information. Most municipalities lack comprehensive budget systems, methods for monitoring and controlling spending, and personnel administration systems to carry out these activities and to run the necessary financial systems. This lack of information fosters confusion in the fiscal and financial administration of departments and municipalities. Local autonomy calls for fiscal responsibility, and the sector thus requires an improved legal framework that sets the rules for autonomous management of resources, as well as incentives and sanctions regarding the prudent management of tax revenues, so that local governments take responsibility for the results of their actions in the area of finance.

1.32 *Weak management of decentralized services.* One of the expectations from decentralization is that the management of local services will be improved. This

requires better administrative and financial performance on the part of municipal governments, and means that communities must be more closely involved in making decisions and in supervising construction work and services. Despite progress made in this direction, serious obstacles remain to be overcome, such as: institutional weakness, particularly in small municipalities, a lack of and instability among qualified personnel, and limited experience in managing urban and social services, among others. The program will support strengthening for municipalities by means of institutional adjustment plans establishing activities of priority that will need to be financed for strengthening to occur.

D. The program's strategy

1.33 The program is coordinated with the Bolivian Poverty Reduction Strategy (EBRP). The EBRP will provide a framework of policies oriented toward the fight against poverty, with specific medium-term objectives and actions. The national dialogue started recognizing the municipality as the privileged unit for undertaking poverty reduction actions, thereby acknowledging that a successful policy for decentralizing public management is essential for the implementation of the EBRP.

Box I-2. Bolivian Poverty Reduction Strategy (EBRP)

At the meeting of the Consultative Group in October 2000, the government presented the principles on which the EBRP will be based. One of its basic elements is to expand the decentralization process to improve efficiency in providing public services and to promote local development. It has been determined that the debt relief resources of the Enhanced HIPC Initiative will be transferred directly to the municipal governments, with a fixed disbursement schedule. The resource distribution formula focuses on poverty criteria: 30% of the resources will be divided equally among the departments, and will be distributed to the municipalities by the Unmet Basic Needs (UBN) poverty indicator. The remaining 70% will be distributed among the country's municipalities in accordance with the poverty indicator.

1.34 In order for the municipalities to play this role in the fight against poverty effectively, priority has been given to sector actions intended to strengthen the institutions of local government. These measures involve revising the policy and mechanisms for transferring resources to the municipalities, and promoting responsible fiscal management of those resources.

1.35 The government's most substantial progress along these policy lines has been in relation to formulating a *compensation policy* and promoting *fiscal responsibility* at the local level. The government, through the DUF, has formulated a compensation policy that will

Box I-3. Financial Reform Plans (PRF) and their relationship to the program

The government is dealing with the problem of municipalities that have exceeded critical borrowing parameters (debt service cannot exceed 20% of current revenues from prior operations and the present value of the overall debt cannot exceed 200% of revenues from the previous fiscal year) with a ***municipal fiscal reorganization policy***. This means making the refinancing of debt in municipalities experiencing difficulties contingent upon their attaining clearly identified fiscal goals, measured by a set of financial management indicators. To that end, the government will reach individual agreements - **Financial Reform Plans.** These plans must be accomplished within a period of three to five years as a condition for refinancing the debt and for potential access to new credits. The Viceministry of the Treasury and Public Credit (VTCP) is responsible for establishing the PRFs.

The relationship of these plans to the program is that the FNDR will be able to finance institution-strengthening measures intended to remedy the causes of the imbalances at issue. Additionally, meeting the conditions and adjustment goals set forth in the PRFs is a necessary but not sufficient as a condition for financing projects by means of credits granted by the FNDR. The institutional adjustment plans (IAP) used by the program (see paragraphs 2.12 and 2.13) incorporate the fiscal adjustment indicators of the PRFs.

provide a clear and transparent framework intended to lend consistency to non-systematic transfers. All sources of nonreimbursable resources intended for the municipalities have been joined together, and will be allocated based on a formula that grants preference to poverty indicators (UBN). These nonreimbursable resources are indicatively allocated for three-year periods, and are intended exclusively for projects in priority sectors as determined in the national dialogue. In order to implement this policy, the investment funds (FIS, FDC, and FNDR) have begun a restructuring process that will separate their transfer and credit operations, under the coordination of the DUF. Transfers will be made through the National Fund for Productive Social Investment (FPS) (resulting from the merger of the FIS and the FDC), while credits will be handled through the FNDR (see Box III-1).

1.36 In terms of managing the transferred assets, the first priority has been to solve the debt issues of some major municipalities in order to provide incentives for fiscal responsibility. To that end, the Ministry of the Treasury approved the Financial Reform Program, and recognizes that, in order for borrowing to be an efficient source of financing, it must be subject to market signals. Means have been proposed to regulate and develop the capital market, which in turn must be complemented by a credit system that fosters responsible fiscal management and allows for private funds to be used in local profit-making projects.

1.37 **The program's support.** This program supports municipal sector development strategies and the government's decentralization strategies, assisting in the formulation and implementation of reforms and direct activities with the municipalities. The main lines of action are:

- *review and adjustment of the sector framework of local governments,* particularly the present distribution of responsibilities and resources within the three levels of public management, and the financing framework of the sector, fostering more active participation by the IFIs and the privatization of the FNDR;
- direct *support* for *poverty reduction investments*, with transfer and municipal credit projects;
- promotion of *fiscal responsibility* at the local level, by means of an instrument that makes the program's contributions subject to the attainment of prudent fiscal management goals (the Institutional Adjustment Plans, see paragraphs 2.12 and 2.13); and
- financing of *sustainable* projects for the *financial and institutional strengthening* of local governments.

1.38 These measures are considered strategically important for achieving the objectives of advances in the institutional role of the municipalities. However, the goal of creating local governments capable of taking on expanded responsibilities in providing services and infrastructure, and becoming active agents of local economic advancement requires a long-term sustained effort. The program proposed here includes specific means for institutional and legal change that demand a longer-term period of development and consolidation. Therefore, a multiphase program is

the most suitable instrument, since the issues of decentralization that are involved are complex processes requiring changes in policy and legislation, the building of consensus, and institutional reform, changes that will take more than a period of four to five years.

1.39 The program is therefore designed to be implemented in two phases, the first of which is described in detail in the following section. The second will depend on the implementation of the first, and on the accomplishment of the actions indicated in Annex II-1.

Box I-4. The Bank's Country Strategy

The main objective of the Bank's strategy in Bolivia is the fight against poverty and follows three lines of action which, in turn, are consistent with three of the four *pillars* of the government's Operating Plan of Action strategy for 1997-2002: (i) economic growth and the creation of opportunities, which includes the environment (*opportunity* pillar); (ii) development of human capital and access to basic social services (*equity* pillar); and (iii) good governance and consolidation of reforms (*institutionality* pillar). The three lines of action in this operation are consistent with the above-mentioned strategy; the operation supports the results of the national dialogue with regard to the objectives of strengthening the decentralization process, economic growth, and the social development of the urban population, particularly for groups with minimal resources. An analysis of the lessons that the Bank has learned and of the operations of other agencies reveals a wealth of ex ante controls and weakness in the policy monitoring of the executing agencies. Most importantly, inquiries made among municipal authorities reveals a poor understanding of the access mechanisms and a certain level of antagonism with the action of the development funds, which explains the lack of ownership of the projects financed. This is the reason for the emphasis in this operation on having the municipalities themselves take on the responsibility for implementing and administering the projects financed by the funds.

E. The Bank's action in the sector

1.40 The Bank has financed two global credit programs for urban development, known as the Global Program for Urban Development and Sanitation (PRODURSA I and II), with loans of US$60 million and US$64 million, respectively, implemented by the FNDR. The first was implemented satisfactorily in the part concerning investment credits, resulting in reestablishing the credit of municipalities during the collapse of the financial system following the crisis of 1985. Institutional strengthening and particularly the land registry line did not experience the expected demand. The second operation, approved in 1993 before the change of players introduced by the LPP and the LDA is presently being implemented satisfactorily, now posting disbursement levels of 93%, nearly all its resources being committed.

1.41 In 1996, the Bank approved the Basic Urban Sanitation Program with a US$70 million loan, also under the responsibility of the FNDR, which has been 40% disbursed. In 1999, an operation in the amount of US$40 million was approved for basic sanitation in small municipalities (BO-0175), but is not yet eligible for disbursement. In 1998 a program in an amount of US$60 million was approved for the housing sector, with a neighborhood improvement component that is being executed satisfactorily by the FNDR. Ten percent of the financing for this program has been disbursed.

1.42 This operation will be complemented by two technical cooperation operations presently in preparation. The first (TC-00-03-001-BO) complements this program by conducting financial audits of a select number of municipalities, which will support the development of municipal financial reform plans. The second

(TC-00-02-088-BO) will support the design and implementation of integrated municipal financial information systems. This operation supports the preparation of a loan planned for next year, which will finance the implementation of these systems in small and medium-sized municipalities.

1.43 This program takes into account the lessons learned by the Bank, through the operations listed above, and complements them with strategic actions and critical reforms in order to adapt the municipalities and the funds to the decentralization strategy. It is through this strategy that the main results are expected to be achieved in the fight to reduce poverty in Bolivia.

F. Actions of other institutions

1.44 This operation is being closely coordinated with a World Bank Programmatic Structural Adjustment Credit (PSAC) operation to support the decentralization process in Bolivia. The financing for this fast-disbursing operation will be conditional on fulfillment of the funding requirements for loans and transfers. This program will support the refinancing of municipal debts and the financing of projects, by means of credits, transfers, and institutional strengthening for entities in the sector. In addition to this program, other donors are developing projects in the municipal sector, particularly German, U.S., and Danish cooperation, among others; their projects are being coordinating at the level of the Donors Committee. The French Fund for Emerging Countries and the Nordic Fund are planning operations to finance urban property records to supplement the program financing.

Table I-7 Donor support for sector reform (US$ millions)

IDB	47
Complementary multilateral financing	
Government of the Netherlands	19
DFID	7
Government of Sweden	3
Government of Denmark	1
GTZ	To be determined
Parallel actions in the sector	
World Bank	80
KfW	15
USAID	5

II. THE PROGRAM

A. General objectives

2.1 The objective of the program is to support Bolivia's policy for increasing municipal management efficiency to expand and improve the quality of the services that local governments provide to their communities. The contribution toward this effort will be made through direct support for municipal investment by means of financing local development projects, and by contributing to improving the institutional and financial framework of the municipal sector, particularly in terms of: (i) fiscal relations and the distribution of responsibilities among the various levels of government; (ii) approval of responsible municipal fiscal administration practices; and (iii) the financing mechanisms (by credits and/or transfers) and control of municipal public spending.

1. Results of the first phase

2.2 In its first phase, the program will help: (i) provide the country with a legal and institutional framework that improves skills at the subnational level, and the allocation of national resources to exercise them and to introduce efficiency criteria in calculating systematic transfers; (ii) strengthen the legitimacy and good governance of local governments; (iii) reform municipal finances and create control and ongoing monitoring mechanisms for municipal fiscal management; (iv) promote the participation of the private sector in providing and administering local public services; (v) introduce the new poverty compensation policy through non-systematic transfers; (vi) lay the foundations for creating a transparent municipal credit market; and (vii) investment in the form of loans and transfers to improve municipal service delivery (see results of phase one which will be evaluated on the basis of the indicators given in Annex II-1).

2. Expected outcomes of the second phase

2.3 The objectives of the second phase of the program will be: (i) to support the implementation of the new system of responsibilities and intergovernmental transfers; (ii) to strengthen the tax base and to continue contributing to municipal fiscal reform; (iii) to provide a sound footing for expanding local government capacity to improve the coverage and quality of services to their communities; (iv) to adapt and consolidate the compensation policy; (v) to support implementation of the strategy to expand the supply of municipal credit; and (vi) investment in the form of loans and transfers to improve municipal service delivery (see outcomes of phase two which will be evaluated on the basis of the indicators given in Annex II-1).

B. Description and components of the program's first phase

2.4 The program is characterized as a process for financing socially beneficial investments in infrastructure and local services, tied to actions relating to the fiscal efforts and administrative management of the beneficiary municipalities. As part of the national strategy for cofinancing the municipalities, the program will be carried out by the FNDR, FPS, and the Ministry of Finance. The Central Funding Office (DUF) will be in charge of coordinating transfer policy and municipal credit policy. In order to gain access to program funds, the municipalities must sign individual agreements with fiscal performance goals over a three to five-year period, depending on the specific situation. An important adjunct to the program are the institutional reforms agreed upon with the central government for the modernization and development of the municipal sector. Policy-making authority for this sector rests with the Ministry of Finance. The program consists of the following components.

1. Municipal investments (US$40 million)

2.5 This component will finance urban and social development projects that correspond to the priorities for the socioeconomic development of the municipalities. Projects in the FNDR's traditional urban investment sectors will be eligible (urban road systems; storm drains; erosion and flood protection; city services such as solid waste collection and disposal, public lighting; transportation terminals, markets, and other urban facilities, environmental protection, parks, and green spaces, among others). Additionally, through transfers or credits, projects will be financed in sectors defined as priorities in the national dialogue process, such as rural development (local roads, irrigation, and other sectors), education, health, basic sanitation[8], rural energy, the environment and natural resources, and institutional strengthening. The investment projects must reflect municipal priorities (they must consist of an annual operating plan [AOP]) and must comply with the guidelines for preparing program projects, which require applicable technical, environmental, institutional, economic, and financial feasibility studies.

2.6 The investments will be financed through *credits, subsidies, or a combination of the two.* The National Fund for Productive Social Investment (FPS), the FNDR, and the municipalities will determine the sources of funding depending on the sector of the investment and the availability of subsidy funds for each municipality[9]. Making physical investments with program funds will depend on achieving the goals agreed upon in the institutional adjustment plans (IAP) prepared for each municipality. In

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8 Only the water and sewer sectors will be eligible for Bank financing insofar as the execution of the other operations financed in this sector is being regularized.

9 In accordance with the compensation policy that is being defined, each municipality will have the right to an annual amount in transfers, which may be used in predetermined priority sectors. It will be up to the municipality to decide whether to use credits or its quota of transfers for projects financed by the program.

the case of municipalities that fall under the Financial Reform Plans of the Ministry of the Treasury, the concession of credits to finance projects will be subject to prior authorization by that ministry.

2. Municipal institutional strengthening (US$11.0 million)

a. Institutional adjustment projects (US$3.8 million)

2.7 This component support the implementation of institutional strengthening programs for municipalities, aimed at producing a profile of prudent financial management, verified by performance indicators established and agreed upon in management agreements between the municipalities and FPS-FNDR. These agreements will result from comprehensive analyses to be performed in each municipality, which will identify the institutional improvement measures that will be supported in each instance. The emphasis of these adjustment projects is on the following sectors: (i) strengthening tax and integrated financial administration policies, procedures, and systems[10]; (ii) setting up information and internal management control systems; (iii) human resource management systems; (iv) measures to improve the efficiency of public services (public cleaning, road maintenance, social services, etc.), by transferring or privatizing them, or by improving management of such services. These projects will be financed with a mix of loans and transfers based on the FPS-FNDR municipal agreement.

b. Real estate registers (US$5.5 million)

2.8 Special emphasis will be given to financing municipal real estate registers, owing to the weakness now present in this area, and to the special scheme for implementing this subcomponent. The need to have a uniform real estate registry system and the complexity of working on the real estate register make it appropriate to hire the services of private companies that will prepare the land registry maps for Bolivia's major cities, and the geographical information system. Then each municipality will have to develop its local land registry system (including the tax list census, property assessments, and setting up the georeference system). The local set-up, operation, and maintenance of the real estate registers will be done by specialized companies, under franchise contracts with the respective municipalities. Additionally, the program will finance comprehensive land registry projects in small and medium-sized cities using conventional procedures, which may also be performed by the private sector. The nature and source of property record project financing will be determined in the municipal assessments and implemented as agreed in the respective IAPs. Eligibility for resources under this subcomponent will be determined by the maturity of the projects identified in each IAP and on the extent to which the agreements specified in the IAP have been fulfilled.

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10 The Bank is considering an operation that complements this program, one that focuses on implementing comprehensive financial administration systems in some 110 municipalities throughout Bolivia.

c. Sector development (US$1.7 million)

2.9 This component consists of designing and implementing strategic measures for municipal sector development, focusing primarily on developing intergovernmental relations and on financing mechanisms. The activities of this subcomponent are as follows:

(i) ***Intergovernmental relations (US$500,000)***: studies will be done and dissemination activities will be undertaken that will complement efforts already underway in the following areas: (a) reviewing the allocation of responsibilities among the various levels of government and the intergovernmental transfer system (along the lines presented in paragraph 1.30); and (b) reviewing the existing regulatory framework, in order to adapt it to the requirements of the new institutional environment of the subnational governments. The aim is to provide municipalities and prefectures with the resources they need to perform the tasks assigned to them, in a fiscally responsible environment.

(ii) ***Sector financing (US$100,000)***: This subcomponent aims to provide new financing modalities for municipalities, including promotion of private financing of the sector, by performing a study that will include an analysis of the capital market, regulatory aspects relating to municipal credit, and developing a strategic plan for the FNDR (including the possibility of private strategic partners participating in financing the municipalities).

(iii) ***Fiscal management (US$1.1 million)***: This activity will support: (a) the creation and maintenance of updated databases on municipal finances in order to provide ongoing monitoring of the municipalities fiscal management, including the design of municipal fiscal performance indicators; and (b) performing periodic risk assessments for the municipalities.

3. Program administration and supervision (US$3.1 million)

2.10 The program's administrative expenses include: (i) the administrative costs for management of the program by the funds (amounts to 2% of the volume of resources administered by the FNDR and 4% for the FPS) and the operating expenses of the coordinating unit; and (ii) the costs of setting up the computerized operational control systems that will serve the two funds and the DUF[11].

2.11 The Support for Execution and Monitoring category finances: (i) the costs of preparing the IAPs; (ii) the promotion and dissemination of the program among the

[11] These costs include: (i) hardware and software for the departmental offices; (ii) the operational integration, administration system, and project monitoring module; and other software and hardware items needed for the operational integration of the FNDR, FPS, and the DUF.

municipalities through the entire country; (iii) contracting for services to evaluate participation and monitor program results, based on the logical framework benchmarks; and (iv) independent auditing of the program.

C. The institutional adjustment plans (IAP)

2.12 In order to participate in the program, municipalities must first submit an institutional adjustment plan. The IAPs will contain institutional and financial analyses of the municipal governments and recommendations concerning the measures they should adopt to improve their fiscal and administration situation. Based on these analyses, goals will be established regarding the financial benchmarks recommended for each municipality. Actual adoption of these measures and compliance with the implementation schedule will be a precondition for access to the program's investment funds.

2.13 The IAPs will include: (i) an analysis of the overall financial situation of each municipality, prepared on the basis of site visits, and containing (three and five year) financial projections concerning the main categories of revenues and expenditures, the borrowing situation, and fiscal performance indicators that are desirable for the size of the municipality; (ii) recommendations concerning adjustment measures, and a projection of their impact on municipal finances; and (iii) institutional development projects recommended to assist the municipalities in meeting their financial and operational efficiency objectives. The IAPs will be prepared by the FNDR's technical team, which has been specially created and trained for this task, in joint agreement with the municipalities, and will prepare an execution agreement in which the financial goals (generally three-year goals) will be formalized, as well as the projects that will make it possible to achieve those goals.

D. Approval of the second stage

2.14 The Bank's approval of the second phase of this operation will be conditional upon proof of progress toward the goals planned in the first stage, commitment of 75% of resources for phase one and disbursement of 50% of the resources, and the availability of IDB concessional resources for Bolivia. A report containing the following information will be prepared to provide proof of progress: (i) an evaluation of compliance with the criteria presented in Annex II-1; (ii) modifications, if any, in program design; and (iii) the benchmarks for results and the table of costs for the second phase.

E. Program structure, costs, and financing

2.15 The scaling of the program into two phases takes into account the funds' execution capacity, the Bank's resources available for the country, complementary sources of funding from other institutions and other Bank programs, and the need to build a critical mass that is important for implementing the new allocation criteria for non-

systematic transfer resources. The capacity of the municipalities to absorb resources on a sustainable basis will depend on the success of the IAP. Of the municipalities and projects in the representative sample, 22 were analyzed and of these each one obtained an IAP with an assessment of the principal financial targets and institution strengthening activities required for successful completion. Also, work commenced on preparing a further 120 IAPs to cover institution strengthening targets set for phase one. Based on the sample of 20 projects being prepared by FNDR in an amount of US$19 million, major disbursements are projected in year one of the program. The 120 IAPs in preparation suggest that, during the first phase of the operation, a significant portion of the Bank's resources will be used for institutional and fiscal strengthening of the municipalities. Additionally, in terms of structuring the credits, part of the World Bank financing will be directed toward refinancing municipal debt, in order to make the municipalities eligible for credit.

2.16 The program was designed on the basis of a preliminary projection of municipal capacity to absorb resources on a sustainable basis.

2.17 The projected table of costs for the entire duration of the program has been calculated for major spending categories, bearing in mind that at the beginning of the second phase, the budget for that phase may be reviewed in greater detail, and the initial calculations for allocations may be revised.

Table II-1. Overall budget of the program
(expressed in millions of US$)

CATEGORY	IDB	LOCAL	TOTAL	PHASE I	PHASE II
1. Administration and supervision	4.2	-	4.7	3.1	1.6
2. Institutional strengthening	18.1	2.8	20.4	11.0	9.4
3. Direct investment	64.1	10.4	74.5	40.0	34.5
Subtotal	86.4	13.2	99.6	54.1	45.5
4. Financial costs	0.9	-	0.9	0.5	0.4
TOTAL	**87.3**	**13.2**	**100.5**	**54.6**	**45.9**

2.18 The table of costs for phase one of the program is presented below:

Table II-2. Budget for the first phase of the program (expressed in millions of US$)

CATEGORY	IDB/FSO	LOCAL	TOTAL	%
1. Administration and supervision	**3.1**	**-**	**3.1**	**5.7**
1.1 General administration	2.0		2.0	
1.1.1 Administrative expenses PCU, FNDR, and FPS	1.7		1.7	
1.1.2 Operating control systems	0.3		0.3	
1.2 Support for execution and monitoring	1.1		1.1	
1.2.1 Independent program audit	0.2		0.2	
1.2.2 Preparation of IAP and monitoring	0.9		0.9	
2. Institutional strengthening	**9.4**	**1.6**	**11.0**	**20.1**
2.1 Municipal adjustment programs	3.2	0.6	3.8	
2.2 Property registers	4.7	0.8	5.5	
2.3 Sector development	1.5	0.2	1.7	
2.3.1 Intergovernmental relations	0.4	0.1	0.5	
2.3.2 Sector financing	0.1		0.1	
2.3.3 Fiscal management	1.0	0.1	1.1	
3. Municipal investment	**34.0**	**6.0**	**40.0**	**73.3**
Subtotal	**46.5**	**7.6**	**54.1**	**99.1**
4. Financial costs	**0.5**	**-**	**0.5**	**0.9**
4.1 Inspection and supervision	0.5		0.5	
TOTAL	**47.0**	**7.6**	**54.6**	
Percentages	**86.0**	**14.0**		**100.0**

F. Financing terms

Table II-3. Financing terms and conditions

Amortization period:	40 years
Grace period:	10 years
Commitment period:	4 years
Disbursement period:	5 years
Interest rate:	1% during the grace period; 2% during the amortization period
Inspection and supervision fee:	1%
Credit fee:	0.75%

III. PROGRAM EXECUTION

A. The borrower, the executing agency, and the co-executing entities

3.1 The borrower is the Republic of Bolivia. The Ministry of Finance through the program coordinating unit will be responsible to the Bank for program administration. The Ministry of Finance is the principal executing agency in establishing regulations governing the development of the institutional and financial framework for the municipal sector and the transfer of resources from the nation to the departments and municipalities. The FPS and the FNDR will share responsibility for execution, respectively administering the lines of financing by transfers and by credit. The municipal governments will be the executing agencies of individual projects in the municipal investment and institutional strengthening component. The VTCP and the Viceministry of Government Coordination (VCG) will also be involved in executing the sector development component, and the National Real Estate Registry Institute (INC) will participate in urban real estate registry operations.

Box III-1. The Executing Agencies

The Central Funding Office (DUF)

The DUF is an entity created by the Government of Bolivia to orient financing policies and to supervise and oversee the functioning of the investment and development funds. It is headed by a chairman appointed by the President of the Republic, and in composed of viceministers from the Ministries of the Presidency, Agriculture, Treasury, and Sustainable Development and the Environment. One of its mandates is to restructure the funds, including merging the FIS and the FDC into a single institution that will administer non-systematic transfers from the government to the municipalities, with the FNDR in charge of financing projects through credits. Additionally, it is proposed that management of the funds be depoliticized by appointing its executives by merit-based public competition.

National Fund for Productive Social Investment (FPS)

The strategy of the DUF to merge the FIS and the FDC is based on creating a new entity, the National Fund for Productive Social Investment (FPS). The FPS will be assigned the responsibilities and resources of the two funds, and the personnel necessary for this new structure will be transferred to it. The FPS will maintain temporary liquidation commissions for both funds, in order to resolve any problems that may arise from their closure. The FIS was in charge of investments in the education, health, and basic sanitation sectors. The FDC was created in 1992 to support small-scale agricultural producers by financing projects to support production, including local roads, bridges, micro-irrigation systems, and providing seed.

National Regional Development Fund (FNDR)

The FNDR was created by law to support the harmonious and balanced development of all regions of Bolivia, by financing programs of public utility. To date, the FNDR has administered four operations financed by the Bank, two by the World Bank, and two by the Government of Japan.

In its twelve years of operation, the FNDR has become known as a bank that supports local development. Until now, it has operated with loans combined with nonreimbursable transfers aimed mainly at the municipalities' urban projects. It has generated a US$181 million portfolio, and its yield has enabled it to become self-sustaining. Its greatest strengths are its capacity to evaluate projects, portfolio management, procurement processes, and supervising consulting services. Its most obvious weaknesses are in controlling contractual terms with the municipal governments and excessive bureaucracy in its internal procedures. Its internal restructuring calls for merging its Development and Operations management structures, and those of Administration and Finance, and creating a new Department of Institutional Development, which will be in charge of strategic planning and systems implementation.

3.2 The program provides for granting municipal governments credits from the FNDR and transfers from the FPS for executing municipal strengthening measures and financing physical investments and urban real estate registries viewed as priorities by the municipal governments, based on the agreement for executing the IAPs.

3.3 The FPS will administer the non-systematic transfer system, which provides for allocating conditional transfers to the municipal governments, in exchange for which the governments will submit investment projects in sectors granted priority under the compensation policy, which includes basic sanitation, health, education, rural electrification, local roads, micro-irrigation, natural resources and the environment, and institutional strengthening. In order to determine local counterpart rates, called "relative prices", the municipalities have been divided into five categories based on UBN. These relative prices are determined for each sector based on the deficiencies of the particular municipality. The greater the deficiency in terms of a particular service, the higher the percentage of the transfer and the lower the local counterpart. In this way, the municipal governments will be the ones who define their priority projects for using the resources allocated in a block by the FPS. These resources will come from programs administered by the FIS, and the amounts that the prefectures or others decide to transfer to the municipal governments, so that whatever nonreimbursable financing they receive will be charged to their block allocation.

3.4 It will be a condition precedent to the first disbursement of financing resources intended for nonreimbursable transfers to municipal governments that the government submit to the Bank the formula established for granting such transfers and the indicative allocation of those transfers to the municipalities for the first two-year period.

3.5 The program's execution mechanism fits within this system, adding the supply of credit for investment in all sectors for which the municipality is responsible through the FNDR, including those sectors established as priorities for non-systematic transfers, leaving up to the municipal governments the decision as to which source they will use for financing their priority projects.

1. Institutional roles

3.6 In its capacity as administrator of both FNDR and FPS (see Box III-1), the DUF will be responsible for approving the Operating Regulations of the program, as well as the standards that apply to the procurement system, draft agreements and contracts, the methodology for the institutional and financial analysis of the municipal governments, guidelines for formulating and evaluating projects, the monitoring manual, the maintenance manual, the plan of accounts, etc. Relations with the Bank will be channeled through the coordinating unit attached to the Ministry of Finance as will the consolidation of program accounts and periodic reports from the FNDR and the FPS to the IDB, as well as monitoring of compliance with the contractual terms agreed upon in the loan contract and in the agreements and contracts reached by the FNDR or the FPS with the municipal governments. This unit will also be responsible for conducting studies of financing in the sector, and will coordinate and supervise promotional activities, the implementation of standardized information systems in the funds, and will conduct the process of evaluating program participation and monitoring. *The FNDR and*

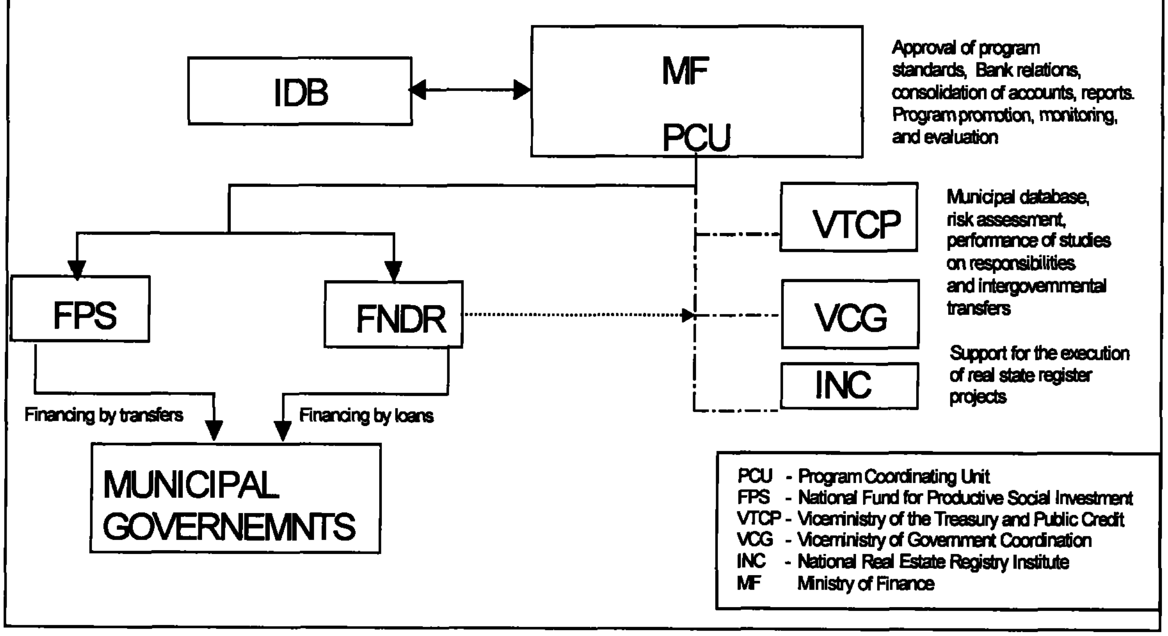
FPS internal procedures manuals prepared in accordance with technical and administrative requirements previously approved by the Bank must be approved as a condition precedent to the first disbursement of the financing.

3.7 *As a condition precedent to the first disbursement of nonreimbursable transfers to the municipal governments, the borrower must demonstrate to the Bank that the FPS has begun to finance at least one municipal project in accordance with the regulations set out in the internal procedures manual mentioned in the preceding clause.*

3.8 It is a condition precedent to the first disbursement of the financing resources that the government demonstrate that it has formed the program coordinating unit and has hired the coordinator and accountant as agreed with the Bank.

3.9 The FPS will be responsible for administering resources intended for nonreimbursable transfers to the municipal governments, evaluating and approving investment and/or institutional strengthening and real estate register projects submitted by the municipal governments that are eligible for such transfers under the compensation policy, and supervising project execution and compliance with the contractual terms agreed upon with the beneficiaries of the transfers.

Box III-2. Organization for Execution



3.10 The role of the FNDR includes performing the financial and institutional analyses of the municipal governments that wish to participate in the program, and establishing the IAPs with them, including the fiscal adjustment measures necessary for accessing investment financing. The FNDR will be responsible for administering the resources intended for loans to the municipal governments, and

therefore will evaluate and approve investment projects and/or institutional strengthening and real estate register projects submitted by the municipal governments that require partial financing through loans. It will administer the portfolio of credits and will supervise compliance with the contractual terms agreed upon with those eligible for credit. Additionally, on behalf of other coexecuting agencies, it will administer the resources of the sector development, digital urban land survey register, and program administration components.

3.11 *The loan contract will include two special clauses establishing equitable rules for expanding the supply of municipal lending, namely that: (i) for the duration of the loan, the borrower must demonstrate to the Bank each year that the FNDR is complying with the standards of the Superintendency of Banks and Financial Institutions; and (ii) the government will arrange with Nacional Financiera de Bolivia (NAFIBO) for a line of financing to provide credit to municipalities through commercial banks to take effect by month 18 after the effective date of the loan contract.*

2. Other participating entities

3.12 The studies on reviewing responsibilities and the intergovernmental transfer system will be conducted by the VCG and the VTCP, respectively, and the VTCP will conduct operations relating to maintaining the financial database and assessing municipal risk. To that end, these entities will prepare benchmarks and will handle the process of contracting for the necessary consulting services, instructing the Ministry of Finance to pay the corresponding liabilities.

3.13 The INC will review national urban real estate registry standards and the bid documents for digital land survey registers and registers for small and medium-sized cities. Along with representatives from the Ministry of the Treasury, the FNDR, and the municipal governments involved, it will form a committee responsible for selecting services for executing the digital mapping project and the geographical information system for a series of metropolitan areas and medium-sized cities. It will support municipal governments that require such assistance in the process of creating and maintaining the digital land survey registers and in supervising the creation of real estate registers in small and medium-sized cities.

B. Instruments regulating the program

3.14 In addition to the loan contract to be reached between the Republic of Bolivia and the Bank, the program will be regulated by the following instruments:

1. Subsidiary loan and transfer agreements

3.15 The Ministry of the Treasury will reach subsidiary agreements with the FNDR and the FPS, through which it will be established that: (i) the resources of the loan are directly disbursed by the Bank to bank accounts of the FNDR and the FPS; (ii) the resources intended for FNDR credits to municipal governments will be transferred

to the FNDR under the same terms and conditions as the Bank's loan to the Republic; (iii) funds intended for nonreimbursable transfers to the municipal governments cannot exceed 40% of the program's resources earmarked for regional investments and support for adjustment plants, and will be transferred to the FPS as transfers from the National Treasury (TGN); (iv) funds for the sector development component, administrative expenses, and any cofinancing for the digital land survey register will be transferred to the FNDR as a transfer from the TGN; (v) the terms of the credits from the FNDR to the municipal governments will include a basic interest rate equivalent to the average rate on United States dollar deposits paid by national banks in the previous six months as published by the Central Bank of Bolivia, a period that takes into account the useful life of the projects, and a grace period linked to the first disbursement or the cutoff date for the final disbursement; and (vi) the FNDR will receive a 2% fee for administering resources not intended for credit, and the FPS will receive a 4% fee on amounts disbursed as transfers to the municipal governments. *The signing of these subsidiary agreements and their submission to the Bank is a condition precedent to the first disbursement of financing.*

2. FNDR/FPS - Municipal government financing contracts

3.16 These contracts will establish the obligations of the FPS or the FNDR and the municipal governments with respect to fiscal reform and the execution, operation, and maintenance of projects financed by nonreimbursable transfers or by credits, in accordance with the terms specified in the Operating Regulations and with specific clauses relating to the type of activity and project to be financed in each case. *As a condition precedent to disbursement of funds for nonreimbursable transfers to municipal governments, models of the agreements signed between the FNDR and FPS and each municipal government governing the latter's participation in the program must have been submitted to the Bank for approval.*

3.17 *As a condition precedent to disbursement of financing for lending to municipal governments, the borrower must demonstrate that the FNDR and the FPS have formed an Approval Committee for Institutional Adjustment Plans (IAP).*

3. Operating Regulations

3.18 Execution of the program will be governed by the Operating Regulations which shall contain, among other things, the criteria for institutional eligibility, a description of eligible activities and projects, the technical, financial, socioeconomic, legal, and environmental criteria for project evaluation, the terms of the financing, and the procedures of the program's operating mechanism and of its control and monitoring system. *As a condition precedent to the first disbursement of financing, the Operating Regulations must be approved by the DUF and must have received the Bank's nonobjection.*

4. Lending conditions

3.19 FNDR will provide loans to the municipalities to finance part of the cost of the projects subject to the following conditions:

a. Interest rate. The basic annual interest rate on the loans granted by the FNDR will be equivalent to the average rate paid on six-month foreign-currency deposits by national banks in the six-month period immediately preceding the date of disbursement for loans denominated in United States dollars (see subparagraph d). The FNDR may charge a higher rate, with the approval of the DUF, based on the municipal government risk and apply the corresponding spread to provisions.

b. Terms. Period for amortization of the loans will be set by the FNDR on the basis of the project evaluation and its useful life, but may not exceed 20 years.

c. Grace period. The grace period for amortization of principal will be a maximum of two years from the date of the first disbursement of the FNDR loan.

d. Maintenance of value. All FNDR loans will contain maintenance of value clauses linked to the rate at which the United States dollar is quoted, as published by the Central Bank on the first business day before the date of payment buying rate in the market.

C. The municipal project cycle

1. Promotion

3.20 Through the coordinating unit, the Ministry of Finance will be responsible for promoting the program. To that end, it will use human resources of the FPS and the FNDR, and the program's methodological guidelines for institutional and financial analysis of municipal governments, guidelines for preparing and submitting urban and social development projects, projects for the development of infrastructure supporting production, and procurement regulations.

3.21 The promotion activities will begin with an opening workshop for the coexecuting agencies, and three or four regional seminars to launch the program, to which municipal executives will be invited, so that the features of this operation and its operational standards may be explained to them.

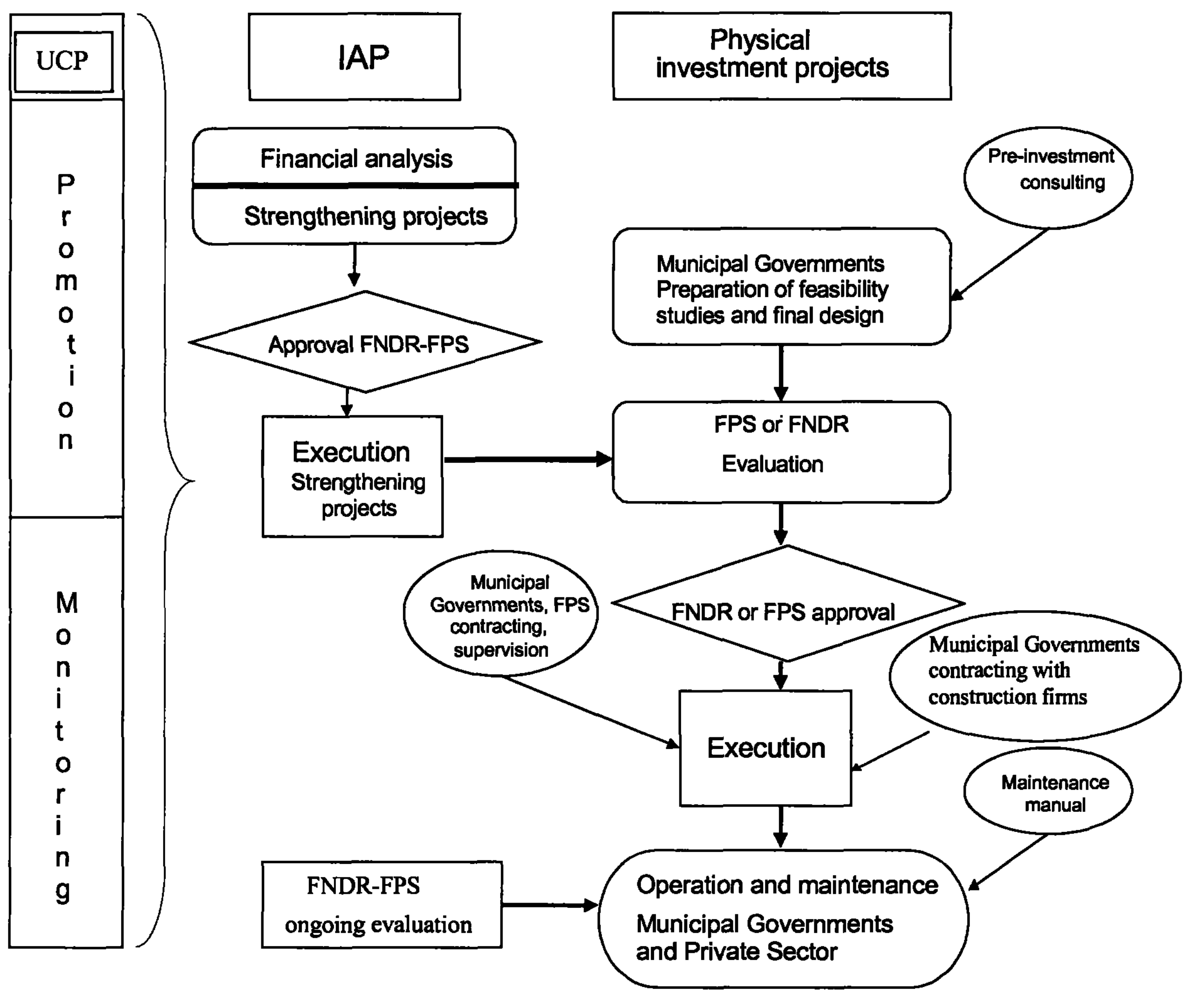
2. Formulation of the IAPs

3.22 The FNDR will conduct the institutional and financial analysis of the municipal governments that wish to enter the program, and will prepare the IAPs with them, including the fiscal adjustment measures necessary to increase the management capacity of the municipal governments.

3. Approval of the municipal IAPs

3.23 The IAPs will be evaluated and approved by the project committee of the FPS-FNDR by joint resolution, which will determine the steps to be taken by the municipality interested in obtaining program financing. In order to execute the IAPs, the executive directors of the FPS and the FNDR shall sign an execution agreement with the municipalities, establishing the terms of the financing (credit and/or subsidies), the role of the FNDR and/or the FPS in supervising and monitoring the adjustment projects, and the obligations of the municipalities in contracting for services, supervising and controlling studies, and other relevant aspects. Once the agreement is signed, the municipal governments must publish a summary of the agreed IAP in one or more locally distributed media publications.

Box III-3. PROJECT CYCLE



4. Preinvestment financing

3.24 The FNDR and the FPS will have a line of preinvestment financing through consulting services to which they will be able to direct the municipalities for preparing institutional strengthening and/or physical investment projects. The financing of preinvestment will be similar to the matrix agreed upon for the successive stages, in the same proportions as defined for credits and/or transfers. For the FPS, these costs will be charged to the block allocation to the municipal government for the sector involved.

5. Approval of projects

3.25 The FNDR, or the FPS for projects eligible for transfers, will evaluate the feasibility studies by applying the criteria set forth in the Operating Regulations; for public services infrastructure projects, this includes the approval of the entity administering the service. If project engineering studies require a final design in accordance with the evaluation report, the municipality must submit it based on the project committee's approval of the feasibility study.

3.26 Approval of investment projects of up to US$1 million will be handled by the credit committee in the case of the FNDR, and the project committee in the case of the FPS. Above that threshold, projects will be approved by the DUF.

6. Project execution

3.27 Institutional strengthening projects, including urban real estate registers, will be executed by the municipal governments through nonreimbursable transfers or credits. With regard to credits, the Operating Regulations will waive compliance with municipal government borrowing benchmarks, since these projects will enable them to improve their financial position.

3.28 The execution of investment projects will be conditional upon the attainment of the performance indicators indicated in the IAP. This means that over-indebted municipal governments cannot execute investment projects until they have completed their financial restructuring, which can be achieved in one to three years of applying the adjustment measures.

7. Supervision and control

3.29 In order to avoid any collusion among firms contracted for conducting studies and construction and the supervisors of those efforts, supervision of project execution, when financing is provided by credits, will be handled by the municipal governments through firms hired by product, not linked to the time of execution of the construction or studies. For projects financed by transfers from the FPS, it will contract for the necessary consulting services to handle sets of projects, and the supervision costs will be prorated among the projects based on unit costs and charged against the respective financing.

3.30 Control of construction work and studies is the responsibility of the official or officials appointed by the municipalities. For service infrastructure projects, the entities running those projects will appoint a construction monitor.

8. Operation and maintenance

3.31 The operation and maintenance of the public services financed by the program that are subject to the collection of fees or other direct collections from users shall be the responsibility of the companies licensed to provide those services, whether public, mixed, private, or autonomous municipal enterprises. Maintenance of works not subject to direct collections (such as the maintenance of storm drains and city streets) is the responsibility of the municipal governments. In order to avoid the repeated bankruptcy of the executors of projects financed by the Bank, the program will have a works maintenance manual that municipal governments will be required to use; the Operating Regulations provide for sanctions that go as far as the suspension of disbursement if the agreed maintenance plans are not followed.

3.32 The urban real estate registers will be operated by private licensees, which will serve metropolitan and dispersed communities, and will be required to update the registers on an ongoing basis. If it is impossible to organize a community for this purpose and small or medium-sized cities are concerned, the municipality will administer their real estate registers directly.

D. Procurement of goods and services

3.33 The program proposes that the investment funds not be involved in the procurement process, as they are now; therefore the procurement of goods and services will be handled and performed by the beneficiary communities and other program coexecuting agencies. If these entities do not have the capacity needed to undertake these procurement processes, they may hire experts or consulting firms to support them in this task; the cost will be charged against their financing. For small municipal governments that receive transfers, which usually lack the capacity for hiring consultants, the FPS will assist them in the procurement process.

3.34 Given the lack of experience on the part of most municipal governments with respect to Bank procedures, the FPS or the FNDR, as appropriate, will grant their prior non-objection to each phase of the procurement process for goods and services, regardless of the amount of the purchase.

1. Construction and goods

3.35 In accordance with the Bank's policy, the international competitive bidding procedure will be used when financing resources are used in foreign currency and the estimated amounts for the contracting are greater than the equivalent of US$2 million, for construction contracts, and the equivalent of US$350,000 for contracts relating to the procurement of hardware and goods. The procurement of goods and the execution of construction work in amounts less than those indicated

above will be governed by the provisions established for those modalities in the program's procurement regulations, which provide that when financing resources are used in foreign currency, no restrictions may be placed on the participation of suppliers from the Bank's member countries.

2. Consulting services

3.36 Consulting services must be chosen and hired in compliance with standard Bank procedures, and international competitive bidding is required for amounts estimated at greater than the equivalent of US$200,000.

3. Procurement modality

3.37 The Bank's Country Office will perform an ex ante review of the first processes of each modality for each of the funds. In accordance with its evaluation, the Country Office may grant the FNDR and/or FPS authorization for ex post implementation of the procedure in the future. Given the amount of contracting in the program, it is expected that the FNDR and the FPS will act as supervisors of procurement procedures that will be carried out by the municipal governments, based on the standard bidding documents of the program's Procurement Plan (Annex III-1).

E. Disbursements

1. Revolving fund

3.38 Given the program's characteristics, and the diversity and parallelism of the actions expected to be financed, and primarily through the disbursement modality provided for the municipal governments as explained below, it is recommended that two revolving funds be established, one at the FPS and the other at the FNDR, together corresponding to 5% of the financing amount.

2. Disbursements to the FNDR and the FPS

3.39 The financing resources will be disbursed to the revolving funds based on the subsequent verification of the purchasing processes and the documents supporting the prior disbursement; the originals of those documents will be kept by the municipal governments and copies will be kept in the offices of the FNDR and the FPS. If the number of transactions to be reviewed is very large, at the Country Office's discretion it shall review a representative sample of the purchasing processes and disbursement documentation.

3. Disbursements to the projects

3.40 The FNDR and the FPS will disburse the financing resources for the municipal governments to a revolving fund that each municipality will maintain in order to execute approved projects. Replenishment of the revolving fund is subject to the submission of the relevant receipts by the municipal governments. For small

municipalities and for the sector development, digital land survey register, and administrative cost components, the FNDR and the FPS will make disbursements directly to the providers of goods and services. These providers will be hired by the municipal governments and other coexecuting agencies. Authorization for the disbursements will depend on their instructions and supervision reports, and on verification that the municipal governments have deposited the counterpart resources in the accounts of the FNDR or the FPS.

4. Retroactive financing

3.41 Prior expenditures up to the amount of US$800,000 will be accepted and charged against the financing. These expenditures include consulting costs incurred in preparing the IAPs (site visits and preparing the 22 institutional reports), preparation of the project sample, the ex post evaluation of executed projects, the preparation of the real estate register components, and costs associated with designing the comprehensive management system of the funds.

F. Program monitoring

1. Bank monitoring

3.42 The program will be monitored by the Bank's Country Office in Bolivia, which will perform an ex ante review of all technical and financial aspects of the first project in each eligible activity, and will conduct inspections by sampling during execution. Special emphasis will be given to compliance with contractual conditions relating to fiscal adjustment benchmarks, updating rates for services financed by the program, third-party management of those services, and the maintenance of construction work and facilities.

2. Monitoring and evaluation

3.43 The coordinating unit of the DUF will hire one or more private research entities to prepare qualitative reports that assess the program's impact on municipal administration and on the quality of life of the beneficiaries. These evaluations will take the following considerations into account: (i) the state of preparation of the studies provided for in the sector development component, and the implementation of the recommendations made in those studies; (ii) the advances made in clarifying the responsibilities of the prefectures and the municipal governments, and in revising the system of intergovernmental transfers; (iii) the situation of the VTCP's municipal database, and the risk assessment operating methods; (iv) the level of compliance with the performance indicators agreed upon in the IAPs and in the VTCP's financial reform plans, and their impact on improving municipal management and on the efficiency and coverage of services; (v) the implementation of the compensation policy; (vi) the operating costs and performance of the FPS and the FNDR, the FNDR's compliance with the standards of the Supervisory Authority of Banks; (vii) the level of municipal governments' access to loans from

the national financial system; and (viii) the extent to which the program goals (see Annex II-1) have been achieved. Two evaluations will be performed, the first 24 months after start up of phase one and the second prior to the execution of phase two of the program.

3. Annual progress report

3.44 The borrower, through the program coordinating unit, will submit a progress report on program execution to the bank during the first quarter of each year. The report will state the financial position, the actions and activities accomplished, the products made, and the goals achieved, as well as the main limitations that have been encountered, and the solutions proposed to overcome them. The format of the report will be agreed upon previously with the Country Office.

4. Reviews and annual operating plans

3.45 Based on the annual progress report, in the first four months of each year reviews will be made of the program, during which the executor and the Bank will examine the progress of the program. These reviews will serve to reach agreement on the AOP for the year in progress, in which the activities and goals to be accomplished will be adjusted, and the program will be planned to its conclusion. The annual review and the AOP must use as benchmarks the fulfillment of commitments and the achievement of the goals set forth in the program's logical framework (Annex II-1).

G. Auditing

3.46 Starting in the fiscal year corresponding to the year in which the program begins, and during its execution, the program's financial statements must be submitted annually within the first four months after the conclusion of the fiscal year, with a qualified opinion from private auditing firms previously found acceptable to the Bank. The cost of this auditing process is included in the program financing.

3.47 *The outside audit of the program will also include special semiannual reports on the results of the evaluation of the internal control structure and a review of procedures and activities relating to procurement and disbursements made by the FPS, FNDR, and municipalities, in accordance with the benchmarks agreed upon with the Bank. This task, to be performed on the basis of a sample of municipalities participating in the program, will be the responsibility of the same firm selected as the program's outside auditor. The executing agency will be responsible for submitting these reports to the Bank within 60 days after close of each quarter.*

IV. VIABILITY, BENEFITS, AND RISKS

A. Viability analysis

4.1 The viability analysis of the program emphasized the following aspects: (i) the feasibility of the operational scheme designed for the program; (ii) the prospect of achieving real change in the sectors proposed in the program; and (iii) the technical viability of the sample of projects.

1. Institutional viability

4.2 The executing agencies of the program, the FNDR and the FPS (as successor to the FIS and FDC), are organizations with which the Bank has extensive experience in working and that are considered ideal for implementing the program. In particular, they have undergone an extensive organizational review in which the following aspects were analyzed: (i) controls; (ii) information systems; (iii) evaluation of the project cycle; (iv) bidding and contracting procedures; (v) monitoring and closing operations; and (vi) administration and finance.

Box IV-1. Strengthening of FIS control mechanisms

In light of its prominent role and the need for greater efficiency and transparency in the FIS-administered program, the Bank reached agreement with the country on conducting early in 2000 an evaluation of this entity's internal environmental control mechanisms, project cycle, operating, administrative, and financial procedures, and other specific aspects of procurement and disbursement designed to ensure that operations are executed in a setting of environmental safety, accountability, and transparency. On the basis of the independent evaluation, which identified shortcomings in these systems and procedures, critical, serious, and major recommendations were made based on the frequency of such lapses in the control environment.

The last critical recommendations was implemented in February of this year. As a result of these improvements, the FPS now has the tools to integrate its operating and accounting systems, a reform that automatically allows cross controls that will significantly reduce the risk of potential errors or irregularities occurring during execution of an operation.

4.3 To analyze the operation's execution scheme, which is innovative owing to the institutional change that the merger of the social funds and municipal credit involves, and their use as an instrument of a unified policy to focus public spending on municipalities, a study was commissioned to evaluate the program's operational needs and to design a uniform management scheme for the funds. This study was done during program preparation. Its conclusions were accepted by the directors of the DUF, complementing the work that has been underway for two years regarding the conceptual formulation of the country's *compensation policy*. The program will support the implementation of this new policy, through the contribution of funds for transfers and credit and through support for the creation of an online system of internal administration and project management. This system will make it possible to monitor each project in real time, as well as progress toward achieving the program's objectives.

4.4 With regard to the feasibility of making changes in the sector (changes in the formula for tax revenue share-outs, in municipal financing schemes, and in the control of municipal fiscal management), the analysis focused on evaluating the

implementation mechanisms of the studies and technical initiatives financed by the program. The government appointed a general coordinator for decentralization projects and urban development financed by international cooperation. This coordinator reports directly to the Minister of the Treasury, and is authorized by the Minister to take the necessary steps jointly with the entities of the national administration, such as the Ministry of the Presidency (responsible for studies of municipal and prefectural responsibilities), the DUF, and other entities that are relevant to this effort. This scheme was deemed adequate insofar as it provides centralized responsibility for achieving the agreed sector changes, although it is acknowledged that there are difficulties in obtaining consensus on issues with political implications.

4.5 To analyze the program's technical feasibility, projects identified in the representative sample of municipal projects were reviewed, as was the experience of the two funds (FNDR and FIS) in executing projects similar to those eligible in the program. This analysis is presented below.

B. Technical and economic viability

1. Selection of municipalities and preparation of the IAPs

4.6 In order to obtain an overall perspective of the institutional situation of the entities that will participate in the program, during the preparation phase an analysis of the institutional and financial situation of a representative sample of municipalities was done, and their demands for institutional development were gauged in the institutional adjustment plan (IAPs). This sample consisted of 22 municipalities selected according to their size and social and geographic characteristics, among others, depicting homogeneous groups.

4.7 The participative methodology of preparing the IAPs, which include fiscal performance indicators for a three-year period, ensures that the strengthening measures are realistic, that they have been defined with reference to real demand, and that they will contribute to the institutional sustainability of the program. Achieving these goals is conditional upon financing projects through credits from the FNDR, and access to transfers from the FPS.

2. Sample of investment projects and performance of the funds

4.8 The sample of program projects included proposals by municipalities where the IAPs were prepared, and other already executed by the FNDR, the FIS, and the FDC. The objective of the analysis of the latter projects was to evaluate the performance of the FNDR and the new fund, in terms of their technical capacity for evaluating, approving, and monitoring projects.

4.9 With regard to the funds' performance, it should be noted that the funds are the executing agencies of various programs receiving financing from the Bank and from other multilateral organizations, and thus their technical guidelines and project

analysis procedures are known to the Bank. The FPS will accept the recommendations from the audit that the FIS has implemented, and will continue to execute those that apply to the new fund, with the monitoring of the Country Office.

4.10 The evaluation of the FNDR's projects indicated a fair degree of success in their promotion, technical analysis, financing, and physical implementation. In the cost analysis of the projects that the FNDR finances, unit costs for materials, labor, and equipment are compared with the organization's database, which contains information from various regions throughout Bolivia and is updated on an ongoing basis with information from submitted projects, and with confirmation from market studies performed *in situ*.

Table IV-1. Economic return of investments in the FNDR (US$ in thousands)

SECTOR	EX ANTE		EX POST	
	ENPV 1/	EIRR 2/	NPV	IRR
Water and Sewer	6,212	62.7%	1,627	20.7%
Trash Collection	462	34.0%	250	24.0%
Pipelines and Drains	182	22.7%	355	27.3%
City streets	133	16.5%	141	16.9%

1/ ENPV: Economic net present value
2/ EIRR: Economic internal rate of return

4.11 The ex post analysis of economic return performed on a representative sample of investments in the main sectors financed by the FNDR reveals a positive economic return despite increases in the investment costs in the projects, on average 6.5% with respect to the estimate, and despite the fact that the impact of the benefits was less than expected (mainly in the sectors where the services provided are covered by fees or rates). However, the satisfactory quality of the economic analysis done by the FNDR was confirmed, as was the need for effective monitoring of contractual clauses concerning fees and other aspects of the operation and maintenance of services. Special emphasis is placed on these aspects in the program's Operating Regulations. A more detailed analysis of the sample of projects is available in the technical files.

C. Environmental and social impact

4.12 In order to support Bolivia in developing its environmental and social impact report, a consultancy was financed through ATN/DC-6972-BO; its benchmarks included the recommendations of the CESI, with special emphasis on the ethnic, gender, and institutional environmental aspects of the municipalities. To evaluate the municipalities' projects and environmental management capacity *in situ*, the consultants visited various cities in the interior of the country, including some small municipalities and communities. On 11 August and 22 September the FNDR made a public announcement of the start of preparations and the preliminary version, respectively, of the environmental and social impact report, which the CESI approved at its meeting on 13 October 2000.

4.13 **The potential positive impacts** of the program derive from investment projects in the municipal services and infrastructure sector. These investments will have varying and positive social impacts, depending on the sector under consideration. The main impacts will be: (i) improving the quality of life and health benchmarks associated with the execution of solid waste collection and disposal projects; (ii) control of erosion and sedimentation, thanks to the recovery of degraded areas and the creation of parks and drainage systems; (iii) a reduction in greenhouse gas emissions by generating electricity from sustainable sources of energy; (iv) a reduction in the impact of project operation, through training of the personnel involved; (v) financing of the natural resources management sector; and (vi) improved environmental protection by strengthening the environmental management and planning of the municipal governments, the FPS, and the FNDR.

4.14 **The potential negative impacts** of the investment projects will occur during construction and in the operational phase. These impacts include: (i) removal of vegetation; (ii) damage to those adjacent to the construction sites; (iii) contamination of surface water and erosion; and (iv) inadequate waste disposal.

4.15 **The program's environmental procedure.** The FNDR, the FIS, and the FDC have extensive experience in eliminating and mitigating negative impacts due to the various programs that they have executed in the past 10 years. This experience is evaluated in the environmental and social impact report. To execute this program, the general and specific measures for each sector were also compiled in the environmental and social impact report, and are now an integral part of the sector guidelines annexed to the Operating Regulations. The environmental procedure annexed the Operating Regulations, which operate in parallel with the scheme presented in Figure III-4, require that all projects follow the sequence described below: (i) complete the environmental brief; (ii) select Category 2 or 3; (iii) for Category 2, prepare the EIA, hold the public hearing, and issue the environmental license; (iv) or, for Category 3, issue the management and mitigation plan and the environmental license; (v) calculate and include the mitigation costs, including environmental liabilities, in the project's budget; (vi) include environmental and monitoring measures in the project's technical specifications document; (vii) conduct monitoring and controls through the environmental unit of the municipal government and the FNDR, or FIS-FDC; (viii) file reports during construction, and prepare a final report upon completion of the work, and submit it to the Viceministry of Environment and Natural Resources; and (ix) strengthen the operating entity (whether private or municipal) through the IAP.

4.16 **Strengthening environmental management.** The program's support for municipal governments with regard to environmental management will be coordinated with CTR-929/SF-BO, which is presently being executed. Its objective is the environmental strengthening of the Ministry of Sustainable Development and Planning, which will support the prefectures and municipal governments by seeking to increase their capacity to evaluate and monitor the environmental impact of investment projects, and to manage their environmental resources. Specifically, the

program will strengthen municipalities by supporting environmental management in community areas, and through annual municipal technical training courses held by the FNDR. The FNDR, in turn, will be supported by the program in the social impact and environmental engineering sector. A TC with French funds is in preparation for establishing models for leases, including environmental clauses that will be used for contracts and their respective administration. By contract, the first two projects in each financed sector will be submitted to the Bank for its approval. This will provide an additional opportunity to verify the adequate integration of the program's environmental standards.

4.17 **Transversal gender and ethnic issues**. The environmental and social impact report analyzed the situation of women, indigenous groups, and youth, in the context of participation in municipal investment projects. With respect to these transversal issues, the following measures are proposed: (i) inclusion of benchmarks and project design requirements, public meetings, and other relevant measures in the sector guidelines; (ii) inclusion of a social expert in evaluating projects financed by the FNDR; and (iii) holding annual training courses on these topics for municipal government managers. Additionally, the DUF is adopting an active role in gender and ethnic issues, and has already developed outlines on this topic, which are now under discussion. The program will mitigate the potential impact that changes in calculating the formula for systematic transfers may have on municipalities with large indigenous populations. To that end, the case of traditional communal lands and taxation on labor will be taken into consideration in the formula.

4.18 In accordance with FNDR's experience, an average of 1% of the value of the physical investment of each project is allocated for environmental protection. For this program, that amount would be approximately US$400,000. It is also expected that the environmental consultant and the social consultant will support the FNDR during the first phase, estimated at three years, at a cost of US$150,000. This cost is included in the administration and supervision costs in Table II-2. During the evaluation of the first phase, the degree to which environmental, gender, and ethnic goals have been achieved will be verified, along with accomplishments in municipal environmental strengthening, and the level of participation of the loan in support of the Ministry of the Environment (929/SF-BO). Specific environmental, gender, and ethnic targets are included in the environmental and social impact report, which will be invaluable in providing guidance on these issues.

D. Impact on poverty and targeting

4.19 The project includes explicit targeting and performance mechanisms oriented toward poverty reduction and improving social equity. Specifically, the project promotes changes in order to reduce horizontal inequalities (among regions), and to reduce vertical inequalities through the proposed compensation mechanism.

4.20 The rationale for qualifying as a PTI is that the investments, which are financed by means of transfers and loans, are oriented to providing municipal services that benefit mainly low-income groups. Seventy percent of FIS (and all FDC) projects are located in areas where an estimated 80% of the population live in conditions of poverty in terms of unmet basic needs.

4.21 The targeting of program resources for transfers will result under the new compensation policy from the system for annual preallocation by municipality, which uses a formula based on the stratified BNI for each municipality. Thus, nonreimbursable funds will be preallocated among the municipalities in proportion to their degree of relative poverty[12], ensuring that funds will be available for sectors accorded priority in the National Dialogue for municipalities based on their higher poverty rate. This preallocation of funds will increase transparency in the system and information for beneficiaries and enhance vertical equity by giving preference to low-income communities to cover the basic needs of their residents in terms of services.

4.22 The preallocation of funds by priority sector will be adjusted in subsequent years, based on the use to which municipalities put the funds, in order to reflect the actual demand of the communities and their spending priorities. The efficiency of spending will in turn be verified according to the technical and economic project eligibility criteria on which the FPS bases authorization for financing.

4.23 As to investment financing with credits, one of the project eligibility criteria used by the FNDR is that at least 50% of the beneficiaries must be living below the poverty line. Eliminated has been the FNDR restriction on activities in municipalities with under 5,000 inhabitants. This change will endow small communities with the borrowing capacity to access credit. Given these considerations, the country will be requesting authorization to use ten additional points in the financing matrix.

E. Benefits

4.24 Through its revision of the sector's institutional framework, the program will help introduce efficiency criteria in intergovernmental transfers to municipal governments, providing incentive for better use of their local fiscal potential, increasing net fiscal savings, and streamlining spending among the various government entities. Preparation of the IAPs will also bring about responsible fiscal behavior, promoting standards of prudent borrowing and maintaining the municipalities' fiscal balance. As a result, the municipalities will be able to increase

12 The population of each municipality has been divided into five groups, ranging from "no UBN" to "extreme poverty". The proportion of extreme poverty has a greater relative weight in the formula that defines the per capita amount assigned to the municipality.

their savings capacity and generate resources for investment and for maintaining their public services, particularly services oriented toward low-income groups.

4.25 The program will create the conditions and provide incentives for mobilizing private funds for the municipal sector. This addition of resources is very necessary and important for the financing of income-producing projects and to promote responsible financial management in municipalities.

4.26 The modernization of management and the expansion of the range of municipal public services, supported by the program, will provide significant advantages for their users, and improvement in the quality of life in cities. The rural development projects, financed by means of transfers, will help improve the quality of life of poor rural populations.

F. Risks

4.27 The country is continuing to experience a period of institutional consolidation in the municipal sector, at the local and central levels. In attempting to modernize this framework, the program will propose changes in the law, which do not depend on approval by the executive branch. This constitutes a potential risk for achieving some of the program's sector reforms objectives.

4.28 Additionally, achieving the program's development objectives and improving the institutional performance of the municipalities also depends on the adequate functioning and implementation of the government's compensation policy. The new system makes the use of transfers more transparent, requiring that the projects submitted be decided upon with the participation of the communities. The challenge lies in the response capacity of small communities and the disposition of government agents to support them. The program seeks to mitigate this risk by financing promotional and project preparation activities, and by requiring that the funds meet goals relating to their response to municipal requests. On the other hand, by adopting a multiphase loan modality and through the methodology of institutional adjustment plans that may run for up to three years, a closer relationship will be established and more frequent monitoring will be performed with regard to the actions undertaken by the municipalities, particularly with respect to the management changes that are planned, so that the necessary adjustments will be facilitated and the requisite technical support may be provided.

LOGICAL FRAMEWORK (FOR PHASES ONE AND TWO)

OBJECTIVES	VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
L nd and improve the services ded by municipal rnments to their nunities.	Improve the quality and increase the coverage of services provided by municipal governments.	• Surveys and monitoring of program participation. • Progress reports. • Inspection visit. • Surveys of status of municipal social services.	• Sustainable municipal growth capacity. • Political stability in the countr
POSE ernize the institutional and cial framework of the cipal sector and the system nditional and unconditional fers to municipalities urage fiscal responsibility e part of municipalities	• A new formula for non-conditional transfers has been adopted to promote efficiency and equity. • Cofinancing system (conditional transfers) set up and the funds formally established. • FNDR strategy plan implemented (capitalization or privatization or other strategies). • Finances of municipalities taking part in the program are in fiscal balance (no current deficits). • Private resources used to finance municipal projects.	• Reports of the VTCP and the General Accounting Office. • Inspection visits. • Program progress reports. • Reports on public investment in the municipalities.	• Commitment of local and national authorities to the program. • Community awareness of its rights and responsibilities. • Decrease in current municipal spending on maintaining and operating productive social investments.

COMPONENTS	PHASE ONE	PHASE TWO	MEANS OF VERIFICATION	ASSUMPTIONS
Municipal investments Financing of productive social projects by means of transfers. Financing of projects with credits from urban and social development projects.	• 75 municipalities are carrying out projects using resources from transfers. • 25 municipalities have undertaken credit operations to finance urban projects.	• A further 75 municipalities are carrying out projects using resources from transfers. • A further 25 municipalities have undertaken credit operations to finance urban projects.	• Inspection visits. • Program project reports. • Budget performance reports. • Financial statements.	• Municipalities have the capaci required to handle contracting • Availability in the market of consultants and consulting fir to provide support for the municipalities. • Participation of the committed municipalities.
stitutional strengthening **Municipal adjustment projects** rams for technical and nistrative strengthening to improve financial rmance of municipalities.	• 75 municipalities (at least 25 with over 10,000 inhabitants) under IAP agreement, and submitting satisfactory fiscal benchmarks.	• A further 75 municipalities (at least 25 with over 10,000 inhabitants) under IAP agreement, and submitting satisfactory fiscal benchmarks.	• Program project reports.	
Municipal property registers	• Property registers in place and functioning in 10 municipalities.	• Property registers in place and functioning in a further 20 municipalities.	• Progress reports	
ctor development **Assignment of functions** Clarify functions of prefectures and municipalities. mplement new tax sharing formula.	• New division of functions introduced. • Studies conducted and proposed changes to law in progress.	• New municipal legislation introduced. • New sharing formula introduced.	• Project reports. • Official Gazette and national budget.	Agreement on funds transfer formu for municipalities reached in natio dialogue.

COMPONENTS	PHASE ONE	PHASE TWO	MEANS OF VERIFICATION	ASSUMPTIONS
Sector financing romote new modalities ncluding private sector inancing with the support of he strategic development of he FNDR to accomplish his aim.	• FNDR operating under regulations of Superintendency of Banking • Studies, including FNDR strategy plan to support private sector involvement, in process • NAFIBO has a line of financing for municipalities through IFIs.	• Recommendations on support for private sector involvement in implementation in process. • Municipalities draw on private financial market to finance investment projects.	Program progress reports and reports of Superintendency of Banks. NAFIBO report and amount of credit extended by commercial banks.	Risk assessment indicators and pro supervision mechanisms have been developed.
Fiscal management ntroduction of municipal iscal management nonitoring systems	• Fiscal information system established at VTCP. • One round of municipal risk ranking completed. • Regulations of Superintendency of Banks, or in the case of bond issues those of Securities Commission, issued.	• Municipalities continue updating fiscal information system.	Program project report.	Risk assessment indicators and pro supervision mechanisms have been developed.

PROGRAM PROCUREMENT PLAN

PROCUREMENTS OF THE PROJECT	FINANCING			PROCUREMENT METHOD	PRE-QUALIFICATION	PUBLICATION OF THE SI		
						YEAR	PRESS	
	IDB	LOCAL	TOTAL				International	Na
ng								
ıdy of responsibilities and : system of ergovernmental transfers	0.5	-	0.5	Shopping	Yes	2001	Yes	
nicipal risk assessment	0.6	-	0.6	Shopping	Yes	2001	Yes	
tor financing	0.4	-	0.4	Shopping	Yes	2001-2002	Yes	
ital mapping	4.0	0.8	4.8	Shopping	Yes	2001	Yes	
ɔgraphic information system	1.2	0.3	1.5	Shopping	Yes	2001	Yes	
nputers and printers	0.3	0.1	0.4	Shopping	Yes	2001-2002	-	
ction								
ban construction and social rks	34.0	6.0	40.0	Shopping	No	2001-2003	No	

PROPOSED RESOLUTION

BOLIVIA. LOAN /SF-BO TO THE REPUBLICA DE BOLIVIA
FISCAL ACCOUNTABILITY AND LOCAL DEVELOPMENT PROGRAM – PHASE I

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the República de Bolivia, as Borrower, for the purpose of granting a financing to cooperate in the execution of the first phase of a Fiscal Accountability and Local Development Program. Such financing will be for the amount of up to US$47,000,000, or its equivalent in other currencies, except that of Bolivia, which are part of the Fund for Special Operations resources of the Bank, and will be subject to the "Special Contractual Conditions" and the "Financial Terms and Conditions" of the Executive Summary of the Loan Proposal.