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Designing Rules for Demand-Driven Rural Investment Funds

The Latin American Experience

Thomas Wiens
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FOREWORD

Demand-driven rural investment funds (DRIFs) offer a major new means for improving the design, implementation and sustainability of rural development programs. DRIFs are mechanisms through which central government transfers funds to local governments and communities to use to address their own priorities. This approach to rural development represents a sharp break with the past, when central governments selected and implemented rural development activities, often with little input from communities — and little impact on development.

However, governments and donors are concerned that local governments are too weak to make decisions about which projects to undertake and lack capacity to implement all but the simplest projects. They worry that funds will be spent improperly or appropriated by local elites. To counteract these problems, central governments have often constrained the choices of communities by limiting the types of projects eligible for financing, and requiring specific procedures for procurement and disbursement. They monitor compliance and retain veto power over community choices of subprojects.

This study explores the extent to which well-designed DRIF rules and incentive structures can substitute for central control, and truly empower communities to take charge of their own development. It identifies the many objectives that DRIFs are meant to satisfy, and shows which are being met and which are not. And it offers practical guidance about how to design DRIFs so that they effectively and sustainably promote rural development.

The analysis was based primarily on the evaluation of World Bank-financed projects in Mexico, Colombia and Brazil which represent early examples of DRIFs. The research was carried out as part of the World Bank's Decentralization, Fiscal Systems and Rural Development Research Program, supported by the Swiss Agency for Development Cooperation, the Royal Ministry of Foreign Affairs of the Government of Norway, and the World Bank.

Alex F. McCalla, Director and Chair, Sector Board

Rural Development

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ABSTRACT

The demand-driven rural investment fund (DRIFs) is a new mechanism for decentralizing decisionmaking authority and financial resources to local governments and communities to use for investments of their choice. They offer great promise for improving the design, implementation and sustainability of rural development programs.

However, to counteract weak capacity of local governments to choose and implement projects well, central governments have often constrained the choices of communities by limiting the types of projects eligible for financing and requiring specific procedures for procurement and disbursement. They also monitor compliance and often retain veto power over community choices of subprojects.

This study explores the extent to which well-designed DRIF rules and incentive structures can substitute for central control. It looks at the different, and often conflicting, motivations of donors, central governments and communities and explores how rules can be devised to allow all actors to achieve their objectives. It identifies the many objectives that DRIFs are meant to satisfy, and shows which are being met and which are not. And it offers practical guidance about how to design DRIFs so that they effectively and sustainably promote rural development.

ABBREVIATIONS and ACRONYMS

DRD	Decentralization and Regional Development (Mexico)
DRIF	demand-driven rural investment fund
FDC	*Fondo de Desarrollo Campesino* (Small-farmer Development Fund, Bolivia)
Fondo DRI	*Fondo Desarrollo Rural Integrado* (Integrated Rural Development Fund, Colombia)
FPM	*Fundo de Participacion Municipal* (Municipal Participation Fund, Brazil)
FUMAC	*Fundo Municipal de Apoio Comunitario* (Municipal Community Fund, Northeast Brazil)
IRR	internal rate of return
MPC	municipal participatory committee
MSF	Municipal Solidarity Fund (*Fondo de Solidaridad Municipal*, Mexico)
NRDP	Northeast Rural Development Program (Brazil, phase 1, 1986–93, and phase 2, reformulated NRDP, 1993–95)
NRPAP	Northeast Rural Poverty Alleviation Program (Brazil, phase 3, 1995–96)
PAC	*Programa de Apoyo Comunitario* (Community Support Program, Northeast Brazil)
PDIC	*Programa de Desarrollo Integrado Campesino* (within *Fondo DRI*) (Integrated Small-Farmer Development Program, Colombia)
PIDC	*Programa Integrado Desarrollo Campesino* (within FDC) (Integrated Small Farmer Development Program, Bolivia)
SEDESOL	*Secretaria Desarrollo Social* (Social Development Secretariat, Mexico)

GLOSSARY

Caudillismo, coronelismo, caciquismo. The *caudillo* historically was the military strongman who could maintain order, though often with iron-fisted brutality. At present what remains of the *caudillo* system is defined as "an informal system of power, practiced by individuals or groups in strategic positions in the economic and political structure. It implies asymmetric relationships among people of different social classes with reciprocal but uneven obligations, characterized by latent threatening." A controversial parallel of the caudillo in the indigenous social structure is the *cacique*. Historically the *cacique* was in charge of organizing and supervising work groups which — according to the Inca and Aztec fiscal legislation — were obliged to give some days of free labor for public works. (This form of tax was called *mita*.) The controversy derives from the extremely variable role of the *cacique*, who did not based his power on his own army and had a smaller group of subordinates than the *caudillo*. Throughout this report, these terms are used to refer to a single politician who retains arbitrary decisionmaking authority and discretionary control over resources.

Clientelismo. Use of resources to reward one's patrons or party. Favoritism based on personal relationships rather than efficiency criteria.

Municipal Assembly. Meeting of the municipal council which is open to all citizens.

Municipal Council. Elected body representing the local legislative power.

Municipal Government. The smallest administrative unit which is composed of the mayor and his assistants. The municipal council is not formally part of the executive organs of the municipal government. However, the term "municipal government" often refers to all the public institutions and organs of municipal powers. In this case, it also comprises the municipal council.

Municipal participatory committee (MPC). An informal body created to administer the resources of demand-driven rural investment funds with variable levels of responsibility. In some cases it may be independent of the municipal government.

Municipality. Generic term for the geographical delimitation of the administrative unit and/or its level of decisionmaking. It is broader than the Municipal Government, as it does not only represent the public, institutional, municipal powers. This term is used though this report with the Spanish connotation, which is not limited to city and town. This report is strictly concerned with rural municipalities.

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EXECUTIVE SUMMARY

Traditionally, central governments have been in charge of designing rural infrastructure projects, often with more or less input from local communities. To ensure efficient execution and minimal costs, project rules often required the use of centralized contracting and procurement. Now, however, many countries are giving communities more control over project choice and execution through the use of "demand-driven investment funds" (DRIFs). Broadly, DRIFs are pools of funds available to communities to invest in their preferred projects. Communities must submit applications for the funds describing in some detail how the funds will be used. However, communities are not free to use the funds in whatever way they want. Central government constrains local decisionmaking with eligibility rules — defining acceptable project types and providing incentives to choose projects of particular sorts — and constrains local implementation power with rules of procurement and disbursement. Generally central authorities monitor compliance with the rules, and also often retain the power to endorse or reject communities' choices of subprojects.

If local governments all functioned effectively, and projects were small and localized, then there would be no need for the rules. Communities could be given access to untied resources from revenue sharing or general purpose block grants, and invest in the projects they prefer, constrained only by availability of resources. However, local governments often lack the capacity to choose and implement projects well: staff with essential skills are lacking, institutions for decisionmaking are weak, and mechanisms of transparency and accountability are absent. In Latin America, as elsewhere in the developing world, *coronelismo* and *clientelismo* are pervasive in rural areas. These shortcomings provide central government with a rationale for overseeing local decisions.

This case study explores the extent to which a carefully-devised rule and incentive structures can replace central control and centrally-imposed constraints, while assuring that *coronelismo* and *clientelismo* do not undermine the objectives of "demand-driven rural investment funds" (DRIFs). It focuses on decentralized projects which have been in operation long enough to have a track record, particularly Colombia's *Fondo DRI*, Brazil's *PAC/FUMAC,* and Mexico's *Solidaridad* projects. Assessing the rules and incentives governing these projects is a difficult task since they are changing from year to year (partly in recognition of imperfections noted below). Therefore not all of the "facts" reported will still be valid when this paper is read. Moreover, we make no attempt to evaluate the performance or design of any of these projects as a whole, relative to each other or relative to previous projects. We rather assume that DRIFs as a class are at the cutting edge of the best approaches to rural poverty, and focus on ways to further improve this instrument.

DRIFs are distinguished from the social fund-type projects of Africa and Latin America by targeting rural areas and by supporting mainly productive infrastructure and natural resources management activities. DRIFs borrow from social funds the goal of poverty alleviation, a thrust toward participatory identification and implementation of many small subprojects, and often a focus on strengthening institutions at the community and municipality level. The similarities between DRIFs and social funds are greater than the differences, and most of the conclusions of this study are equally applicable to social funds.

Goals of DRIFs

DRIFs are intended to meet many policy objectives, which are often in conflict. Various institutions involved in developing, financing, and implementing projects often also have conflicting objectives. The primary objectives are:

- **Target rural poverty (goal 1)**. Grant-funded projects should primarily benefit the poor. DRIF rules should be established so that most of the benefits go to the poor, or at least so that the benefits are distributed more equitably than normally.

- **Give communities control over project choice and implementation (goal 2)**. When community members choose their projects, and help pay for and implement them, they are much more likely to value and sustain them. Full community involvement usually requires decentralized decisionmaking.

- **Build municipal capacity (goal 3)**. DRIFs should help local governments develop permanent capacity to plan and execute small projects, where this is lacking. Where local governments already possess adequate capacity, DRIFs can help transfer responsibility for selecting and implementing small projects to local governments. Either way, DRIFs may be designed to foster decentralized decisionmaking and implementation.

Other objectives are common to international development projects:

- **Choose projects which are economically viable (goal 4)**. Curiously, this most universal of goals conflicts with the goal of involving local people in choosing and implementing projects (goal 2). Local communities may choose projects which cannot pass the test of viability (generally defined as projects with acceptable economic rates of return). Requiring viability gives outsiders the power to veto community choice. This goal may also conflict with the goal of targeting poverty (goal 1). The poor often live in resource-poor and isolated regions, in conditions that make it particularly difficult for projects to succeed.

- **Implement projects efficiently (goal 5)**. This sensible goal may conflict with the goal of involving local people in choosing and implementing projects (goal 2) and perhaps that of targeting poverty (goal 1). Generally, implementing projects efficiently requires hiring experts with skills and experience from outside the community. Poor communities are less likely than others to have members with the necessary expertise and experience to implement projects efficiently.

- **Manage funds efficiently and honestly (goal 6).** Donor and governments have developed complex regulations to control procurement, accounting, and auditing to ensure the efficient and honest use of funds. However, these rules, which authorities designed in response to experiences with centralized projects, frequently conflict with goals 1 and 2. Targeting poverty means working with poor communities that typically lack the technical capacity to satisfy the regulations.

- **Effectively manage project operation and maintenance, including recurrent financing (goal 7).** This goal suggests that local people should participate in the daily management of the project, at least of small subprojects for which professional management is not feasible.

- **Respond to priorities of people outside the community (goal 8).** Central governments or external donors may give priority to certain types of subprojects, and not others. There are many reasons why. For example, national constitutions may require countries to provide specific goods or services to its citizens, such as access to education or health care, which demand priority. Countries may require that projects or programs be clearly separate in content, so new projects do not duplicate older ones. Whatever the reasons for the preferences, this goal conflicts with that of giving communities control over project choice (goal 2).

Finally, some important but largely unstated goals of individuals or institutions may influence design and implementation:

- **Conform to institutional imperatives (goal 9).** Institutional or bureaucratic rules do not always promote — and may even be at cross-purposes with — project goals. Yet, policymakers may require projects to follow institutional imperatives anyway, even though this has a negative impact on project design.

- **Administer projects cost-effectively (goal 10).** The goal is to minimize the time and effort required to develop, implement, and supervise the project. This is often a high priority and other goals are often sacrificed in pursuit of cost-effectiveness.

- **Get reelected (goal 11).** This is often the most important goal for national and local political leaders. Indeed, politicians are likely to promote other goals only to the extent that they facilitate getting reelected. Of course many of the other goals do not particularly further this one.

- **Reward one's patrons or political supporters (goal 12).** This is a crucial goal of politicians, which is even more important where localities restrict the number of terms politicians can serve. This is the definition of *clientelismo.* Usually politicians reward patrons by giving them contracts outside the competitive bidding process. Hence *clientelismo* conflicts with the goals of choosing economically viable projects and executing and managing them efficiently (goals 4–7).

Participation as a means. We do not take "participation" as a general goal, even though it may be central to this kind of project. This is because participation at different stages of the project cycle can exist and serve quite different goals, at the possible expense of other goals.

Project Background

The Fundo Municipal de Apoio Comunitario (FUMAC) and Programa de Apoio Comunitario (PAC) in Northeast Brazil. The Brazilian Northeast Rural Poverty Alleviation Program (NRPAP) represents one decade of efforts to alleviate rural poverty in northeast Brazil. Development of the program has passed through three different phases, each incorporating lessons of experience from the previous one:

1) The original Northeast Rural Development Program (NRDP) lasted from 1986 to 1993. The program had a small demand-driven component which distinguished itself from the rest of the program through its capacity to respond to the needs of small producers and its high disbursement rate.

2) The Northeast Rural Development Program was reformulated in 1993, by expanding and improving upon its demand-driven component. The beneficiaries choose from among eligible types of subprojects investments meeting their most critical needs. The reformulated Northeast Rural Development Program worked through two different delivery mechanisms:

   Programa de Apoio Comunitario (Community Support Program, PAC) in which rural communities submit their proposal directly to the State. The State screens, approves, and releases funds for subprojects interacting directly with the beneficiaries.

   Fundo Municipal de Apoio Comunitario (Municipal Fund for Community Support, FUMAC), in which a municipal participatory committee is created to screen, prioritize, and submit proposals to the State. The municipal participatory committee is not a formal municipal structure, though the municipal government is represented, together with representatives of communities and civil society.

3) The Northeast Rural Poverty Alleviation Program (NRPAP) started in 1995–96. This phase expanded the use of FUMAC and introduced a third delivery mechanism (which has barely begun to function).

   Fundo Municipal de Apoio Comunitario-Piloto (Pilot Municipal Fund for Community Support, FUMAC-P), under which the municipal participatory committee assumes additional implementation responsibilities (besides those of FUMAC), receives a firm annual budget, and manages the resources. The new mechanism is intended to transfer as much responsibility to the municipal level as possible.

Fondo DRI

Like the Northeast Brazil Program, the Colombian *Fondo DRI* has been operating for two decades to reduce rural poverty, and has evolved from a centralized rural development program. By contrast to the program in Brazil, its conversion to a community based program has been piecemeal, and is still not complete. Colombian municipalities, which have been efficiently soliciting financing and implementing most subprojects for years, are responsible for its success. In 1990 with the support of a Bank loan, the program began to finance subprojects proposed and managed by the municipalities, reinforcing the mayor's authority. Even now, however, the resources are rigidly allocated among specific types of investments: technical assistance, organization and training, watershed management and fisheries, rural women, marketing, rural roads, water supply and sewerage, electrification, and flood control. For example, the resources available for roads cannot be used for technical assistance, and vice-versa.

Mexico Municipal Solidarity Fund (MSF). The National Solidarity Program, now renamed the *Superación de la Pobreza,* was the Mexican Government's primary tool to reduce poverty and provide services to underserved communities. It was initiated in 1988 and included 30 subprograms to target health, education, nutrition, employment, infrastructure, agriculture, institutional development, and income-generating subprojects for the poor. Therefore it is not a single program, but a general approach to reducing poverty, and an umbrella for many different components. The program was built on four principles common to the whole program: (a) community participation; (b) poverty targeting; (c) decentralization; and (d) responsibility and cost sharing among federal government, states, municipalities, and beneficiary communities. While the umbrella program also finances large subprojects, the Municipal Solidarity Fund finances only small subprojects, which are completely managed at municipal and community levels. Subprojects were identified through community assemblies, and were selected by a specially-formed municipal participatory committees called Solidarity Councils (one per municipality). The Solidarity Committees (one per subproject) were in charge of implementing the subprojects. The Solidarity Councils decided the final priorities and identified the investments, given simple eligibility criteria and minimal procedural rules.

Findings

How well have the three DRIFs achieved the eight goals most important to the World Bank? Which rules (or types of rules) have proven most useful, and least useful, in achieving these goals?

- **Target rural poverty (goal 1).** It appears that the DRIFs have not been particularly effective in targeting poor localities, although we have no way of comparing how well

DRIFs target poverty compared with other programs. This is because formulas have not generally been used to allocate funds; when used, formulas have included several criterion unrelated to poverty; and additional eligibility conditions which would exclude the nonpoor from the benefits of the subprojects have not been applied or enforced. Colombia's *Fondo DRI* is the most successful of the three projects in targeting poor localities. Project managers used a cofinancing matrix which heavily favored poorer municipalities to allocate funds.

- **Give communities control over project choice and implementation (goal 2).** In all three DRIFs, communities are responsible for identifying projects and submitting proposals for financing. It is unclear, however, to what extent the process is really participatory, or is instead dominated by outside influences (the mayor, contractors, or nongovernmental organizations). The requirement that beneficiary communities provide some proportion of subproject funds should ensure that beneficiaries at least desire the subprojects even if they do not regard them as their highest priorities. After all, all the DRIFs constrain freedom of choice by imposing eligibility, cofinancing, and feasibility criteria. Colombia imposes the greatest constraints on communities: *Fondo DRI,* until recently, rigidly allocated funds according to subproject type. In Mexico, where guidelines emphasize participation, experience has been mixed and generally fallen far short of the guidelines. There are few rules governing allocation of resources from the Municipal Solidarity Fund, and enforcement is weak. Therefore outcomes depend largely on the attitudes of local political and administrative authorities. Bolivia, with its requirement that communities adopt a participatory process of planning and priority setting, has developed the most elaborate participatory scheme.

- **Build municipal capacity (goal 3).** In all but Brazil's PAC, municipal level authorities set priorities and choose subprojects among those proposed by communities. Municipalities have received considerable technical assistance to help strengthen their investment management capacities. The extent to which the mayor, the existing municipal council or a parallel municipal participatory council has dominated subproject selection has varied among countries and localities. On the whole, Colombia's *Fondo DRI* has tended to reinforce the mayor's authority: the municipal participatory committees have not functioned as envisioned. The Brazil and Mexico DRIFs made more of an effort to include beneficiaries and other members of civil society in decisionmaking (reflecting central government distrust of local government). This effort has been especially successful in Brazil, perhaps because civil society at the grassroots level (in the municipalities eligible for FUMAC) may be stronger than in Mexico, and because Brazil encouraged communities to develop mechanisms for indirect, rather than direct representation, of beneficiaries.

- **Choose projects which are economically viable (goal 4).** The Mexico DRIF has relied entirely on beneficiary participation to achieve the goal of viability and sustainability. Most of the subprojects financed by the Municipal Solidarity Fund appear to have addressed basic social needs at substantially lower unit cost than other government projects. There have been too few productive-type projects under the Mexican program to judge whether participation would also have been effective for these projects. However experience from a limited number of subprojects in Chiapas suggests that productive subprojects may be less sustainable than subprojects addressing basic needs. There is no evidence that subprojects in Mexico were of higher quality than in the other countries, even though Mexico screened the subproject proposals for feasibility. However, there are too little data available on project performance following completion to allow us to draw firm conclusions at this time. It is clear that requiring full economic evaluation (plus environmental impact and gender analysis) of every subproject is a costly strategy, and probably an unrealistic goal given technical capabilities in local areas in these countries. Unfortunately little effort has been devoted to developing and applying rules of thumb which could be used to screen out most unviable or unsustainable subprojects quickly and easily.

- **Implement projects efficiently (goal 5).** Is it better to implement subprojects through contractors or participatory self-management? There is too little information to be able to say for sure. We do know that in Mexico, which allows communities to retain saved funds to expand subprojects, communities have completed projects at lower unit costs than in the other countries. Although routine monitoring data provide information only on whether or not projects, as originally proposed, were completed, physical audits show that communities were able to expand projects by an average of 10 percent using the original budgets.

- **Manage funds efficiently and honestly (goal 6).** The three programs have all experienced difficulties with disbursements, which were late or difficult to access because central governments were unable to advance funds. The World Bank's disbursement procedures are not designed to deal with this situation. But authorities have increasingly been able to find ways to manage disbursements to meet the needs of dispersed and decentralized communities, yet conform to World Bank rules. A weakness has been the failure of governments to enforce subproject rules through sanctions: this would demonstrate that government takes seriously the need for honest funds management. And, where the World Bank and implementing agencies (at central or local levels) differ significantly in their commitment to various project goals, the World Bank should disburse funds directly to these agencies to give them the incentive to observe agreed rules. This is the lesson from the Mexican experience.

- **Effectively manage project operation and maintenance, including recurrent financing (goal 7).** None of the programs have performed particularly well in achieving this goal, according to the little information available. Indeed, information from local or partial surveys suggests that a high proportion of subprojects may not be sustainable. With infrastructure subprojects, communities need help to strengthen their capacities to better manage operations and maintenance. Sustainability is not guaranteed simply because communities formally agree to take responsibility for operating and maintaining subprojects. With productive subprojects, sustainability can be improved with careful analysis of project proposals for financial viability and sustainability before they are started.

- **Respond to priorities of people outside the community (goal 8)**. Through the use of incentives, all three projects encourage communities to choose projects which conform to external priorities — limiting true community identification (goal 2). Brazil limits the cost of subprojects by type. Colombia, until recently, rigidly earmarked funds by subproject type. And Mexico gives priority to subprojects meeting basic needs, requiring communities to pay a larger proportion of costs for amenity infrastructure subprojects than other types. Because countries classify projects differently, it is impossible to see how this has affected the distribution of projects by type, so we cannot be sure how extensively the imposition of external priorities has distorted local preferences.

This study has identified the conflicts among objectives, and the advantages and disadvantages of various rules which mediate between them. Unfortunately, we have not been able to identify the optimal DRIF design. This is in part because data available on the three projects are insufficient. In addition, differences in multiple variables among DRIFs make it difficult to identify with certainty relationships between subproject rules and outcomes (there are too many variables, and the sample contains only three projects). Still, some important conclusions can be drawn:

- **Design DRIF rules to reflect local conditions**. There is no one optimal design suitable for DRIFs in all places at all times. The particular set of rules agreed for each DRIF, at each stage of its evolution, must result from negotiations among actors with different preferences and objectives — in different political, social, and economic contexts.

- **Consider offering communities with different capacities, different financing packages**. Within the same country communities differ in their level of development, organization, and method of decisionmaking. Brazil has dealt with this by offering different programs to different communities depending on their capacities to implement subprojects. Communities with greater capacities take greater responsibility for implementing an annual development program, which FUMAC supports. Those with more limited capacities receive financing to complete a single subproject, with financing under PAC.