

What subnational governments spend on and how they spend it

● The level and composition of subnational government spending in Latin America and the Caribbean.

● Budgetary rigidities faced by subnational governments.

● Mechanisms to improve the quality of subnational government spending.

3

Key messages

1

Decentralization in Latin America has increased public spending managed by subnational governments, although it remains below the OECD average. Decentralized countries, such as Brazil and Argentina, exhibit a high share of subnational spending, unlike centralized states, such as Chile and Ecuador, where the role of these governments is more limited.

2

Subnational government spending per capita varies widely across the region. In general, per capita spending decreases as population size increases, reflecting economies of scale.

3

Some countries allow subnational governments to borrow without explicit authorization or guarantees from the central government, complementing this option with financial sustainability rules. These include debt and expenditure composition limits, externally verified financial projections for early corrective actions, and central government intervention mechanisms—such as expenditure controls—in cases of insolvency.

4

Spending floors in key areas, such as health and education, can enhance the coverage of these basic services. However, their effectiveness depends on the quality of governance and on combining regulations with local autonomy in the use of resources.

5

Public procurement, which accounts for a significant portion of subnational government spending, is vulnerable to inefficiencies and corruption. Competitive procurement methods, such as framework agreements and auctions, can improve efficiency by reducing cost overruns and discretion. However, they may also increase administrative rigidity, underscoring the need for a balance between control and flexibility, tailored to local capacities.

6

Central government audits, especially when conducted randomly and independently, are effective tools for reducing corruption in subnational governments. Internal controls offer more direct preventive potential and can be effective if independence and professionalization are ensured.

7

Results-based financing aligns resources with specific goals, incentivizing subnational governments to maximize the efficiency and impact of public spending. Its effectiveness depends on factors such as autonomy in fund management, technical support for policy implementation, and clearly defined performance metrics.

What subnational governments spend on and how they spend it¹

Introduction

The decentralization process in Latin America and the Caribbean (LAC) has redefined the role of subnational governments, expanding their responsibility for public service delivery and resource management. This shift has led to an increase in their share of total public spending, with significant variations between countries and levels of government. Analyzing how and on what these governments spend provides key insights into the progress and challenges of decentralization, as well as its implications for the well-being of the population and the efficient use of public resources.

This chapter delves into the composition of subnational spending, highlighting differences across countries and levels of government. The findings should be interpreted in the context of the complexities of subnational public finance data, described in Box 3.1. The chapter examines the priorities of regional governments in sectors such as education, health, and social protection,

as well as the focus of local governments on administrative expenses, community infrastructure, and housing. These differences help identify the responsibilities and priorities associated with each level of government within the framework of decentralization.

Budgetary autonomy is a crucial aspect of decentralization, enabling subnational governments to allocate and manage resources according to local priorities. However, it also presents incentive challenges. Subnational authorities may make decisions driven by short-term goals, prioritizing popularity and reelection prospects, with the assumption that any shortfalls will eventually be covered by the central government. This could lead to issues such as underinvestment in infrastructure, overstaffing, or excessive borrowing.

¹ This chapter was written by Pablo Brassiolo and Rodrigo Cifuentes, with assistance from Pedro Di Plácido and Rodrigo Fernández.

Box 3.1

Complexities in subnational public finance data

The primary sources of information for analyzing subnational public finances in Latin America and the Caribbean (LAC) are budget execution reports published by governments on the websites of ministries of finance or specialized agencies. For instance, in Mexico, the National Institute of Statistics and Geography provides fiscal data for states and municipalities through the System of National Accounts. In Peru, the Ministry of Economy and Finance publishes detailed budget execution data for regional and local governments. In Brazil, the National Treasury Secretariat collects fiscal data for states and municipalities. In some cases, this is complemented by public debt information, enabling a more comprehensive analysis of subnational finances. While these sources provide broad access to fiscal information, they also face limitations such as a lack of harmonization in budget classifications across countries, methodological changes within individual countries, and differences in temporal coverage.

These limitations not only complicate the interpretation of available data but also present significant challenges regarding access and processing. Budget classifications vary significantly across countries, as each follows its own criteria for recording fiscal information. For example, in some cases, data are organized by object of expenditure, requiring conversion into a standardized economic classification system across countries using respective budget classification manuals. Additional challenges arise from data formatting, as some data are presented in formats less conducive to manipulation and analysis. In some instances, it is also necessary to combine information from multiple databases.

This diversity poses a significant challenge to cross-country analyses of subnational public finances in the region. To address these challenges, the authors of this report undertook processes to reclassify and harmonize data. These efforts made it possible to compare the magnitude and composition of fiscal variables across subnational governments, identify regional patterns, and delve into key areas such as spending, public investment, and fiscal revenues. Understanding the limitations in data coverage, heterogeneity, and accessibility is critical for accurately interpreting the findings and recommendations presented in this report.

In most countries in the region, subnational governments face various restrictions on their autonomy. One limitation stems from regulations that dictate the use of certain funds, such as transfers from the central government allocated for specific purposes. Additionally, constitutional or legal mandates in some countries establish minimum spending requirements in specific sectors. Furthermore, subnational governments typically need central government authorization to incur debt, and in cases where this is not required, borrowing is subject to quantitative limits and expenditure composition constraints. Finally, in financial crises, central government support is often contingent on the implementation of a fiscal adjustment program.

Tools to promote the efficient use of public resources at the subnational level include public procurement regulations, control mechanisms, and incentives for better spending. Public procurement represents a significant portion of subnational government spending, covering everything from routine acquisitions to large-scale infrastructure projects. Its importance lies not only in the scale of resources mobilized but also in the challenges of ensuring efficiency and transparency. This chapter explores tools such as competitive procurement methods and framework agreements, analyzing their potential to reduce resource mismanagement, particularly in contexts with limited institutional capacity.

As for control mechanisms, the chapter examines both external controls, specifically audits conducted by higher-level government entities, and internal controls implemented by subnational entities themselves. These mechanisms aim to prevent the misuse of public resources, strengthen accountability, and ensure transparency in governance. However, their design and application face significant challenges, including the need to ensure political independence, minimize unintended effects, and strike an appropriate balance between oversight and administrative flexibility, particularly in public procurement processes.

Lastly, the chapter explores incentives to enhance the efficiency of subnational spending, such as results-based financing. This approach links resource allocation to the achievement of specific targets, creating incentives for more efficient, results-oriented public management. The chapter addresses both the opportunities offered by this strategy and the challenges it poses, including the need for robust monitoring and evaluation systems that allow for performance measurement and effectively link it to budget allocation.

Expenditure levels and composition

The magnitude of subnational spending

The share of subnational spending in total public expenditures in Latin America and the Caribbean has nearly doubled over the past 40 years (Radics et al., 2022), coinciding with the progress of decentralization. Despite this increase, subnational spending remains low compared to countries in the Organisation for Economic Co-operation and Development (OECD), with notable variability across countries in the region.



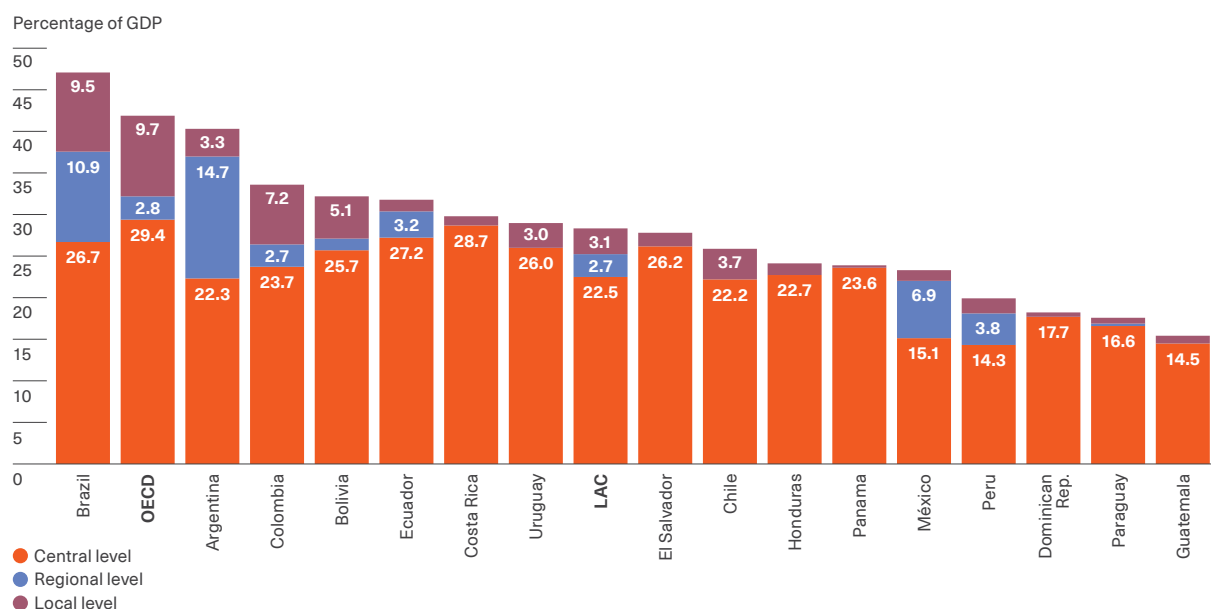
Subnational spending remains low compared to OECD countries and shows considerable variation among countries in the region

Graph 3.1 illustrates public spending broken down by government level as a percentage of GDP in Latin America and the Caribbean. On average, subnational governments in the region included in the sample spend 5.8% of GDP, significantly less than the 12.5% recorded in OECD countries.

The magnitude of subnational spending varies significantly across countries, reflecting differing degrees of decentralization. This is evident in the proportion of total public spending executed by regional and local governments in each country. In federal countries like Argentina, Brazil, and Mexico, subnational governments execute a higher share of total public spending compared to other countries in the region. In contrast, unitary countries such as Chile, Ecuador, and Uruguay exhibit lower levels of decentralization and subnational spending. Bolivia, Colombia, and Peru occupy intermediate positions, with subnational participation higher than in other countries in the region. In Central American and Caribbean countries, public spending is predominantly concentrated at the central government level.

An additional aspect, not reflected in the graph, is that the proportion of total spending executed by subnational levels has remained stable over the past decade. This suggests a lack of significant progress in the decentralization process in recent years.

Graph 3.1
Public spending by government level in 2022



Note: Data for Peru and Panama corresponds to 2021, while data for Honduras corresponds to 2020. For this graph, IMF data was used for the central level of Ecuador and the Dominican Republic, while national sources were used for their subnational governments. In Panama, national sources were used for central-level data, while IMF data was used for local-level information. For Argentina, Bolivia, and Uruguay, only national sources were used for all levels of government.

Source: Authors based on national sources for Argentina (MECON, 2023b), Bolivia (UDAPE, 2023a), Ecuador (BCE, 2023), Panama (INEC, 2023a), and the Dominican Republic (DIGEPRES, 2023); for Uruguay (MEF (Uruguay), 2023; OTU, 2023a); and for other countries, IMF (2024a).

The composition of subnational spending

An analysis of subnational spending by economic function reveals substantial differences across countries and levels of government. At the regional government level, education is the primary area of expenditure in most countries, accounting for between 15% in Brazil and 53% in Paraguay (Graph 3.2, Panel A). Health also plays a significant role, ranging from 7% in Paraguay to 27% in Peru. Social protection represents up to 39% of expenditures in Paraguay and approximately 20% in Argentina and Brazil, including household transfers such as pensions for public employees, disability benefits, subsidies for families with dependent children, and other forms of support aimed at mitigating economic and social risks. In Brazil and Mexico, around a quarter of regional budgets are allocated to general public services, which include administrative and operational expenses such as

salaries for government staff in executive and legislative roles and the maintenance of public buildings.

At the local government level, spending patterns differ significantly from those observed at the regional level (Graph 3.2, Panel B). Most local governments allocate a substantial share of their budgets to general public services, primarily covering administrative salaries and operational expenses, which account for 15% to 31% of total spending. Expenditures on housing and community services are also significant but vary widely across countries, ranging from just 2% in the Dominican Republic to 39% in Argentina. This category includes urban and community development as well as essential services such as potable water and street lighting. Spending on

“economic affairs,” which encompasses productive sectors like transportation, communications, and energy, exceeds 25% of total expenditures in four of six countries, reaching 43% in El Salvador. Environmental protection also represents a notable share of local spending, particularly in the Dominican Republic (29%), and includes activities such as wastewater management, urban drainage services, and biodiversity conservation.

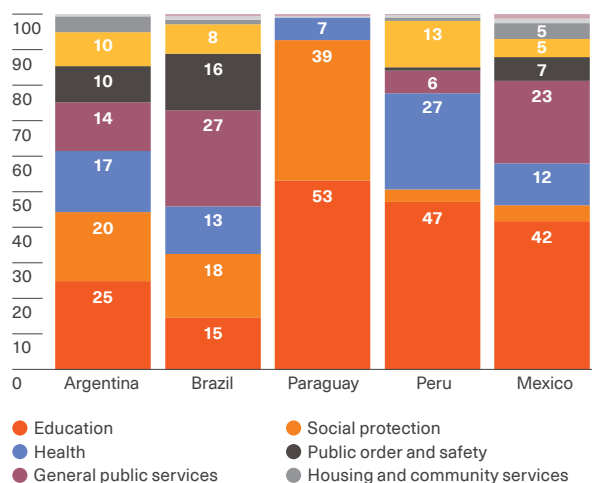
The comparison between government levels highlights clear patterns that reflect distinct competencies, consistent with the descriptions in the previous chapter. In Argentina and Brazil, both

regional and local governments allocate budgets to education and health. However, provinces in Argentina bear a larger share of these expenditures, while municipalities in Brazil play a greater role. In Peru, almost all spending on education and health falls under regional governments, with minimal local participation. Some functions appear exclusive to a specific government level: environmental protection, housing, and community services are typically the responsibility of local governments. Subnational spending on public order and security is generally low, except in federal countries, where it accounts for 7% in Mexico and 16% in Brazil.

Graph 3.2
Functional composition of subnational government spending

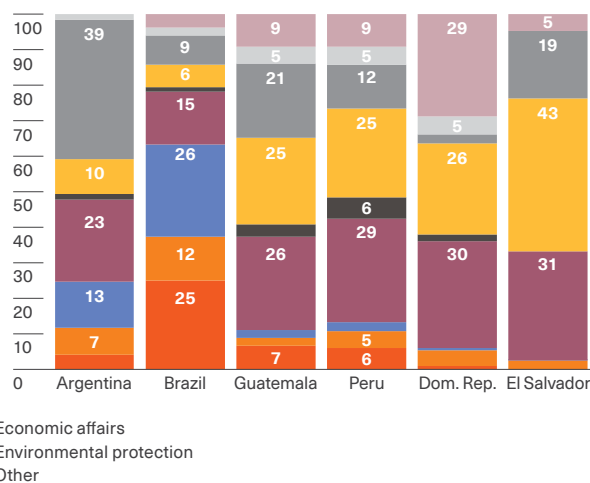
**Panel A.
Regional governments**

Percentage



**Panel B.
Local governments**

Percentage



Note: Spending functions correspond to the United Nations' Classification of the Functions of Government (COFOG) one-digit categories, except for “other,” which groups “recreation, culture, and religion” and “defense.” Data reflects the most recent year with available information. Data for Argentina does not include the “environmental protection” category.

Source: Authors based on IMF (2022) for El Salvador and national sources for the other countries (see Table A.3.1 of the appendix available in the online edition of the RED).

An alternative way to categorize subnational spending is by distinguishing between current expenditures, capital expenditures, and debt services. Table 3.1 presents this breakdown for regional (Panel A) and local (Panel B) governments in eight countries with available

information. For regional governments, spending is primarily focused on operational and administrative activities, with more than 80% allocated to current expenditures in countries such as Argentina, Brazil, Colombia, Mexico, and Uruguay. In these countries,

personnel expenses are significant, alongside social security and current transfers.² In contrast, capital expenditures represent a smaller share, indicating lower direct investment in infrastructure. Bolivia stands out as an exception, with 53% of regional spending directed toward capital investments. Debt service costs are moderate in most countries, except in Brazil, where they reach 6.9% of total expenditures.

Local governments exhibit a similar pattern in the distribution of spending, with current expenditures

dominating, although this varies by country. For example, in Peru, 55% of local government spending is allocated to infrastructure investment, contrasting with the general trend. Bolivia, Guatemala, and Honduras also stand out, with capital expenditures accounting for around or exceeding one-third of total spending. Within current expenditures, most resources are directed toward salaries and the purchase of goods and services. Local-level debt service payments are generally low, with exceptions like El Salvador, where they represent nearly 16% of total spending.

Table 3.1
Economic classification of subnational spending

Panel A. Regional governments

	ARG	BOL	BRA	COL	MEX	PRY	PER	URY
Current expenditures	84.3	45.3	84.8	87.3	90.6	68.7	73.8	83.0
Personnel	40.4	16.7	31.5	31.8	20.5	12.5	45.3	51.5
Social security	11.7		17.3				7.2	
Current transfers	21.6	6.2	17.6	33.2	65.0	47.2	0.04	
Other current expenditures	10.6	22.4	18.3	22.3	5.0	9.1	21.2	31.6
Capital expenditures	11.4	53.1	8.4	8.9	4.6	31.3	25.0	14.5
Debt service	4.3	1.6	6.9	3.8	4.8	0.0	1.2	2.5
Total expenditures	100	100	100	100	100	100	100	100

Panel B. Local governments

	ARG	BOL	BRA	CHL	COL	CRI	SLV	GTM	HND	MEX	PRY	PER	DOM
Current expenditures	82.1	64.3	89.5	93.0	85.9	70.6	59.8	62.7	54.6	71.2	74.1	43.8	67.7
Personnel	44.7	20.8	43.2	48.5	18.9	37.2	34.9	29.4	29.5	35.9	20.6	8.7	35.0
Social security			7.8	0.9									
Current transfers	6.2	5.6	0.4	21.2	9.0	10.6	0.7	2.1	2.2	8.2	14.8	0.9	4.0
Other current expenditures	31.1	37.9	38.1	22.4	58.0	22.8	24.2	31.2	22.9	27.1	38.6	34.2	28.7
Capital expenditures	18.1	34.3	9.6	5.1	11.2	25.9	23.7	33.4	42.1	26.1	23.8	55.1	25.7
Debt service		1.4	0.9	1.9	2.9	3.5	16.5	3.9	3.3	2.8	2.1	1.1	6.6
Total expenditures	100	100	100	100	100	100	100	100	100	100	100	100	100

Note: The values correspond to 2022. For Uruguay's regional governments, it is not possible to distinguish between current and capital transfers, which make up 5% of total spending. Consequently, percentages have been adjusted to exclude these items.

Source: Authors based on national sources (see Table A.3.1 of the appendix available in the online edition of the RED).

2 Personnel expenditures generally include salaries for public sector employees, the state's contributions to social security as an employer, and other forms of compensation. Social security expenditures cover payments to retired public sector employees, as well as social benefits such as bonuses and subsidies for disability, maternity, and support for socially vulnerable populations.



With 10,149 inhabitants, the municipality of Huasco, in Chile, has a population close to the median among local governments in the region.

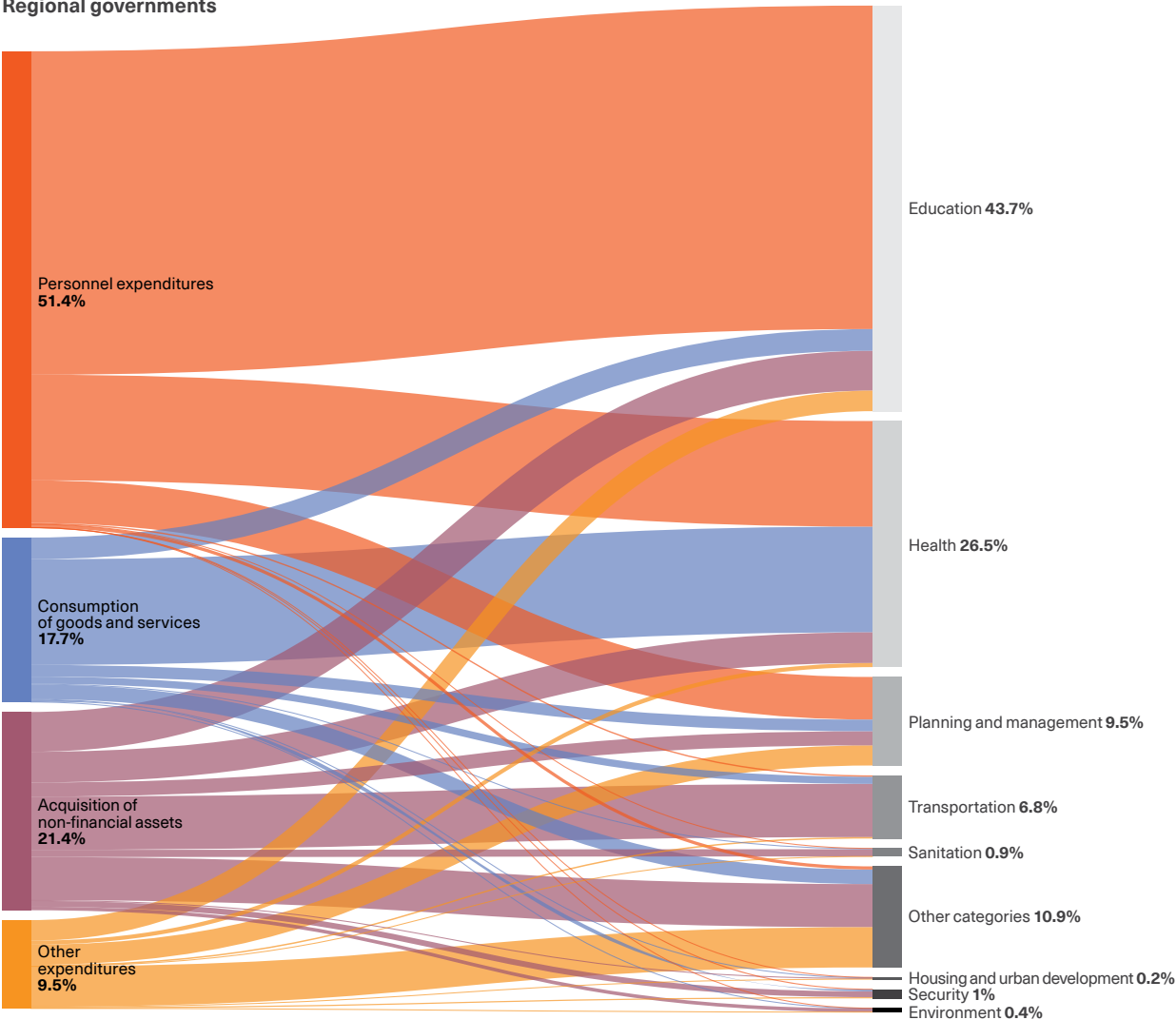
The combination of economic and functional classifications of subnational spending provides an interesting perspective on resource allocation at these levels of government, revealing, for example, how personnel expenditures are distributed across sectors, or which functions are prioritized in capital investments (see Graph 3.3).

In Peru, regional governments allocate more than half of their budget (51%) to personnel expenses,

primarily for salaries in the education, health, and planning and management sectors, which include public administration officials. Public investment, or the acquisition of non-financial assets, accounts for 21% and is distributed across education, health, transportation, and other sectors. Consumption of goods and services represents 18% of the budget, mostly directed toward health, including hospital supplies such as equipment, medical products, and pharmaceuticals.

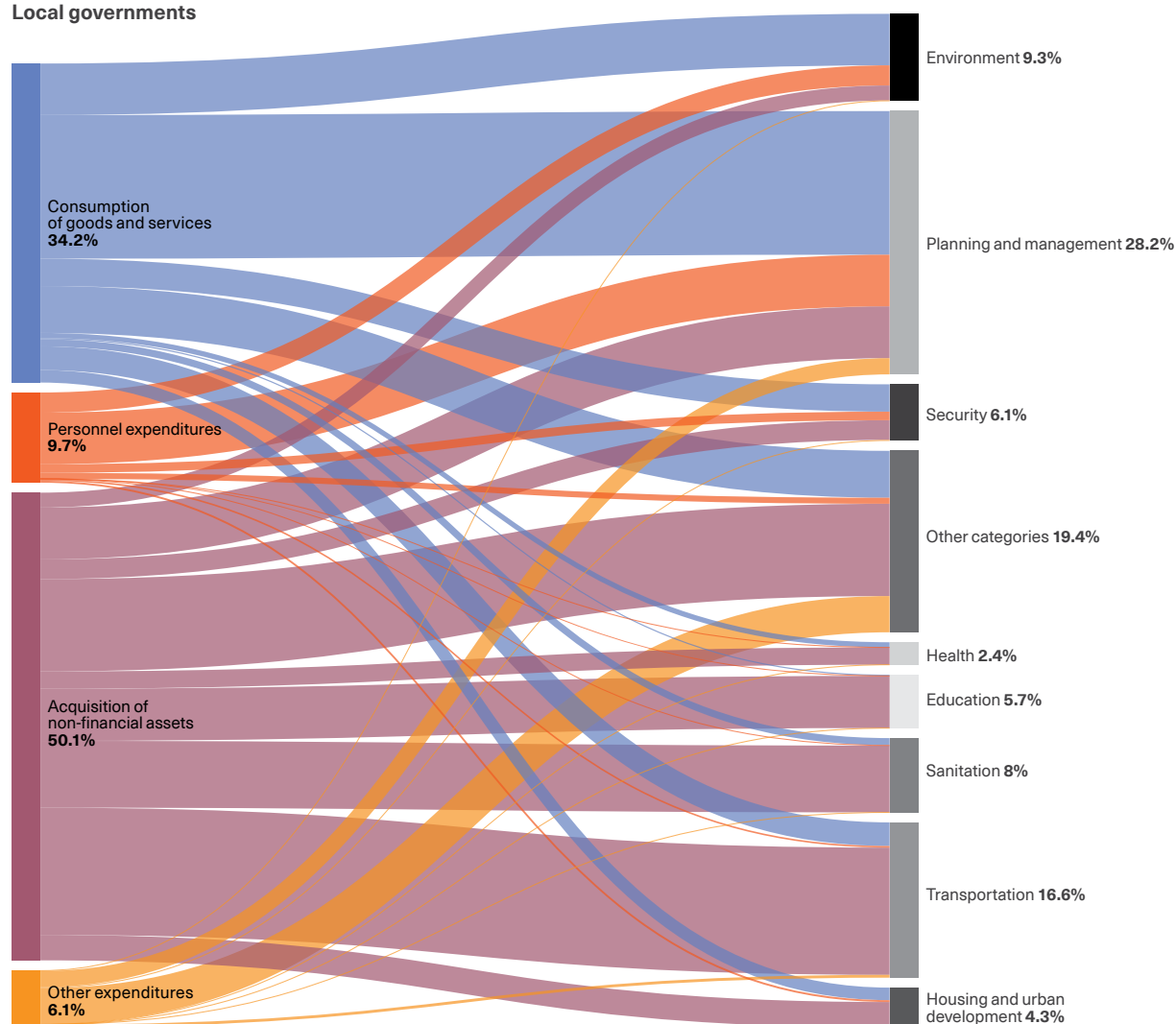
Graph 3.3
Composition of spending in Peru by function and economic classification in 2023

Panel A.
Regional governments



Continued on the next page →

Panel B.
Local governments



Note: Combines economic classification with purpose and function classification for 2023.

Source: Authors based on data from MEF of Peru (2024a).

At the local level in Peru, personnel spending is lower, not exceeding 10% of the budget, and is primarily allocated to planning and management (e.g., salaries of municipal officials). Public investment is the largest component of local spending (approximately 50% of the total) and is distributed across sectors such as transportation,

sanitation, education, and health (see Chapter 4 of this report). Consumption of goods and services accounts for 34% of total expenditure, largely directed toward planning and management, including essential supplies for the functioning of the State.

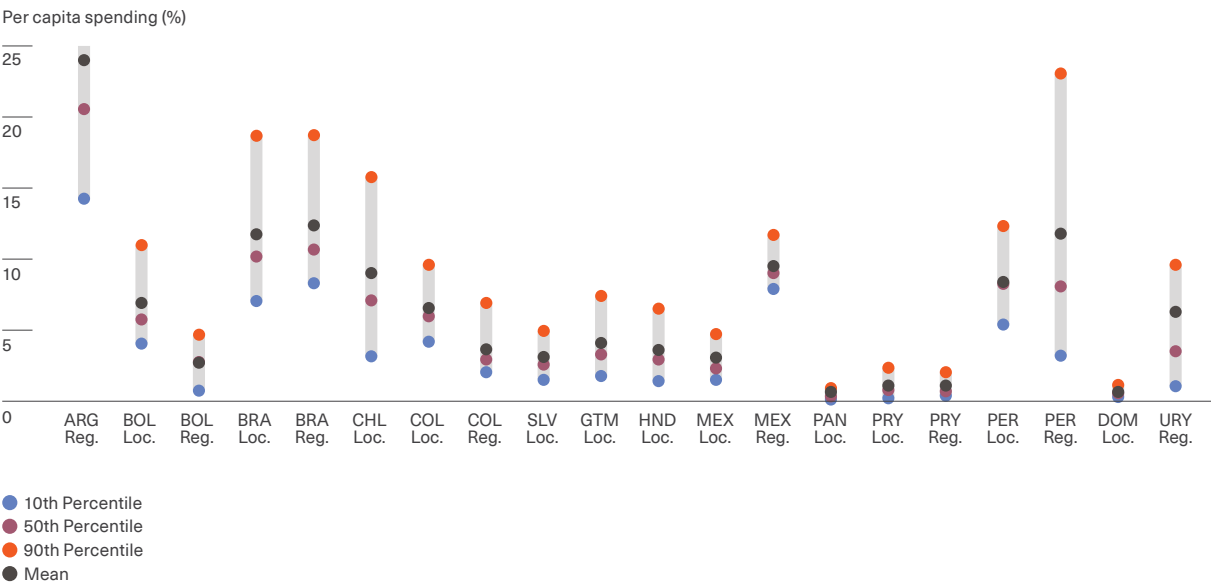
Heterogeneity in spending

Subnational government spending per capita exhibits significant heterogeneity both across and within countries (Graph 3.4). Across countries, the average per capita spending of Paraguay's regional governments is equivalent to 1.1% of the country's per capita GDP, compared to 24% in Argentina. Among local governments, the range is narrower, from 0.7% in Panama and the Dominican Republic to 11.8% in Brazil. Within individual countries, spending per capita also shows notable variation. This variation is minimal among local governments

in Panama and the Dominican Republic but considerably greater for regional governments in Argentina and Uruguay, as well as local governments in Peru and Chile.

●● Subnational government spending per capita exhibits significant heterogeneity across countries and within each country

Graph 3.4
Distribution of per capita spending at the regional and local levels



Note: The graph displays the mean and the 10th, 50th, and 90th percentiles of public spending per capita, expressed as a percentage of national per capita GDP and adjusted for purchasing power parity (PPP), for regional and local governments in countries with available data. The data correspond to 2022, except for Bolivia, for which information from 2021 is used. The vertical axis has been truncated for visualization purposes.

Source: Authors based on IMF data (2024b, 2024d) and national sources (see Table A.3.1 of the appendix available in the online edition of the RED).

This section examines the extent to which variation in subnational spending can be linked to two factors. The first is the population size of each jurisdiction, as economies of scale may influence the services provided by subnational governments.³ The second

factor is the GDP level of each jurisdiction, which helps assess the extent to which subnational government spending is redistributive within a country. Subnational GDP data is available for only a subset of countries.

Table 3.2

Elasticity of per capita spending with respect to population and per capita GDP by jurisdiction

Country	Level of government	Observations	Population	GDP per capita
Argentina	Regional	24	-0.37***	0.50***
Bolivia	Regional	9	-0.63***	-0.48
Brazil	Regional	27	-0.23***	0.31**
Colombia	Regional	32	-0.83***	-1.56***
Mexico	Regional	32	-0.09**	0.18***
Paraguay	Regional	17	-0.78***	n.a.
Peru	Regional	25	-0.31***	-0.21
Uruguay	Regional	19	-0.25**	0.10
Bolivia	Local	336	0.12***	n.a.
Brazil	Local	5545	-0.20***	0.21***
Chile	Local	345	-0.36***	n.a.
Colombia	Local	1102	-0.16***	0.09***
Dominican Republic	Local	393	-0.34***	n.a.
El Salvador	Local	237	-0.21***	n.a.
Guatemala	Local	340	-0.52***	n.a.
Honduras	Local	272	-0.50***	n.a.
Mexico	Local	2385	-0.15***	n.a.
Panama	Local	83	-0.28***	n.a.
Paraguay	Local	240	-0.71***	n.a.
Peru	Local	1890	-0.24***	n.a.
Rep. Dominicana	Local	393	-0.34***	n.a.

Note: The dependent variable is per capita spending in PPP-adjusted dollars, divided by national per capita GDP. Variables in the regression are logged. Observations reflect the full sample. Outliers were removed for local-level regressions by excluding values below the 2nd and above the 98th percentiles of both variables. For regional-level regressions, the most populous jurisdictions in Argentina, Brazil, Colombia, Mexico, Paraguay, Peru, and Uruguay were excluded in population regressions, while the lowest-GDP jurisdictions in Mexico and Uruguay were excluded in GDP regressions. The abbreviation "n.a." refers to unavailable data. ***Significant at 1%. **Significant at 5%. *Significant at 10%.

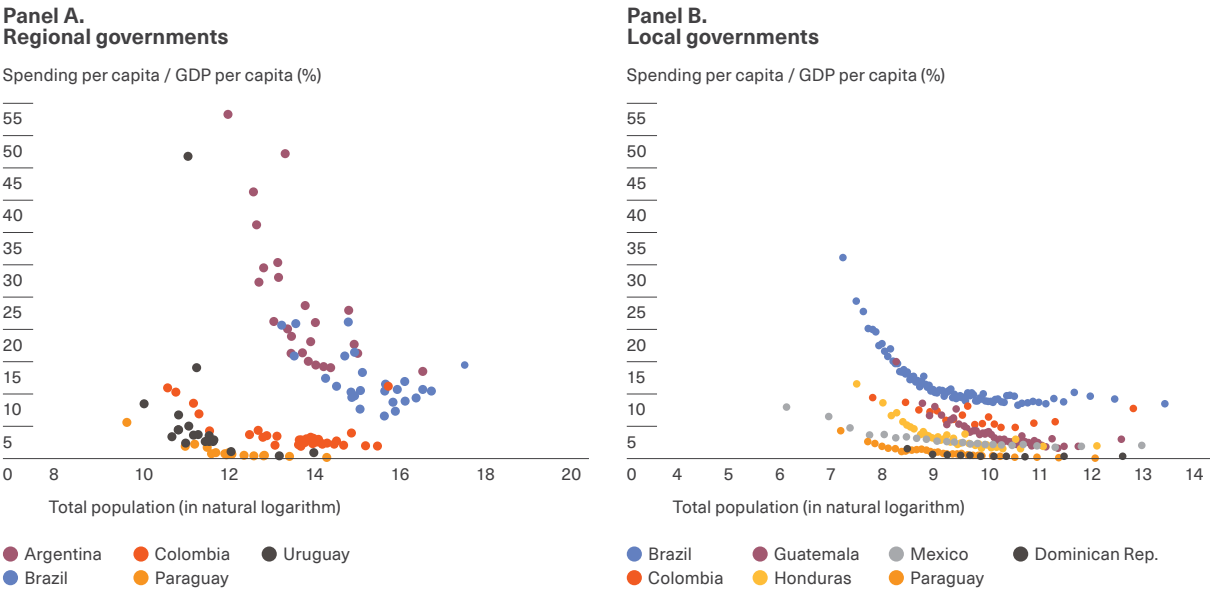
Source: Authors based on IMF data (2024b, 2024d) and national sources (see Table A.3.1 of the appendix available in the online edition of the RED).

3 Another possibility for the association between spending and population size is the connection of population size to a third variable that serves as a policy objective. For example, if less populated areas have higher levels of poverty, per capita public spending might be higher to address this situation. Another possibility is the objective of increasing the population in certain areas, for instance, for sovereignty purposes. High per capita public spending may aim to attract additional population.

The elasticity of per capita spending with respect to population size is negative and significant for regional governments across all eight countries analyzed, indicating the presence of economies of scale. A similar result is observed for local governments in 11 of the 12 countries with available data (Table 3.2), except for one where the elasticity is positive and significant. Elasticity values, however, vary widely, ranging from -0.83 to 0.12, reflecting differences in the intensity of economies of scale across countries. One consistent trend in the data is that per capita spending by regional governments declines more sharply with population increases compared to local governments. The average elasticity for regional governments is -0.34, while for local governments, it is -0.30.

The linear estimation, however, obscures an interesting relationship, as illustrated in Graph 3.5, which excludes some countries for clarity: in certain cases, economies of scale clearly level off at a specific population threshold, beyond which per capita spending stabilizes. One interpretation of these results is that governments require a minimum structure to operate effectively (Martínez et al., 2024). This pattern is evident in five of the eight regional governments and eight of the 12 local governments analyzed. For the remaining cases, the relationship is either consistently decreasing as population increases (e.g., regional governments in Peru and Bolivia and local governments in Chile and Peru) or remains constant (e.g., regional governments in Mexico and local governments in El Salvador and Panama).

Graph 3.5
Per capita spending and population



Note: Per capita spending is measured in PPP-adjusted dollars, divided by national per capita GDP. Panel B shows the average for groups of municipalities generated using the 'binscatter' algorithm by Cattaneo et al. (2024).

Source: Authors based on IMF data (2024b, 2024d) and national sources (see Table A.3.1 of the appendix available in the online edition of the RED).

The second factor analyzed is the elasticity of per capita spending with respect to the per capita GDP of each jurisdiction. This analysis helps determine the extent to which subnational spending, whether regional or local, is redistributive across different countries. Data on jurisdiction-level GDP is available for seven of the eight countries with regional government spending data and only two of the 12 countries with local government spending data.

For regional governments, a wide range of results is observed. In Colombia, elasticity is negative and significant, indicating that jurisdictions with higher per capita GDP have lower per capita spending. This suggests that subnational spending is progressive in relation to the distribution of per capita GDP. In Bolivia, Peru, and Uruguay, elasticity is not

statistically different from zero, which also signals progressive spending, as all residents effectively receive similar levels of spending from their regional government regardless of their jurisdiction's GDP. In other countries, such as Argentina, Brazil, and Mexico, regional governments show elasticities of per capita spending relative to per capita GDP ranging from 0.18 (Mexico) to 0.5 (Argentina). An elasticity below 1 indicates some degree of redistribution, though this diminishes as elasticity approaches 1.

For local governments, data is more limited. In Colombia and, to a lesser extent, Brazil, per capita spending shows a weak correlation with local GDP, indicating a significant degree of redistribution at the local level.

Fiscal balances

The fiscal balances of subnational governments are a key indicator of their capacity to fund public services, manage decentralized responsibilities, and ensure financial sustainability. Fiscal conditions across the region exhibit significant variation, shaped by differences in legal frameworks that determine subnational governments' authority to collect revenue and decide on expenditures, their administrative capacities, and their access to intergovernmental transfers.

Graph 3.6 offers a comparative snapshot of fiscal balances in 2022 for several countries in Latin America and the Caribbean, highlighting substantial variability both between and within countries in the fiscal performance of subnational governments. In some cases, subnational jurisdictions demonstrate relatively strong fiscal positions. For example, over 65% of regional governments in Peru and state and municipal governments in Brazil reported surpluses

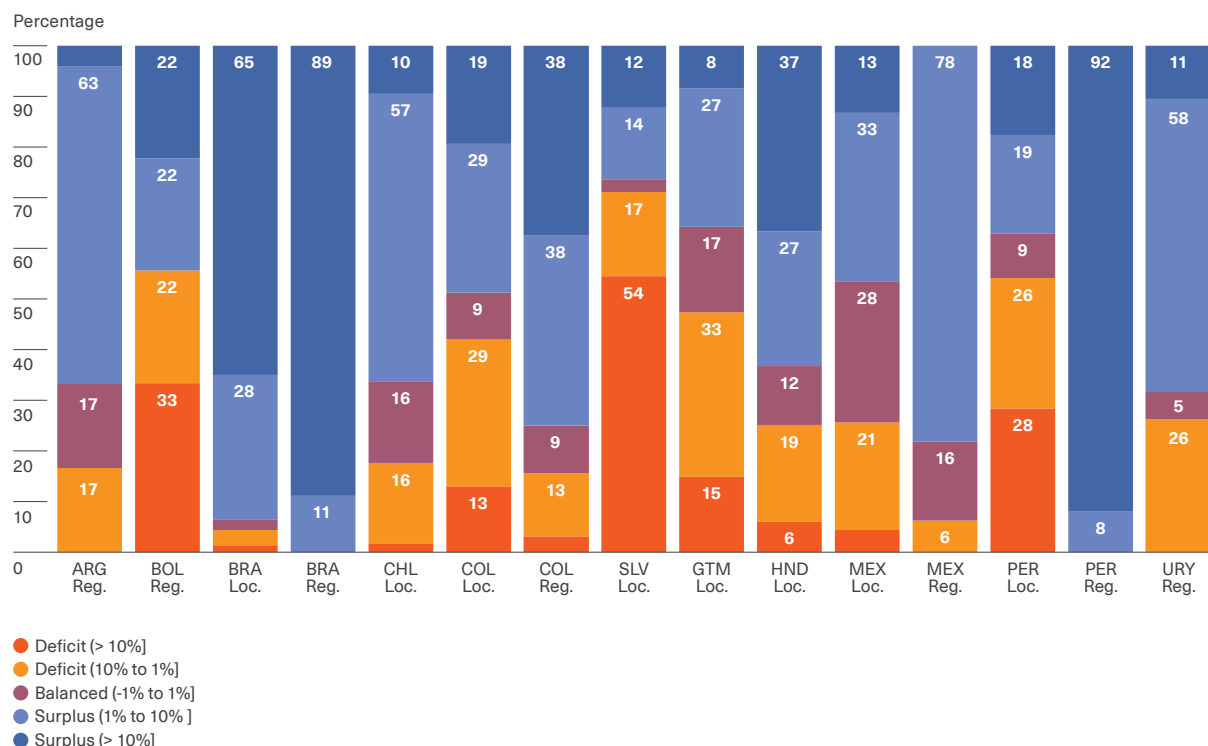
exceeding 10% of their revenues. Conversely, most local governments in El Salvador experienced deficits in 2022. In the other countries, subnational fiscal balances are highly diverse, with governments spanning the entire range of fiscal results.

It is important to note that fiscal balances reflect both subnational governments' capacity to manage their resources as well as their adherence to fiscal rules that limit deficits or promote the generation of surpluses. While the absence of deficits in some entities may be influenced by these rules, it often also signals a comfortable fiscal position, enabling them to meet obligations without resorting to borrowing.

The following section will delve deeper into the role of these fiscal rules and their impact on financial sustainability.

Graph 3.6

Percentage of subnational governments in Latin America and the Caribbean with deficit, balanced, and surplus fiscal balances in 2022



Note: Data for Bolivia corresponds to 2021. Fiscal balances are presented as a percentage of each jurisdiction's total revenues.

Source: Authors based on countries' budget execution data (see Table A.3.1 of the appendix available in the online edition of the RED).

Budgetary constraints and autonomy

The share of subnational governments in aggregate spending is an imperfect indicator of their responsibilities, as it does not fully reflect their autonomy to plan, allocate, and execute budgets (Ter-Minassian, 2020). Several factors constrain subnational governments' autonomy in allocating resources. These include budget rigidities, which make it challenging to adjust mandatory expenditures such as salaries, pensions, and debt servicing. On the other hand, some regulations dictate both the amount and allocation of spending, such as earmarked transfers and spending

floors that mandate minimum levels for priority areas. Finally, fiscal restrictions, such as fiscal responsibility laws, are meant to prevent excessive borrowing or unsustainable spending patterns. While these measures are intended to ensure fiscal sustainability, they often limit the flexibility of subnational governments to respond to specific circumstances.

Budgetary rigidities and fiscal sustainability

Some public spending components are difficult to modify or adjust due to institutional, legal, contractual, or other restrictions, limiting governments' ability to alter expenditures in the short term. Wages, pensions, and public debt servicing are among the most inflexible categories, often influenced by macroeconomic and demographic trends (Cetrángolo et al., 2009; Olaberria and Herrera, 2020).



Spending rigidity limits the autonomy of subnational governments and poses challenges to fiscal sustainability

These rigidities not only limit subnational governments' autonomy but also pose challenges for fiscal sustainability, especially during recessions. Revenue declines in these periods worsen financing needs due to the inflexibility of mandatory expenditures like wages and pensions. To mitigate such risks, some countries have established limits through fiscal responsibility laws. For instance, in Brazil, states and municipalities are required to cap personnel expenditures at 60% of net current revenues (Bornhorst et al., 2019).

In addition to constraining subnational governments' autonomy in resource allocation, spending rigidities pose significant challenges for fiscal sustainability, particularly during recessions. Revenue declines during such periods exacerbate financing needs due to the inflexibility of mandatory expenditures, such as wages and pensions. To mitigate these risks, some countries have implemented limits in their fiscal responsibility laws. In Brazil, for instance, states and municipalities are required to cap personnel expenditures at no more than 60% of net current revenues (Bornhorst et al., 2019).

The share of expenditures allocated to personnel, social security, and debt servicing varies significantly across countries and levels of government. In the countries included in Table 3.1, personnel spending averages 31% of total expenditure at both regional and local levels. Social security expenditures are higher in federal countries like Argentina and Brazil, where subnational governments typically manage their own systems. Debt servicing payments average around 3% of total expenditures at the regional level and 4% at the local level. Together, these relatively rigid components of subnational public spending represent 43% and 36% of the total expenditures of regional and local governments, respectively.

Constraints on spending amounts and allocations

Spending autonomy can also be limited by regulations governing the use of specific funds, such as revenues from non-renewable natural resources or transfers from higher levels of government with earmarked allocations. Graph 3.7 shows that the share of earmarked resources in subnational spending varies widely across countries. In Argentina, Brazil, and Uruguay, where subnational governments have more autonomy in resource allocation, the share of earmarked resources is lower. In Chile, Colombia, Guatemala, and El Salvador, a larger share of resources is earmarked. Bolivia stands out, with 80% of regional government spending financed by

earmarked resources, mostly allocated to investment. These funds are primarily used for infrastructure, followed by education and health (see Chapter 5).

Budget floors are another limitation on spending autonomy, as they set minimum spending amounts or percentages for specific sectors like education and health. These regulations aim to ensure compliance with constitutional or legal obligations and are justified by the merit-good nature of these sectors or as mechanisms to address time inconsistency issues (Cetrángolo et al., 2009)⁴. While these measures

4 Merit public goods are those that provide additional social benefits not always recognized by individuals. This justifies their financing or regulation by the state to ensure broader access. Examples include basic education, public health, and other social expenditures.

may limit subnational governments' ability to adapt spending to local needs, they ensure minimum resource allocations for priority areas, which can yield significant benefits if well-implemented.

●●

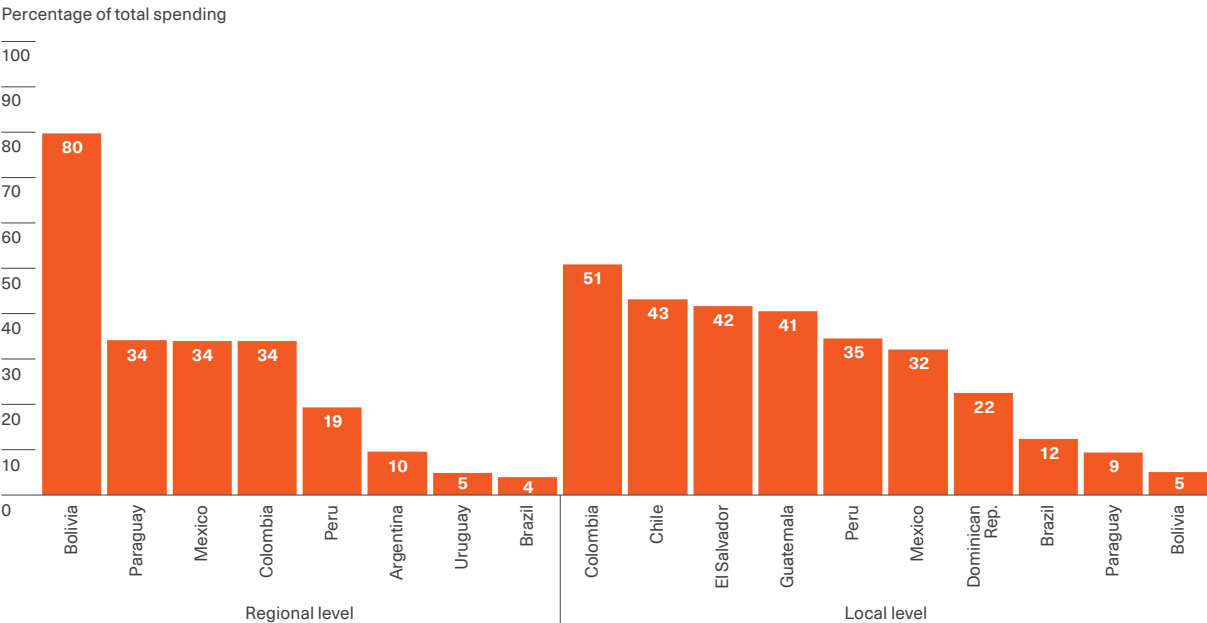
Spending floors ensure a minimum allocation of resources to priority areas, which can yield significant benefits if implemented effectively

For example, Brazil's Constitution mandates minimum spending levels for health and education to ensure consistent investment in these essential sectors for social well-being. States must allocate 12% of their revenues to health, while municipalities

must allocate at least 15%. Both levels of government are required to invest 25% of their revenues in education.

A study by Clarke et al. (2024), commissioned for this report, shows that introducing spending floors for health in Brazilian municipalities significantly increased sectoral spending, particularly in jurisdictions that had previously allocated less than the mandated percentage. Additional resources were used mainly for healthcare infrastructure, personnel recruitment, and administrative costs, leading to expanded primary care coverage and improved access to municipal hospitals. This investment in health reduced infant mortality, particularly neonatal deaths and those caused by perinatal conditions, demonstrating the positive impact of targeted public spending in priority areas.

Graph 3.7
Earmarked transfer revenues as a percentage of total subnational spending in Latin American and Caribbean countries, circa 2023



Note: Data correspond to 2019 for El Salvador, 2021 for Bolivia, 2022 for Brazil, Chile, Colombia, Guatemala, and Mexico, and 2023 for Argentina, Paraguay, Peru, the Dominican Republic, and Uruguay.

Source: Authors based on national sources (see Table A.3.1 of the appendix available in the online edition of the RED).

The study highlights two key lessons. First, although the new regulations established minimum spending requirements for health, municipalities retained autonomy to decide how to allocate resources within the sector, which was critical to the measure's success. Second, the results were uneven across the country. In municipalities with high levels of corruption, the positive effects of increased health spending were less pronounced.

Conversely, municipalities with stronger management practices and better institutional capacity made more effective use of additional resources, achieving superior health outcomes. Brazil's experience shows that spending floors, when combined with flexibility in resource allocation and supported by strong governance, can improve access to critical services and generate positive impacts on social well-being.

Rules for the sustainability of subnational finances

The trend toward granting subnational governments greater financial autonomy has been accompanied by restrictions aimed at addressing the challenge of fiscal discipline at this level of government. This challenge can be summarized as a tendency toward over-indebtedness, based on the expectation that a financial rescue will come from a third party or that the responsibility can be passed on to another authority in the future. While this issue has been extensively studied at the central government level, it also exists at the subnational level and can, as will be explained below, be even more pressing.



The trend toward granting subnational governments greater financial autonomy has been accompanied by restrictions aimed at addressing the challenge of fiscal discipline at this level of government

One approach to address this problem has been to prohibit, through high-level legislation (e.g., in the constitution), the central government from providing financial aid to subnational entities, thereby discouraging excessive borrowing. However, this prohibition is not always credible for at least two reasons.

First, a subnational government's default can impact the central government's creditworthiness. Rodden (2002) argues that this may happen if the subnational government relies heavily on transfers from the central government. In such cases, the central government is perceived as responsible for covering the financial contingencies of the subnational entities that depend on it. Failing to do so could be interpreted as a sign of financial weakness at the central level.⁵

Second, the population of the subnational jurisdiction is part of the electorate for the central government, meaning voters may reward national candidates who offer to ease their financial burden.

Finally, the expectation of a bailout exacerbates the level of over-indebtedness among borrowers. To address this issue, some countries, regardless of their progress in decentralization, have retained control over subnational borrowing, requiring central government authorization for any new debt (see Chapter 4). Others, particularly but not exclusively federal countries, have permitted subnational financing under specific rules.

Some countries have experienced financial crises triggered by subnational debt. The following sections examine three such cases—Brazil, Colombia, and Mexico—and the characteristics of the rules they adopted. Before delving into each case, it is important to highlight key lessons from

⁵ Empirical evidence aligns with the existence of rules limiting subnational government borrowing in countries where their financing relies more heavily on transfers (von Hagen and Eichengreen, 1996; Rodden, 2002).

these experiences. First, successful rule-based frameworks for controlling subnational debt growth (as in Colombia and Mexico) can be summarized in three key components: (1) limits on borrowing and expenditure composition; (2) forward-looking information systems to enable early corrective action; and (3) a resolution mechanism (backed by the state) that includes a fiscal adjustment program in cases where subnational governments face financial distress. However, it is essential to consider the costs of the information and monitoring systems required by such frameworks.

● ● **Some countries have experienced financial crises stemming from the indebtedness of subnational jurisdictions**

Second, Brazil's experience underscores the importance of credible rules and the need to evaluate their effects at different points in the economic cycle.

Rules for subnational governments in Brazil

The decentralization drive initiated by Brazil's 1988 Constitution triggered a subnational debt crisis a decade later. Subnational debt rose from 7% of GDP in 1991 to 20% in 2002, becoming unsustainable for issuers. The central government carried out bailouts between 1998 and 2001. At the same time, the Fiscal Responsibility Law (LRF) was enacted in 2000, establishing limits on spending and borrowing for both federal and subnational governments (states and municipalities).

● ● **In Brazil, subnational government debt increased from 7% of GDP in 1991 to 20% in 2002, becoming unsustainable for issuers**

Initially, the LRF focused on two limits: (1) personnel spending as a percentage of current revenues and (2) the maximum level of debt subnational governments could incur relative to net current revenues (Arreaza et al., 2022).

While this framework successfully reduced subnational debt during the first decade of the 21st century—a period of economic growth—it failed to do so during the subsequent decade, when Brazil experienced recessions in 2014 and 2016. This led to a new subnational financial crisis in 2016 and another costly federal bailout.

Medas et al. (2019) attribute this failure primarily to two factors. First, the enforcement of compliance with the established limits was not rigorously applied by those responsible. The authors, along with others, argue that the belief that the federal government would ultimately bail out insolvent subnational entities was never fully dispelled.

Second, the design of the rule introduced procyclicality in personnel spending, which proved difficult to manage. During periods of economic expansion, higher tax revenues across all levels of government enabled increased personnel spending. However, when the economic cycle reversed and revenues declined, reducing personnel spending became challenging due to legal restrictions on terminating labor contracts.⁶

6 One solution to this problem is to define spending minimums based on trend income rather than current income and to establish a stabilization fund to absorb fluctuations in expenditures throughout the economic cycle. Nonetheless, there is consensus that other elements of Brazil's fiscal rule require attention, a discussion beyond the scope of this section.

Box 3.2

Debt restructuring laws for subnational governments

The existence of a well-defined, transparent, and enforceable bankruptcy process strengthens the credibility of the commitment to avoid bailouts and ensures that those involved in a financially unsustainable situation bear the associated costs. This, in turn, provides appropriate ex-ante incentives for both lenders and borrowers.

A bankruptcy law for subnational governments cannot simply be an extension of corporate bankruptcy laws, as subnational entities have unique characteristics. In particular, most of their assets cannot be seized, and they must continue operating since the provision of essential public services cannot be interrupted during the financial recovery period. This presents a challenge in determining the resources necessary to maintain operations. The more resources allocated to essential services at the expense of debt repayment, the longer the adjustment period will be.

Many subnational debt restructuring laws have been enacted in response to financial distress (Canuto & Liu, 2013). The urgency of managing crises often leads to laws being designed ad hoc, taking into account the relative strengths of a country's institutions at a given moment. Colombia's Law 550 of 1999, for example, assigns the subnational bankruptcy process to the Superintendence of Companies, expanding its jurisdiction to oversee these governments for this purpose. A different approach was taken in Hungary, where the 1996 municipal bankruptcy law placed the administration of these processes under the judiciary (Canuto & Liu, 2013). Both countries have successfully resolved their initial crises and established financially sustainable conditions for subnational governments. This underscores the fact that the most effective institutional designs depend on the specific characteristics of each country.

Rules for subnational governments in Colombia

Colombia's 1991 Constitution promoted fiscal decentralization, granting subnational jurisdictions (departments and municipalities) more resources and greater autonomy over their use. However, the lack of incentives for fiscal discipline and access to borrowing led to a 320% increase in subnational debt between 1992 and 1997, forcing the central government to undertake a costly bailout (Fedelino, 2010). This prompted the adoption of fiscal discipline measures, which successfully restored economic health in the early 2000s (Pérez-Valbuena, Melo-Becerra et al., 2024).

The fiscal rule framework in Colombia includes several elements. The "Traffic Light Law" (1997) sets

borrowing limits based on two indicators: one of solvency (the ratio of interest payments to operational surplus) and one of sustainability (the ratio of total debt to current revenues). If the solvency indicator is below 40% and the sustainability indicator is under 80%, the entity can take on new debt without requiring authorization from the Ministry of Finance. Otherwise, authorization is needed.⁷

Another important measure for overcoming a high debt scenario in Colombia was the introduction of debt restructuring agreements under Law 550 of 1999. When departments and municipalities face payment defaults, they can voluntarily enter into these agreements, which impose spending restrictions. Laws that regulate these debt restructuring schemes are essential for incentivizing sound financing management of subnational governments (see the Box 3.2). Additionally, in 2000,

⁷ The solvency indicator threshold for these purposes was raised to 60% in 2003.



The State of Amazonas in Brazil is the largest regional government by land area in Latin America and the Caribbean.

limits were established on the ratio of operating expenses to freely disposable current revenues.

Since 2003, subnational governments have been required to present a 'medium-term fiscal framework,' consisting of a financial plan that demonstrates their debt repayment capacity, as certified by a credit rating agency. Under this regulation, jurisdictions may only access central government financing for short-term liquidity needs and are prohibited from taking on new debt if they are in default on loans granted or guaranteed by the central government.

Evidence indicates that the introduction of these rules has succeeded in maintaining subnational financial sustainability (Chamorro and Urrea, 2016; Sánchez and Zenteno, 2011). Their implementation has also ensured that operational spending limits reduce the likelihood of deficits without compromising the provision of public goods (Carreri and Martínez, 2024). However, there is room to advance toward what are referred to as "second-generation" fiscal rules. One key improvement is the inclusion of "escape clauses" within these rules to better address crises. This need became evident globally during the COVID-19 pandemic, when some regulatory restrictions had to be lifted. These clauses aim to facilitate adjustments in an orderly and predictable manner.

● ●

In Colombia, evidence shows that subnational financial sustainability has been achieved through the introduction of fiscal rules, which have reduced the risk of deficits without compromising the provision of public goods

Rules for subnational governments in Mexico

Mexico underwent a fiscal decentralization process in the 1990s and 2000s. Initially, the regulatory framework relied on market mechanisms. However, by 1996, subnational debt had reached 2.2% of GDP,

and these governments were unable to service it, prompting a federal bailout. During the global financial crisis, subnational debt rose again, from 1.6% of GDP in 2007 to 2.9% in 2017.

In 2016, the Law on Financial Discipline for Federal Entities and Municipalities (LDF) was enacted, introducing controls on subnational debt. This law was made possible by a constitutional reform passed in 2013.

● ●

In Mexico, the 2016 Financial Discipline Law for Federal Entities and Municipalities (LDF) was enacted, establishing controls on subnational government debt

The system establishes a debt limit framework based on sustainability indicators that determine whether a subnational government can take on financial obligations. Additionally, a debt registry and a contracting mechanism were created to ensure borrowing is done at the lowest cost.

The framework also includes a series of spending rules. If subnational governments can access debt, it may only be used for investment purposes (the "golden rule"). Personnel spending is subject to a maximum growth rate, current surpluses must be saved, and non-productive expenditures must be adjusted in the event of deficits.

Similar to Colombia, Mexico's framework establishes information standards, including fiscal framework projections for five years at the state level and three years at the municipal level. Finally, in cases of insolvency, a debt restructuring mechanism is in place, with federal government guarantees conditioned on the implementation of fiscal adjustment measures.

In this way, Mexico's fiscal rule shares elements with Colombia's framework. Empirical evidence shows that the rule has been effective in containing subnational government debt (Del Castillo and Cabral, 2024).

Public procurement

Public procurement is the process by which public sector organizations acquire the goods and services needed to provide public services. These purchases range from the routine acquisition of supplies essential for an organization's day-to-day operations to large-scale infrastructure projects.⁸

Procurement accounts for a significant portion of subnational government expenditures in Latin America and the Caribbean, as shown in Graph 3.8. On average, nearly half of local government spending and about one-third of regional government spending is allocated to procurement. Among local governments, Peru records the highest share of spending on procurement, reaching 86% of total expenditures, followed by Bolivia at over 70%. For regional governments, Bolivia also stands out, allocating more than 60% of its budget to procurement.⁹ The high share of procurement in total spending in these countries is primarily due to the significant role of public investment, which is included in procurement expenditures.

Public procurement management is one of the areas of public administration most susceptible to inefficiency and waste. These issues can arise even from well-intentioned actions by public officials, due to factors such as a lack of technical skills to negotiate better terms, an absence of incentives to minimize costs, or excessive regulatory burdens that hinder streamlined and efficient processes. Such conditions can result in the purchase of inputs that are more expensive or of lower quality than what could be obtained in the market. Bandiera et al. (2009) found that approximately 80% of excess spending on generic goods procurement in Italy was attributable to these types of inefficiencies. In such cases, the quality of public services provided with these inputs may also suffer.

Wasteful spending can also stem from corruption, where public officials intentionally exploit discretion in decision-making to gain direct benefits, such as illicit rents. Public works contracting is particularly susceptible to corruption due to the high value of contracts, the difficulty of verifying every detail of construction quality, and the specificity of projects, which limits the number of suppliers capable of executing them (Fajardo et al., 2019). These conditions create incentives and opportunities for collusion between public officials and companies, often resulting in increased costs for the state. A well-known regional example is the Odebrecht case, where the company paid bribes to secure contracts or renegotiate terms to its advantage, leading to cost increases of up to 40% over initial project estimates (Campos et al., 2021).



Public works contracting is particularly susceptible to corruption

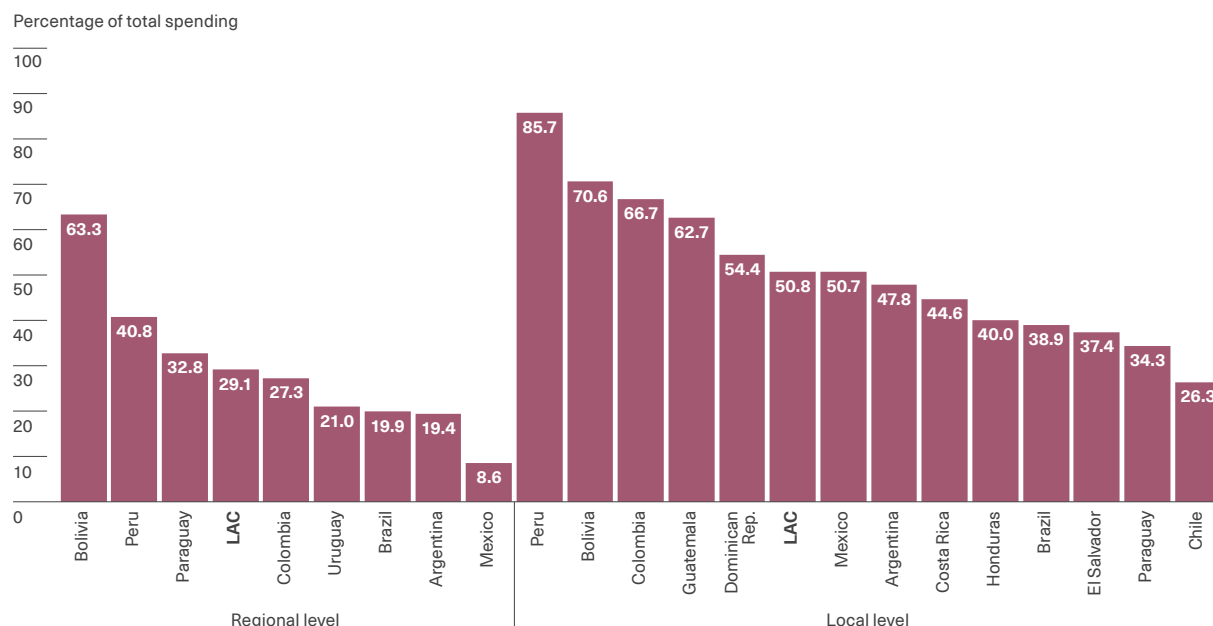
Such circumstances underscore the importance of clear and effective public procurement regulations aimed at improving process efficiency and reducing opportunities for corruption through transparency and control mechanisms. These norms and mechanisms are particularly relevant for subnational governments, where technical capacity and resources for procurement management are often limited.

⁸ In this chapter, the terms purchases and procurement are used interchangeably to refer to public procurement, encompassing both the acquisition of goods and services and the contracting of public works.

⁹ These figures are derived from the categories "consumption of goods and services" and "acquisition of non-financial assets (or gross capital formation)" in government budget executions. They are not directly comparable to OECD data based on the System of National Accounts (SNA). For more details on the methodology used to estimate public procurement expenditures and the differences with the SNA, see the methodological note in Graph 3.8.

Graph 3.8

Public procurement as a percentage of total subnational government spending in Latin America and the Caribbean, 2022



Note: Public procurement is estimated as the sum of the consumption of goods and services and the acquisition of non-financial assets (gross fixed capital formation) according to government budget execution. This approach aligns with OECD (2024) criteria and IMF Government Finance Statistics, encompassing a broader range of countries than those available in the IMF database. The methodology follows the Government Finance Statistics Manual (GFSM), which provides an accounting framework for evaluating fiscal policy but differs from other systems like the System of National Accounts (SNA). Unlike GFSM, SNA also includes the costs of goods and services financed by the government, such as subsidies or transfers for goods and services consumed by other sectors.

Source: Authors based on countries' budget execution data (see Table A.3.1 of the appendix available in the online edition of the RED).

Given that procurement represents a significant portion of subnational spending, any improvement in its management can have substantial impacts on spending quality and the delivery of public services. Centralized regulatory and support systems for procurement, such as digital platforms or standardized procurement modalities, can be particularly beneficial for subnational entities. Adopting these practices can optimize costs, reduce corruption risks, and improve transaction transparency.

One key element of public procurement systems to enhance spending efficiency is defining different procurement modalities, including two notable ones: framework agreements and auctions.

Framework agreements. These are among the most used modalities and involve agreements with suppliers to provide generic products under pre-established conditions to any purchasing entity within the system. Their aim is to simplify and expedite repetitive purchases of highly standardized goods or services. Framework agreements promote automatic decision-making, reducing discretion among purchasing entities and, consequently, minimizing both resource waste and corruption opportunities.

Using framework agreements can generate significant procurement cost savings. For example, Bandiera et al. (2009) demonstrated that Italy's central procurement agency significantly reduced price differences for identical products and

achieved substantial savings when purchasing generic goods through these agreements. By centralizing price negotiations, this modality also reduces inefficiencies stemming from a lack of technical skills or incentives to minimize costs at the local level—an especially relevant outcome for subnational governments with limited capacities. These results suggest that expanding the coverage of public procurement systems to subnational entities and implementing framework agreements for the widest possible range of generic goods could effectively improve subnational spending efficiency.

Framework agreements are available in the public procurement systems of most Latin American and Caribbean countries, though their use is not always mandatory. A 2018 survey found that national public procurement agencies in 10 of the 15 countries analyzed offer centrally negotiated framework agreements (Graph 3.9).¹⁰ Of these, such agreements are mandatory at all levels of government in two countries (Ecuador and Guatemala), mandatory only for central governments in six countries (Chile, Colombia, Costa Rica, Honduras, Mexico, and Paraguay), and voluntary in the remaining two (Brazil and Uruguay) (OECD, 2024c).¹¹

Despite their availability, a key challenge in many countries is encouraging broader use of this tool, particularly at subnational levels. In Peru, for instance, public procurement through framework agreements accounted for just 1% of local government procurement spending and 5% for regional governments. This limited use is partly due to a preference for more flexible modalities (e.g., direct contracting for smaller amounts) and institutional limitations that hinder adequate planning to leverage these agreements (Contraloría General de la República, 2023).

Auctions. Auctions are effective mechanisms for promoting competition and achieving better conditions for acquiring goods and services procured less frequently. One particular type is reverse auctions, where the purchasing entity specifies the required goods or services and awards the contract to the lowest-priced bid. This modality is especially effective in reducing costs in contexts with many suppliers. However, a key requirement for maximizing its benefits is defining precise specifications for the goods and services. Without this, focusing solely on price may result in suboptimal outcomes if factors like quality are not adequately considered (Lalive and Schmutzler, 2015).



Framework agreements and auctions improve procurement efficiency and are further enhanced by digital tools

Framework agreements and auctions improve procurement efficiency and are further enhanced by digital tools. Framework agreements are key to setting up electronic catalogs that provide access to standardized goods and services at pre-established prices, simplifying purchases and increasing transparency. Electronic reverse auctions facilitate competitive processes online, optimizing supplier participation and reducing costs. Both tools are often integrated into public procurement portals that manage all stages of contracting, from announcements to awards and contract monitoring.¹²

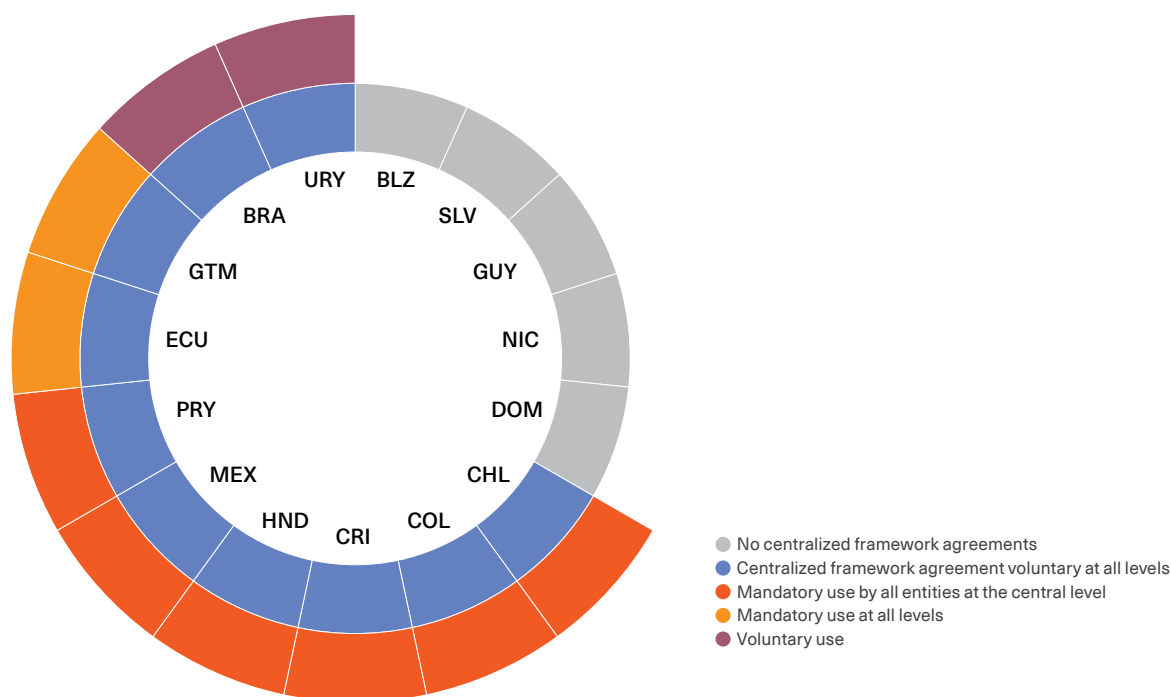
10 The five countries where central public procurement agencies did not offer framework agreements at the time of the survey are Belize, the Dominican Republic, El Salvador, Guyana, and Nicaragua.

11 While it is desirable for framework agreements to be mandatory for purchases by subnational entities, their mere existence, even when their use is voluntary, can generate cost savings for public sector organizations that carry out these transactions independently, due to informational externalities (Lotti et al., 2024).

12 For an analysis of the impact of these digital tools on subnational procurement, see Chapter 8.

Graph 3.9

Availability and coverage of centralized framework agreements in Latin America and the Caribbean by government level



Source: Authors based on OECD (2020a).

A critical aspect of public procurement system design is balancing control and flexibility. While procurement rules limit discretionary decision-making by purchasing entities, they can also result in costs in terms of administrative inefficiency if they impose excessive rigidity on the process. This rigidity can lead to additional costs in delivering public services or encourage the use of exceptions to bypass rules. In fact, one of the region's ongoing challenges is reducing overreliance on exceptions while maintaining an appropriate balance between control and flexibility (Izquierdo et al., 2018).

Uniform application of centralized rules to all subnational entities, without considering their varying technical and administrative capacities, is another common issue. This approach, while aimed at standardizing procedures and ensuring compliance, may place a disproportionate burden

on smaller or resource-limited subnational governments that struggle to meet the requirements intended for entities with greater institutional capacity.

For example, in Brazil, it has been documented that resource-constrained governments struggle to pay suppliers within the timelines set by regulations. This problem stems from centralized rules that, when uniformly applied, create an outsized administrative burden for smaller municipalities lacking the technical and operational capacity to manage complex procurement processes (Dahis et al., 2023). The lack of flexibility in regulations makes it difficult for these municipalities to adapt their procedures to their actual capacities, often leading to delays in budget execution and, consequently, in payments to suppliers. These delays further discourage the participation of small

suppliers, especially local ones, for whom such lags translate into higher financial costs.

In Peru, the lack of flexibility in regulations has significant consequences, such as the frequent use of exceptions. According to a study by the CGR of Peru (2023), procurements without formal process—defined as direct purchases below certain thresholds—accounted for one-third of subnational government procurements in 2022. While this mechanism was designed to address exceptional situations or low-value needs, its administrative flexibility has led to widespread use. However, the study reveals that this modality has often been misused, particularly through contract splitting to circumvent the regular processes mandated by regulations.

These examples highlight how excessive control combined with inflexible regulations can lead to negative outcomes, especially for smaller subnational governments or those with limited capacities. Possible solutions to strike a balance

between control and flexibility include simplifying procedures for low-value purchases, reassessing thresholds for simpler procurement methods, and implementing more streamlined processes for recurring purchases. These measures could help mitigate inefficiencies while maintaining transparency in public procurement.

Finally, one of the most important findings from the study by Bandiera et al. (2009), mentioned earlier, is that the majority of cost overruns in the procurement of generic goods in Italy stem more from inefficiencies in procurement processes than from corruption. The widespread use of centralized procurement agreements effectively addresses the former issue but not the latter. This suggests that encouraging subnational governments to adopt centralized public procurement systems could significantly reduce procurement cost overruns. However, such measures must be complemented by ex post controls, such as external audits, which will be discussed in the next section.

Other controls and incentives: Audits and results-based financing

Control Mechanisms

Rules that limit public officials' authority in resource use may prove insufficient if not complemented by effective corrective and preventive controls. Even when regulations are in place, officials may find ways to circumvent them, such as splitting contracts to keep them below thresholds that require more rigorous procurement processes or invoking exceptional conditions to enable discretionary decisions. Controls can be carried out by internal government entities or by a higher jurisdiction.

External audits

One key tool to strengthen oversight of fund use at the subnational level is central government audits, whose effectiveness as an anti-corruption mechanism has been widely documented.

One of the most notable examples is Brazil's audit program, launched in 2003 and operated by the Comptroller General of the Union (CGU) to detect and reduce corruption in municipal governments through random verification processes. The CGU selects municipalities through a public lottery to

review the management of federal funds allocated to local projects. Audit results are published in the media and shared with judicial and law enforcement authorities.

This program has proven to be an effective instrument for reducing corruption in audited municipalities. Avis et al. (2018) found that the decline in corruption was mainly driven by officials' heightened perception of legal costs, rather than by electoral pressure alone. In audited municipalities, the incidence of corrupt practices fell by nearly 8% compared to non-audited ones, with even greater reductions in municipalities audited multiple times. Key mechanisms included judicial accountability, exposing officials to potential investigations and legal sanctions, and the public dissemination of audit results, which reinforced social and political pressure against corruption.



Central government audits are an effective tool for reducing corruption at the subnational level

The program's success factors include the CGU's autonomy and the randomness of the audit selection process, which limits political interference and enhances credibility. Additionally, extensive media coverage of audit results, particularly in areas with access to local radio and television, maximized the program's impact by increasing pressure on corrupt officials. Moreover, the presence of judicial districts in audited municipalities significantly increased the likelihood of audit findings leading to legal actions, strengthening the program's deterrent effect. Avis et al. (2018) found that municipalities with judicial districts were 35% more likely to see legal consequences from audit findings, reinforcing the deterrence of corruption through potential judicial sanctions.

However, external audits have a limited capacity to strengthen other areas of public management, such as resource planning, accounting, and transparency. This limitation arises because, although audits detect violations, the penalties resulting from them are often lighter than those imposed for

corruption cases, reducing their deterrent effect. This conclusion is supported by the study of De La O et al. (2023), which evaluated the impact of national and state audits on municipalities in Mexico regarding compliance with regulations governing the use of resources from the Municipal Social Infrastructure Fund (FISM). Although municipalities have discretion in the use of these funds, they are required to adhere to programmatic rules (defining priority sectors), accounting standards (e.g., documenting and justifying all expenses), and transparency requirements (such as sharing the annual project plan with the Ministry of Social Development and reporting expenses to the Ministry of Finance). The authors found no significant effect of audits on compliance with these guidelines.

External audits may also have unintended consequences for public management. Gerardino et al. (2024) found that in Chile, audits focusing on public procurement discouraged the use of competitive bidding, instead favoring less-regulated direct contracts. This occurred because competitive bidding processes were more likely to be audited, increasing the chances of detecting potential violations, which in turn made officials more reluctant to use them. This finding underscores the importance of designing control mechanisms that enhance transparency and efficiency without discouraging competitive practices, particularly in subnational governments with limited capacities.

Internal controls

Internal supervision, unlike external oversight, has the potential to be a more direct and therefore more effective strategy for preventing the misuse of public resources. In a study commissioned for this report, Toral (2024) highlights significant disparities in the formalization and professionalization of internal control systems among local governments in Brazil. While most municipalities have internal control units, many of these lack political independence and dedicated functions for auditing and anti-corruption, which significantly hinders their ability to enforce accountability.

The study also found that legislative reforms aimed at strengthening internal control led to an increase in the number of auditors, addressing one of the primary weaknesses in Brazil's municipal internal control units: insufficient staffing.¹³ It also linked these reforms to reductions in municipal workforces and increases in the proportion of civil service contracts (as opposed to temporary contracts more vulnerable to political influence). Therefore, internal controls can play a crucial role in reducing the clientelist use of public employment. Together, these findings emphasize the need to strengthen internal control systems in the region to enhance accountability and efficiency in public administration.

Political independence is crucial for internal control units to avoid conflicts of interest that can arise when auditors depend on the local authorities they are tasked with overseeing. When mayors have the authority to appoint auditors, those auditors may feel pressured to soften their evaluations to maintain good relationships or secure their positions, thereby compromising the transparency and objectivity of oversight. To address this issue, Italy implemented a reform in 2011 that centralized the selection of municipal finance auditors,

assigning them randomly through a national system. While the reform increased central government intervention and reduced subnational autonomy, Vannutelli (2022) found that it significantly improved municipal fiscal performance, including greater tax collection capacity, the achievement of budget surpluses, and higher debt repayment rates, aligning with national fiscal objectives.

This example illustrates how intergovernmental relationships are fundamental to designing effective control systems. When subnational governments face institutional constraints, studies by Avis et al. (2018) and Vannutelli (2022) highlight that centralized support can be effective in ensuring transparency and accountability. For instance, in Brazil, the CGU operates as a centralized body to audit municipalities, achieving significant reductions in corruption. Similarly, the reform implemented in Italy, which centralized and randomized the assignment of municipal auditors, improved local fiscal performance. These cases underscore how central governments can play a crucial role in control systems, though they also raise the challenge of balancing this support with subnational autonomy.

Incentives for improved spending: Results-based financing

Results-based financing is a public management tool aimed at improving the efficiency of expenditures. This approach allocates resources based on specific performance targets for the delivery of goods and services, thereby creating incentives to optimize the use of public funds. In Latin America and the Caribbean, the adoption of this strategy has been notable. According to Pimenta et al. (2023), a survey of 24 countries in the region found that 14 of the 17 respondents use some form of results-based financing. Progress has been made in establishing performance frameworks, developing monitoring and evaluation systems, improving budget transparency, implementing quality-of-expenditure assessments, and adopting

training strategies. While these developments reflect a growing interest in enhancing public management by incorporating performance indicators into resource allocation, significant challenges remain that limit the strategy's effectiveness.

One of the main barriers is the weak integration of monitoring and evaluation systems with budgetary processes, which hinders the use of performance outcomes to guide resource allocation. Additionally, performance evaluations are often limited in scope and lack sufficient institutionalization, reducing their influence on budgetary decisions.

13 According to an assessment of the organizational structure of municipal control units in Brazil, 83% of these units have fewer than five employees (World Bank, 2022a).

Although the use of results-based financing is widespread, empirical evidence on its effectiveness remains limited. A notable example is Ceará, a state in Brazil, where, since 2007, part of the revenue from a state consumption tax (Imposto sobre Circulação de Mercadorias e Serviços [ICMS]) has been distributed to municipalities based on their performance in education, health, and environmental indicators, with a strong focus on education metrics.¹⁴ According to Loureiro et al. (2020), this system incentivized local authorities to prioritize improvements in education quality, achieving significant results in both performance and equity. Since its implementation, Ceará has recorded the largest increase in the national education quality index among Brazilian states, rising from the bottom rankings to becoming a leader. Additionally, disparities in educational outcomes among different regions and socioeconomic groups within the state have narrowed.

Loureiro et al. (2020) attribute the success of Ceará's system to three key factors: the autonomy of municipalities to allocate funds and manage schools; the relative importance of ICMS funds in municipal revenues, particularly in poorer municipalities; and the technical support provided by the state government, which strengthened the capacity of municipal education departments to implement educational policies. These elements suggest that Ceará's model could be adapted to other contexts, provided that performance metrics are tailored appropriately, technical capacity for monitoring is ensured, and local specificities are taken into account.

¹⁴ Ceará allocates one-quarter of its consumption tax revenue to municipalities, distributing 72% based on education indicators, 20% on health indicators, and 8% on environmental indicators.



Seat of government for the municipality of La Plata,
Buenos Aires, Argentina.