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Social Funds and Decentralization: Optimal Institutional Design[1]

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Summary

Most of the 60+ developing countries that have established social funds are decentralizing their governments as well. But the question of how to tailor social funds – originally a highly centralized model – for a decentralizing context is scarcely addressed in the literature. This paper examines the implications of decentralization for the institutional design of social funds step-by-step through the project cycle. The topic is doubly important because a social fund can increase its effectiveness and the sustainability of its investments by reorganizing internal processes to take advantage of the political and civic institutions that decentralization creates. Local government has an informational advantage in local needs and characteristics (time and place), whereas the fund will have access to better technology and knowledge of sectoral best practice. The key is to create institutional incentives which best combine these relative advantages, leading to better investments. I describe a quick and easy system by which funds can conduct routine appraisal of project success, which can in turn inform staff performance evaluations, improve internal procedures, and even permit a performance ranking of local governments. While experience has shown that SFs can help strengthen local governments, strengthening central institutions should be dropped as a central SF goal.

Keywords: Social Funds, Decentralization, Poverty Alleviation, Institutional Design

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1. Introduction

Both social funds and decentralization are major phenomena across the developing world. More than 60 countries across Africa, Asia and Latin America have introduced social funds over the past two decades (van Domelen 2002), while estimates of the number of countries decentralizing range as high as "nearly all countries worldwide" (Manor 1999, vii). Each reform has inspired its own literature. The decentralization literature is enormous, comprising hundreds of studies going back at least to the 1950s (Faguet 2002). The social fund (SF) literature is smaller but has been growing fast lately, as SFs continue to sprout around the world and more and more resources are committed to them.

It is evident from such estimates that most social funds operate in countries at various stages of decentralization. But there has been almost no treatment in the literature of how the social fund model – originally a very centralized one for reasons of history and administrative efficiency – can best take advantage of a decentralized framework. This paper seeks to fill that gap. The subject is doubly important as the two reforms are arguably powerful complements, each a boon to the other's effectiveness, as I will argue below.

It is important to note that several fundamental questions about both phenomena: Is decentralization preferable to centralization?[3] Are SFs beneficial organizational forms? lie beyond the scope of a paper that assumes the existence of both initiatives, and asks: How can a social fund best be adapted to a decentralized institutional environment? This paper accordingly locates itself squarely in the social fund literature, while making use of a number of theoretical and empirical insights from the decentralization literature.

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[3] Faguet (2004) addresses this question directly.

Most studies of social funds examine broad questions of their effectiveness vis-à-vis poverty alleviation, providing social services and investment targeted to the poor, and strengthening state and civic institutions. They divide roughly equally between positive, neutral, and negative evaluations. Amongst the latter, one of the most influential contributions is Tendler (2000), which reviews donors' own evaluations and finds that social funds are poor at job creation and at reaching the poorest of the poor. In both cases, traditional social programs were much more effective at reaching these central social fund goals. Furthermore, and despite official discourse, SFs have continued to rely on donor funding over time, and are thus an unsustainable institutional model. Vivian (1995) and Cornia (2001) agree, the latter arguing that social funds – first established to ameliorate the social costs of structural adjustment – have played only a minor role in decreasing the number of "adjustment poor", or offsetting adjustment-related declines in social expenditure. Alternative models of social assistance operate at lower cost, higher efficiency and easier replicability. Van Dijk (1992) corroborates this last point, arguing that Guyana and Jordan's difficulties implementing a Bolivian-style social fund shows the poor replicability of the underlying model. And Dijkstra (2004) maintains that social funds distort sectoral coherence in water and sanitation, health, and education, privileging donor priorities over sectoral priorities.

In the neutral camp, de Haan, Holland and Kanji (2002) argue that social funds are responsive and flexible and *can* benefit the poor. But they are small compared to the problems they are meant to tackle, and hence no substitute for national systems of social protection. Citing evidence from a World Bank OED study of 66 social funds, Carvalho and White (2004) show that the vast majority of beneficiaries were satisfied with the projects they received. But they worry that SFs have largely failed to strengthen community capacity, operating as users rather than producers of social capital; and SF policies are rarely integrated with sound sectoral strategies in the areas in which they operate. Schady (2000) shows that although Peru's FONCODES were distorted by political factors, they did flow disproportionately to the poor, reaching a larger fraction of them than other, similar programs. And Carvalho *et al.* (2000) point out that while SF facilities usually had better staff and equipment than comparator facilities, their operation and maintenance suffered deficiencies during the operational life of the investments.

Positive evaluations of social funds have used an often sophisticated empirical approach, and have refuted a number of these claims. Denouncing the "myths" that have grown up around social funds, van Domelen (2002) cites a six-country study, including over 21,000 treatment households and many more controls, to mount a defense. Her evidence shows that social fund projects[4] are better targeted to the poor than other government programs, and respond to important local needs. SF investment improved not only the quality of infrastructure in education, health, and water and sanitation, but also access to and utilization of services. And these investments have proved sustainable, with most SF facilities are still operating several years after completion. Newman *et al.* (2002) provide careful econometric evidence to come to similar conclusions for the case of Bolivia: SF health projects raised utilization rates and were associated with substantial decreases in under-five mortality rates; SF water investments increased the quantity of water available to the poor, and decreased under-five mortality by a similar amount again. Paxson and Schady (2002) use nonparametric regressions, differences-in-differences, and instrumental variable estimations to show convincingly that school investments by FONCODES reached poor districts, and poor households within those districts, where they served to increase school attendance rates for the young. Marcus (2002) draws on evidence

[4] Donors usually refer to SF "subprojects", as their own financing of SF operations are the primary "projects". For simplicity I ignore this and refer to SF-financed schemes as "projects" (*e.g.* a school, a sewerage system).

from Mali, Tajikistan and Mongolia to argue that social funds provide effective social services, help the poor to build up assets, and enable them to benefit from economic growth. Lastly, Jack (2001) uses institutional economics to argue that key characteristics of the social fund model – especially delegated authority and deep political devolution – imply that where existing political institutions fail to deliver assistance to the vulnerable, a well-designed SF can improve the situation.

Given such a rich and growing debate on social funds, the dearth of studies examining social funds and decentralization is notable. There appear to be only four studies that acknowledge the issue. Noting that social funds tend to evolve organically through experimentation and learning, whereas decentralization is usually designed from above, Van Donge (2004) "pleads for an organic growth of decentralization instead of legislating it into existence" (p.346), though how this might be achieved is not entirely clear. Benería and Mendoza (1995) conclude their study of structural adjustment in Mexico, Honduras and Nicaragua with a call for the Central American social funds to embrace community participation and back a deep process of democratic decentralization. Only Schroeder (2000) and Beall (2005) directly address the question of how social funds and decentralization interact. Both stress the importance of social funds and decentralization complementing each other. But Beall's focus is on broader issues of social policy, and Schroeder's evidence is necessarily scant as the case he studies – Malawi – had only begun to decentralize.

This paper answers that question for the general case of social funds in a decentralized institutional environment, using evidence from Latin America, Africa and Asia. The rest of the paper proceeds as follows. Section 2 discusses key analytical concepts. Section 3 examines the implications of decentralization for each step of the project cycle, from project identification to implementation. Section 4 concludes with a discussion of operation and maintenance and institutional strengthening, issues that are affected by all SF processes, and which thus provide a rhetorical lens through which the paper's arguments can be summarized.

2. Key Analytical Concepts

Before entering into the argument it is important that we define key concepts clearly.

2.1 What is a Social Fund?

Varying definitions of what is a social fund abound; the proceedings of the Second International Conference on Social Funds (World Bank 2000d,1) provides one of the simplest and most direct formulations: "Social funds directly finance small community-managed projects, helping to empower the poor and vulnerable by allowing them to become actively involved in their own development." They are organs of the central state, and often report to the president or a privileged minister (of planning, of the presidency) with a coordinating role. Their financial support mostly consists of grants.

Where the state lacks credibility or institutional presence, a social fund can be organized outside the state, as a non-governmental organization, as is the case with the Kosovo Community Development Fund. This SF works in close coordination with local governments as well as central state organs, while maintaining its independence as an extra-governmental institution. Parker and Serrano (2000) provide other alternatives: Municipal development funds (50+ countries) provide credits to local governments and other institutions investing in local infrastructure. By intermediating public credit and promoting investment efficiency, they seek to engender a self-sustaining municipal credit market that local governments will be able to access. Local development funds (14 countries) eschew dedicated administrative units, seeking instead to work through the prevailing legal and regulatory framework to provide block grant-like support for local governments. They seek not only direct impacts through small-scale investments but also to test and develop procedures and mechanisms that make decentralization more effective.

2.2 What is Decentralization?

Definitions abound here as well, with authors often providing extended typologies that typically include deconcentration, delegation, devolution, privatization and others. As I have argued elsewhere (see Faguet 2002), such distinctions may reflect the richness of policy experimentation occurring throughout the world, but they do analysis a disservice by conflating fundamentally different reforms under a common title. The incentives and institutional forms created by deconcentration and devolution, to pick just two, are not the same, and should not be treated as such. In the interests of analytical clarity, this paper adopts a stricter, narrower definition. **Decentralization** hereafter refers to the devolution by central (i.e. national) government of specific functions, with all of the administrative, political and economic attributes that these entail, to local (i.e. municipal) governments which are independent of the center within a legally delimited geographic and functional domain.

From the point of view of public service delivery, the key differences between centralized and decentralized government can be distilled into two issues: information and accountability (see figure 1). **Information** is important for the prioritization of projects amongst competing uses of public funds, and the design of interventions best suited to meet a specific need. These informational requirements can be broken down into three types:

i. **Local needs and real demand –** including demographic data (e.g. illiteracy and infant mortality rates), the extent and quality of existing services, and the degree of community support for a particular project;

ii. **Local geographic, economic and social characteristics –** important to project siting, timing and design (e.g. where to place a clinic, when to build it, what materials); and

iii. **Best practice –** technical or organizational knowledge specific to the project chosen, which permits efficiency and effectiveness in service provision (e.g. the proper dimensions of a classroom, medical equipment required in a primary health clinic).

Figure 1

Key Differences Between Centralized and Decentralized Government

1 Information
→ Local Demand
→ Local Characteristics
→ Best Practice
2 Accountability

Local government will tend to have an advantage in both the quantity and quality of the first two, locally-specific types of information. But central government, with its superior resources and the ability to attract highly-trained staff, will tend to have a superior command of the third – sectoral best practice. How best to combine these relative advantages is the key question, and a theme that runs throughout the rest of this paper.

At the most basic level, a relationship of **accountability** exists when agents must report to principals and respond for their actions. In practice, given normal assumptions about goal selection, accountability implies that party A has the power to make party B carry out party A’s wishes. For the purposes of this paper, accountability can be defined as the process by which the public officials serving a particular community are given clear incentives to provide projects that concretely address local needs. Local government accomplishes this by placing politicians’ fate in the hands of local voters, in the presence of a transparent electoral mechanism. Central government could in theory accomplish the same through the design of appropriate salary and bonus incentives for its officials, but this in turn requires higher-level officials to be interested in and informed of the state of affairs in that community. This is a logical circularity, as there is little incentive for any central official to focus on conditions in any particular community. With their broad mandates, central government officials will be less accountable to voters in a given district than the district's own local government.

2.3 Social Funds and the Structure of the State: Efficiency vs. Complexity

A country's governmental regime will strongly affect the way in which a social fund operates, and the activities it needs to undertake to achieve its goals. In a central, unitary state, central government agencies will tend to carry out all aspects of social investment themselves, from promotion and needs assessment to project design, financing, supervision of execution, and often initial operation and maintenance of the services in question (these are treated in detail below). This may include catalyzing community organization and fomenting its consensus around a given project. The question, then, is which central agencies will carry out each of these tasks. Given that social funds often arise out of the weakness of the state in precisely these activities, as discussed above, it is more likely than not that the funds themselves will organize the majority of these activities. Where line ministries are weak even in the regulatory and normative aspects of their sectors, funds can find themselves essentially setting policy via innovation in their projects and the collective weight of the portfolios they finance.

The process of decentralization changes a social fund's role fundamentally. No longer can it approach rural communities as an administrative *terra nullis*, abandoned by other arms of the state, but rather as a social unit where civic organizations and political institutions exist to express the popular will and respond to local needs. The fund is no longer the catalyst for local preference revelation and consensus-building. When it enters a new region local priorities should already have been determined. Multiple and complementary procedures will exist for ascertaining local opinion and planning future priorities, including elections, lobbying by civic and business groups, and others. Equally importantly, the fund will no longer be the prime source of money locally. Local government will have its own budget, and the administrative ability to finance projects independently. The fund's primary role will then be to ask what priorities have been identified and offer to co-finance those which fall under its mandate, in the process injecting a measure of technical expertise in the design and planning of local services. The power relationship between citizens and the fund is thus significantly redressed. Neither the fund nor any other central agency is in a position to arbitrate local preferences and bestow generosity upon a grateful populace. Rather, projects advance through negotiation between fund, local government and community institutions on a playing field now tilting back towards level. These differences are summarized in figure 2.

Figure 2

Important SF Qualities in an Environment Which Is:

	Centralized		**Decentralized**
1	Process efficiency	1	Manage complexity
2	Competence throughout the project cycle	2	Negotiation
		3	Listening/Openness
3	Command and control	4	Coordination and delegation

The greater number of independent actors intervening in the project process inevitably increases the complexity of the fund's task. Issues which it could previously deal with internally or amongst a small number of central agencies are now externalized and multiplied. These enter into fund operations in the form of electoral politics, as local leaders seek to exploit SF resources for political gain, and SFs must work with local leaders from parties which at the national level are in opposition. They also appear as issues of institutional capacity, where project success may depend on the quality of municipal and community leaders, and the fund cannot address shortcomings in a particular project through a simple re-allocation of its own staff. Whereas SFs operating in a centralized environment may well find a top-down command structure efficient, one facing government decentralization must learn different abilities – negotiation, consensus-building, and the ability to engender trust amongst a wide variety of external actors. We return to this theme below.

If decentralization presents social funds with significant challenges, social funds also offer a significant advantage when dealing with a decentralized framework. Social funds are flexible, demand-driven institutions, and hence must be counted amongst the most appropriate ways in which donors can support social investment and combat poverty in a decentralized country. Top-down sectoral projects, in which priorities and actions at the district level are defined in the center and then carried out over a number of years by a small project team, are fundamentally inconsistent with a governing framework in which many such decisions are assigned to elected local governments. Granting unelected technocrats the power to make and unmake local projects risks weakening district institutions and undermining the authority of legitimately elected district authorities. Social funds, on the other hand, are by their nature designed to respond to demand, and can easily be adapted to work with decentralized government. When the two work together to reach the fund's goals they are also advancing toward local government's goals, in the process strengthening its effectiveness and legitimacy in the eyes of the voters. And when a fund works effectively with a given local government, it establishes relationships of trust which facilitate institutional strengthening and the transfer of organizational abilities from fund to district, tasks which top-down projects lacking such a history of cooperation will find more difficult to achieve. However, when a social fund continues to operate in a centralized fashion in a decentralized or decentralizing context, the same weakening of local institutions is likely to occur (Carvalho *et al.* 2002).

This underlines an important general lesson about social fund design: SFs must work within the bounds and norms of the local government process, and where possible try to enhance it. They must be sensitive to politics, and designed explicitly to enhance the accountability and transparency of politics. SF practices which are not consistent with a country's legal and institutional framework for local government will tend to undermine the latter, and may at the limit expose local officials to charges of illegality in the natural course of project business. This is of particular importance as often in the past SF design was a sort of unconstrained maximization, seeking the greatest levels of efficiency while admitting few concessions to existing government procedure. In a decentralized environment this temptation must be resisted, as working successfully with existing local government and civic institutions is important to a social fund's success, defined both in narrow project terms and broadly as overall social impact. Hence at an early stage SF design should take into account the country's laws, norms, accounting standards, and other institutional framework for local (and regional) government, and design SF processes around these.

3. Social Fund Design – The Project Cycle

3.1 Revelation of Local Demand and Project Identification

Approaching Communities and Sensing Their Needs

Project identification is probably the most important stage of the project cycle, and we accordingly spend the most time on it. It is the first exposure that rural communities have to social fund staff and procedures, and sets the tone for the interactions – cooperative, paternalistic or conflictive – that follow. This first stage of the project cycle consists of two distinct components: (a) determining communities' needs and preferences for public investment, and (b) identifying a project the SF can finance which responds to these needs.

The fundamental questions are: How is first contact with the community made? Do fund staff interact with local government officials? with communities? Do they arrive to meet with local government and inquire about local priorities, or do they arrive with funding priorities or even specific projects already defined? As discussed above, under decentralization local governments are the arbiters of local priorities and agents of local development. As such they should have already carried out a broad form of demand revelation natural to their role as the agents of the will of the people. World Bank (2000b) notes that there is no one single way to go about this. Methods that communities and municipalities can employ include: village mapping, semi-structured interviews, transects, problem and solution analysis, etc. Whatever the method, communities should have identified projects which are included in the fund's menu, and ideally also others that go beyond them. In such a context fund staff should approach local government officials seeking to help them, within the context of the preferences they've articulated, and not try to change these. Where local government has not identified local needs or is too weak to do so, the fund should be prepared to help it, offering both financial and technical support, and only after this is done discuss projects it might finance. It should not seek to carry out this essential function of local government itself, and should not commence operations in a community suffering from a planning vacuum.

Social fund staff should also work with civic organizations to ensure that specific projects are supported by the communities that will benefit from them and eventually (help to) operate and maintain them. But they must take care to do this in a way which respects the local institutional order and does not generate tensions between civic groups and their local government. Working in such a way will allow fund staff to establish a good rapport with local authorities, ultimately strengthening them – as well as civic organizations – in the eyes of local citizens. Furthermore, a consensus based on local institutions and norms of governance will tend to be much more robust than one centered on SF procedures, and thus more likely to lead to project success.

In this spirit, the consensus sought by a fund should be spontaneous, and not driven by the needs of the fund's pipeline. In operational terms, this means that SF staff should be prepared to walk away from a district whose priorities do not match its financing menu, or where consensus is not readily forthcoming, instead of undertaking to "build consensus" by convincing local leaders to go along with their plans. The conundrum of attempting to avoid such behavior is that poor project identification is operationally more efficient than good identification. SF staff conducting repeated project identifications will find it in their interests to skip preference revelation, which is costly, and proceed directly to projects the fund is willing to finance. Agreements generated in this way may be observationally equivalent to those about which there is a proper local consensus. Over time this operational tendency can become difficult to break. In addition, fund staff have numerous and subtle ways of influencing local "demand". A fund employee arriving in a poor village by jeep has immense authority by virtue of her very presence –dress, mode of transport, speaking patterns, etc. Officials who arrive offering a menu of choices will almost inevitably distort community preferences unless they take strong measures to ascertain local needs as detailed here. And the consequences of such distortions may well be grave. Poor communities with limited resources to dedicate to collective action may never achieve their highest priority project if they expend energy securing a social fund project lower down their list. This also argues for the creation of relatively open and flexible menus of eligible investments – or the creation of simple 'negative lists' that provide maximum flexibility at the local level.

Fund and Community Performance Incentives

The best way to promote good project identification is via the incentives that SF employees face, and not through general organizational directives. Staff managing a super-abundance of projects at the earliest stage of the project cycle, where few resources have been invested in any given one, will be more likely to abandon an unpromising one than those seeking to nurse a few projects to approval. Likewise, the performance of staff involved in identification should be based in part on the ultimate success of projects in the medium term, and not entirely on project approvals or – worse – on the proportion of projects approved. This is part of a general recommendation which applies throughout the project cycle. The performance of staff at each stage should be judged by long-term project success, and not just on the successful passing-on of projects to the next stage of the cycle. Simple indicators connecting staff members to the number of successful and unsuccessful projects they were (closely) associated with would substitute for project pass-through. This would serve to focus employees' minds on the characteristics of successful projects, and highlight particularly successful staff for others to emulate. A simple system for measuring project success is described in the conclusion (O&M).

Incentives are not only for SF staff – they should also be binding on communities. Measures to ensure that both local government and the relevant community actively support a project should be built into the SF project identification system. It is important that this test be satisfied early in the project cycle, and not wait for a later stage when vested interests become sufficiently strong that the process of project approval can be distorted by economic or political interests pursuing private gain. In this way projects which do not command local support can be discarded early on, without wasting SF resources.

The question of what constitutes sufficient evidence of support for a project is an important one. Early social funds, such as Bolivia's ESF, often relied on simple declaratory evidence of local support, such as community resolutions, letters from mayors or other local leaders, or verbal expressions of enthusiasm. But such evidence is close to costless, and will often be proffered on behalf of projects that are valued marginally by a community with few outside options. By contrast, municipal and community contributions in cash and kind, especially when made up-front in the project identification and design phases, represent a much higher hurdle. They require communities in particular to raise funds and solve the collective action problem, and thus constitute an acid test of their commitment. But such requirements call for a greater degree of trust on the part of communities in both the SF and local governments, and carry an accordingly larger danger of disillusion and credibility loss if a project to which communities have contributed fails to reach fruition.

The attainment of such strong community and local government support has powerful implications for ex-post project sustainability. Projects which enjoy firm local support from early on are more likely to receive the long-term political and financial support of local governments which feel committed to them. They are also more likely to benefit from counterpart contributions and social participation of communities that have made them their own. Evidence from Peru, for example, shows that increased participation in the identification of social fund projects was associated with improved sustainability and an increased probability of project success (World Bank 2000d). Key elements of effective project identification are summarized in figure 3.

Figure 3

Elements of Effective Project Identification

1 Work through local government to support community to identify its own needs.
2 Ascertain and accept local needs that are identified.
3 Be prepared to walk away from communities whose needs do not match SF priorities.
4 Ensure specific projects are supported by beneficiary communities via cash, labor & in-kind contributions.
5 Tie SF staff incentives to long-term project success, and not project pass-through or approval rate.

Lastly, identifying a project from a community's expressed needs may be less obvious than is at first apparent. This is because raw needs will generally take the form of social problems, such as low literacy or chronic disease, the solutions to which may not be obvious, or – worse yet – about which the affected community may be mistaken. For example, a community suffering from cholera may demand a health clinic when the appropriate intervention may in fact be an education campaign combined with a potable water project. Although social funds will typically have no particular advantage in needs identification *per se*, other than the resources and commitment to facilitate it, they will have the technical ability to turn information on raw needs into feasible and financeable projects, which communities and even local governments may well lack. Cooperation between fund and community can thus optimize the utilization of different types of information available for planning a local project, so long as the fund deals sensitively with community needs and the two agree on the form that a solution to the latter's problems will take. These lessons have been put to good use in Argentina and Bolivia (World Bank 2000a), and ignored at significant cost in Peru (Serrano 2000a).

A last lesson from the field is that a competitive mechanism for project selection can generate important benefits. Chief amongst these is the introduction of an element of contestability into the fund's project-identification-as-resource-allocation mechanism, which according to the public management literature is an essential component of any well-functioning budget process. Good local decisions depend on having tradeoffs between alternative investments in order to arrive at the option with the highest benefits – to identify the highest-value project. Another benefit is that competition sends clear signals about investment priorities, selection criteria and the rules of the game more generally. On the negative side, competitive selection can make pipelines lumpy and lead to operational bottlenecks, and the deadlines it involves may work against more disadvantaged groups. But coherent process design combined with the sorts of outreach and technical assistance discussed above can overcome these drawbacks.

3.2 Project Design

Once a project based on a community's needs has been identified, it must be designed. Project design transforms a project idea into specific technical plans, with a budget and timetable. This implies resolving important questions like size/scale, technology and location, to name a few, which impact greatly on who will eventually benefit from the project and the character of benefits received – that is, on ultimate project success. The social fund must be careful not to internalize these functions. Local governments and communities must be included in project design and thereafter if the project is to become a success.

The project design process must, again, strike a careful balance between the social fund's technical expertise and efficiency in project design, and the community's specific knowledge about needs and surroundings. For example, locals will know better where best to site a school in order to exploit sunlight, avoid floods and facilitate access. But fund staff will be better informed about architectural best practice, and education ministry technical standards for construction. Both types of knowledge are important to the design process, which must be capable of melding diverse information into a single set of technical and budgetary plans. Hence a design process must contain incentives for each side to contribute its share of the necessary information. Such incentives occur naturally in local government via the electoral process. They may also occur below the municipal level where local communities are institutionalized in self-governing and accountable structures. In both cases, local representatives will face incentives to proffer the necessary local knowledge, and it is incumbent upon the social fund to structure a design process which encourages them to do so.

Long-term project sustainability also requires that local communities and governments be included in the design process, especially where one or the other will be required to fund operation and maintenance of a project once SF involvement has come to a close. Forcing local authorities to confront the long-term costs of running a project early on will help ensure projects are designed for the level of resources available. Evidence from Peru indicates that greater local participation in the design of a project is associated with increased utilization *ex post* and increased probabilities of project success.

But this marks the Achilles' heel of project design. The process of consultation by which local inputs are obtained is costly. And unlike local authorities, social fund staff are (usually) central government employees, and ultimately accountable to their superiors within the fund, not to citizens of the districts in which their projects are located. Hence a social fund must have internal incentives that lead its staff to include the inputs of local community and government representatives in the design process. This can be achieved by structuring the process to actively seek out local consensus and approval of both the relevant community and district government during project design. If project design is a coordinated exercise between fund staff and local representatives, and the approval of local government and community authorities is required at crucial junctures throughout, the resulting project is much more likely to address real needs and maximize local benefits than if the project is an in-house SF design. Local approval should be substantive, involving the commitment or expenditure of resources, and not just pro-forma. And importantly, as for project identification, the design process will improve if staff performance is judged by long-term project sustainability and success and not simple project pass-through or successful project approvals. Figure 4 lists key elements of good project design.

Figure 4

Elements of Good Project Design

1. Ability to integrate technical information on project design with locally-specific information on needs and the environment
2. Incentives for SF staff to include community and local government inputs into the design process
   - → Require local approval at crucial junctures
   - → Judge staff performance according to long-term project success

3.3 Project Approval

Project approval refers to the formal and substantive acceptance of a project by social fund management, implying that the project meets SF technical, social and financial standards, and the fund agrees to finance it. Regardless of its degree of administrative deconcentration, this should be an internal process that rigorously confirms that a social and governmental consensus exists for the project, and that standards of project design have been met. Although some funds, such as Peru's FONCODES, have chosen to delegate responsibility for approval of small projects to field staff, it is important to stress that final responsibility for approval rests with the fund's management. Social funds are ultimately judged by the projects they finance, and hence approval is one of their core functions.

What approval criteria should socials fund use? Approval criteria can be separated into six general categories:

i. Real local **need**

ii. Community and local government **commitment** to the project

iii. **Technical design standards** particular to each sector or sub-sector (e.g. schools, roads, microcredit loans)

iv. **Cost**

v. **Sustainability** – technical, financial and social

vi. **Environmental impact**

The approval process must be structured so that all of these are satisfied before a project can be approved, and must delineate clear thresholds for the satisfaction of each. Potential trade-offs between competing criteria must be considered, and exchange rates, if any, specified. This means the rate at which, say, cost indicators in excess of minimum standards can compensate for shortfalls in environmental standards. This issue should be addressed explicitly from the outset, as such trade-offs will tend to emerge anyway in the give-and-take of SF operations. The challenge is to design an approval system which combines rigorous review of project criteria with a sufficiently high degree of transparency that the process itself serves as an incentive for fund employees and local authorities at earlier stages of the project cycle to develop good projects. Though explicit criteria are part of this, transparency is only complete when the reasons for project approvals – and more importantly rejection – are made fully public, allowing the staff and communities involved to learn from experience.

Including local governments on the executive board of a social fund can broaden transparency and dissemination dramatically, thus multiplying such incentive effects. It can additionally provide a means for injecting the views and priorities of local governments into SF processes. This is perhaps best accomplished by nominating representative of local government associations, and not mayors or local councilmen, to the fund's board, thus hopefully avoiding conflicts of interest. Lastly, and once again, measuring the performance of staff who approve projects via long-term project success is preferable in itself, and can help filter good incentives backwards through the project cycle to staff at the identification and design stages.

3.4 Project Implementation/Execution

Project implementation refers to the execution of programs (e.g. literacy campaigns, vaccinations), or the construction and initial operation (during a handover phase) of project infrastructure. It is especially concerned with oversight of these processes to ensure that technical and social standards set out in the project design are met.

The most important implementation issues concern the types of project implementation that are allowed, and the extent of local government and community participation that these imply. The first social funds relied on private contractors or NGOs to execute projects. More recent attempts to target the poor, combined with the rise of community-driven development, have led SFs to pay project funds directly to community groups, and allow them to contract and oversee project activities themselves. Such direct contracting can make projects cheaper by using more local materials, labor and management, as well as more sustainable through increased local commitment. It can also serve to strengthen local government's legitimacy and capacity through learning-by-doing.

Although the familiar trade-off of participation vs. efficiency applies here as well, it can be largely overcome by careful calibration of contracting arrangements to project type. Small, relatively simple infrastructure projects, for example, are well suited to direct contracting, and in sparsely populated countries may be more efficiently implemented by communities that by private contractors. In Bolivia, for example, contractors could only be convinced to bid for various types of rural infrastructure projects when they were bundled together into big contracts. But this implied large transport costs and significant coordination problems for urban firms headquartered far from beneficiary communities, as well as non-trivial learning periods for employees unfamiliar with local conditions. Community implementation, by contrast, took longer but often resulted in overall efficiency gains through lowered costs. A cross-country impact assessment of social funds found that closer community involvement and greater community responsibility generally reduced project costs (World Bank 2000d). Project quality can also improve as a result of strong accountability and an intimate knowledge of local conditions.

Social fund supervision of direct contracting should become a process of technology transfer by the fund to the community (or local government) in which the former – which knows how – teaches the latter – which is interested, present on the ground and able to operate much more cheaply – how to build or implement a project, manage skilled labor, organize group work, and check the quality of technical inputs. In effect, the fund uses supervision to teach communities to organize and run social investment projects, transferring important managerial skills which both community and local government can exploit in the future. In community-driven projects, local mechanisms of accountability will take care of basic issues of compliance (e.g. amounts of raw materials used, number of days worked) allowing fund supervision to become less intensive, and more focused on technical or managerial issues in which it has a particular comparative advantage.

A number of multi-country studies agree that communities should be allowed to manage money directly, and use community contracting where possible (Alton 1999, World Bank 2000b, Parker and Serrano 2000). The benefits include: (i) Better supervision; (ii) Better accountability; (iii) Building local capacity; (iii) Greater mobilization of local resources; and (iv) Productive efficiency. Additional activities that may be contracted out at the project implementation stage include: (a) Drawing up technical and legal bidding documents; (b) Conducting bidding procedures; and (c) Conducting supervision of project construction/implementation. The decision of which of these to contract out should also be taken in light of project characteristics, and the institutional characteristics and comparative advantages of each actor in the process: fund, municipality, and community.

Regardless of contracting arrangements, the large amounts of information that local governments and beneficiary communities will tend to amass about project implementation should be exploited by social fund staff, who should encourage locals to record and systematize it. Fund procedure should seek to harvest such information as an additional tool of project supervision.

4. Conclusions: Operation and Maintenance (O&M) and Institutional Strengthening (IS)

Two of the most important questions facing social funds are long term project sustainability, and the extent to which the gestation of these projects strengthens or weakens existing public and civic institutions. Both O&M and IS directly reflect the quality of processes that a fund uses to prepare projects, and hence each offers a useful lens through which to review and summarize the preceding arguments. We conclude by examining decentralization's effects on SFs' ability to achieve both goals.

Operation and maintenance refers to the operation of a project or program once social fund involvement with it has ended. Strictly speaking this is beyond the social fund's remit. But how it prepares projects strongly affects the chances for long-term O&M success. In a decentralized framework, municipalities and communities will tend to be the ultimate owners of projects. The best social funds can do for O&M in such an environment is to carry out careful project identification, design, approval and implementation, and follow the guidelines set out above before handing a project on. This is why involving local government at each stage of the project cycle is of such great importance. Where identification and design have been done competently, a project should benefit from local enthusiasm in ways that make long term operation and maintenance much more likely.

But the issue should not be left there. Funds should actively investigate whether or not their projects are successful over time. How is project success measured? Doing so with high precision is a thorny issue, and should not be attempted in this context. Instead, funds should institute a simple and quick program in which all projects are visited at regular intervals after completion, say three and five years, and assessed according to simple criteria as to whether they are still operational and delivering a reasonable flow of benefits. Information from interviews of a few key local actors, plus visible evidence, would be used to rate projects on something like a five point system. Such *ex-post* project visits could be worked into the regular field trips of SF evaluation and implementation staff. Projects at both extremes would receive extra attention in the form of additional interview questions to relevant community leaders, to ascertain why they are so good or bad. Aggregate results from this process could then feed into the continuous improvement of SF procedures, as well as evaluation of staff performance. The results from more rigorous, formal surveys, such as a World Bank study of 66 social funds (see below), could be used to fine-tune these rating systems.

Such results should then be aggregated at the municipal level to make voters aware of their local government's performance. A social fund might create a rough-and-ready sustainability index, for example, by which local governments (or central agencies) are ranked in terms of the long-term results they achieve. The dissemination of such an indicator nationwide would allow communities to compare their performance on fairly transparent, standardized terms. In the best case this could create a competitive dynamic conducive to the improvement of maintenance and the long-term sustainability of projects.

Institutional strengthening arises as the final topic not as an afterthought, but because, like O&M, it is more a cumulative product of the entire project cycle than a specific stage within it. The objects of IS should properly be local and national institutions, both public and private, and not the SF itself. IS occurs along four main transmission paths:

- **Direct effects**, in which SFs finance explicit institutional-development activities, usually with local government and civic organizations;
- **Demonstration effects**, whereby the SF's example of institutional efficiency causes other branches of government to adopt its norms and procedures;
- **Supply effects.** By supplying large amounts of investment funds otherwise not available, SFs can generate institutional capacity in government agencies equal to their own high technical standards;[5] and
- **Demand effects**, which refer to the demand-stoking effect of SFs at the grass-roots level, where a new, responsive agency serves to increase beneficiary expectations, and hence demand, on line ministries and local agencies, thereby stimulating their capacity to respond.

Hence institutional strengthening happens throughout project identification, design, approval, implementation and O&M, and in a well-designed SF it should be impossible to separate it from any of these stages. Given this, the main thrust of a good institutional strengthening program resides in social funds undertaking a well-thought-out and coherent project cycle. This is amply discussed above. Beyond that, and to the extent that IS depends on the transfer of institutional learning from fund to external institutions, strengthening can be improved through the explicit incorporation of technology transfer

[5] On the other hand, the existence of SFs might cause resources (people and resources) to be diverted from other governmental agencies (at either the central or local level), leading to institutional *weakening* of other parts of central or local government.

mechanisms throughout the project cycle. These can include everything from asking SF staff and contractors to be alert to local officials' needs, to training sessions conducted by visiting SF staff, to including explicit IS components in SF projects. Municipalities and institutions where IS has occurred can be "twinned" with those untrained so that they teach each other. And support can be sought from associations of municipalities, NGOs, or professional organizations of public-sector officials for specific training activities. Empirical evidence supports these claims. The World Bank study of 66 social funds (Carvalho *et al.*, 2000; Carvalho and White, 2004) found that SFs can strengthen local government capacity by working directly with them and giving them significant decision-making powers.

But strengthening central government institutions should be dropped as a central social fund objective. The same Bank study finds that, among central government institutions, SFs have been successful in strengthening mainly themselves (Carvalho *et al.* 2000). But this is only to be expected, as detailed consideration of how SFs interact with other state organisms shows. Most importantly, SF staff are typically paid much better than regular public employees, and as a result attract high-fliers who might not otherwise work for the state. The fund is specially exempted from a number of restrictions that bind other central agencies, and comes to be seen as more prestigious than "regular" government. Feelings of alienation and jealousy vis-à-vis line ministry employees ensue, and tend to intensify over time. Where central government is concerned, the supply and demand effects generated by SF activity are effectively weakening institutions instead of strengthening them. For IS to occur, direct effects and demonstration effects would have to outweigh these negative influences. But in such an atmosphere, expecting a social fund to have success teaching line ministry staff how to be more like it is simply unrealistic, as experience around the world confirms.

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