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Fiscal Transfers in Asia

Challenges and opportunities for financing sustainable development at the local level

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Children at a public school assembly in Jakarta, Indonesia. Education is an important part of subnational government expenditures.

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Farmer with cattle on a bridge in Viet Nam. Local roads and bridges improve the livelihoods of farmers.

Prashanth Vishwanathan – UNDP India
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Section 3 discusses the effects of fiscal transfers on incentives for SDG-related budgeting and spending.

Section 4 discusses the geographic equity effects of fiscal transfers and implications for SDG 10.

Section 5 reviews emerging experiences of governments leveraging performance-based fiscal transfers to create positive incentives for better SNG performance in delivering services critical to the sustainable development agenda.

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Acronyms

APA	Annual performance assessment
CFC	Central Finance Commission (India)
CG	Conditional Grant
DAK	Dana Alokasi Kabupaten (Conditional Grant transfers in Indonesia)
DAU	Dana Alokasi Umum (Unconditional Grant transfers in Indonesia)
DDC	District Development Committee
FY	Fiscal year
GDP	Gross Domestic Product
GLDF	General Local Development Fund (Mongolia)
GP	Gram Panchayat
HR	Human resources
IRA	Internal Revenue Allotment (the Philippines)
LDF	Local Development Fund (Mongolia)
LoCAL	Local Climate Adaptive Living Facility, a UNCDF project
MCs	Minimum Conditions
MDGs	Millennium Development Goals
MTFF	Medium-Term Fiscal Framework
NRR	Natural resource revenues
OECD	Organisation for Economic Co-operation and Development
PBG	Performance-Based Grant
PFM	Public finance management
PMs	Performance Measures
PRI	Panchayat Raj Institution (India)
RS	Revenue Sharing (transfers)
SDC	Swiss Agency for Development and Cooperation
SDGs	Sustainable Development Goals
SNA	Subnational administration
SNG	Subnational government
UCG	Unconditional Grant
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UP	Union Parishad (Bangladesh)
VAT	Value-added tax
VDC	Village Development Committee (Nepal)

Explanatory notes

Year N	The year for which grant allocations are being made (i.e. the next fiscal year)
Year N-1	The year in which the calculations are being made for year N (i.e. the current fiscal year)
Year N-2	The year before the year when these calculations are being made (i.e. the latest year for which tax collection data could conceivably be available, or the previous fiscal year)

Overview

Much of the public expenditure critical for achieving the Sustainable Development Goals (SDGs) – such as expenditures on rural roads, irrigation, health and education – is managed locally by subnational governments (SNGs). Due to the low own-source revenue capacity of most subnational governments, fiscal transfers from central governments are essential for making these expenditures possible and thus for making progress to achieve the SDGs. The resourcing, design and administration of the various fiscal transfer instruments, the way they are allocated across SNGs, and the way they incentivize subnational governments all matter greatly for achieving the SDGs. This report summarizes experiences in fiscal transfers in Asia and makes key recommendations.

Key recommendations:

For better resourcing of fiscal transfers:

- Support research to estimate the costs of local service delivery mandates in accordance with service standards, and use the estimation to advocate for increasing subnational budget resources
- Consider incorporating incentives in fiscal transfers for greater local revenue-generation effort

For better design of fiscal transfers:

- Make the rationale and objectives of each fiscal transfer instrument explicit, especially for revenue-sharing arrangements and Conditional Grants
- Establish clear rules for determining the overall national fiscal transfer pools
- Allocate fiscal transfers to SNGs in a predictable manner with clear criteria
- Avoid "gap-filling" or "deficit" grant transfers
- Move towards a higher share of Unconditional Grants in the mix of fiscal transfers, over time
- Avoid allocation of transfers to SNGs on the basis of existing number of staff and stock of facilities
- Use Conditional Grants sparingly, to finance service responsibilities requiring tight compliance with national standards such as health, education and social protection

For better administration of fiscal transfers:

- Signal transfer amounts to SNGs early enough to allow sufficient time for subnational budget preparation
- Give clear guidance to subnational governments on eligible and non-eligible uses of grants
- Strengthen subnational planning and budgeting capacities
- Streamline funds release procedures, reporting requirements and other treasury procedures
- Allow carry-over of funds accompanied with accountability measures

For making expenditures more equitable across SNGs:

- Ensure national fund pools for equalizing transfers (Unconditional Grants) are adequate for the task
- Beware of establishing revenue assignments or revenue-sharing arrangements which create inequities for which other transfers cannot compensate
- Take into account own-source revenues and revenue-sharing transfers when allocating fiscal transfers to SNGs
- Design allocation formulas for Unconditional Grants to ensure they are genuinely equalizing
- Link Conditional Grants to service needs and standards
- Allocate Conditional Grants based on service outputs reflecting service needs and standards

For positive performance incentives for SDG-related service delivery:

- Generally, use indicators of "process" performance for Performance-Based Grants (PBGs); use "output" indicators only for sectoral or thematic PBGs; and beware of using "outcome" indicators since the latter are very challenging or not feasible in practice
- Put in place basic preconditions for the good performance of SNGs, e.g. laws, regulations and capacity
- Conduct preliminary ground work, e.g. baseline studies, determination of reasonable standards and assessment of capacities
- Choose appropriate performance criteria, e.g. relevant, objective, verifiable, few in number and based on reasonable standards of performance
- Design PBGs with appropriate size, selectivity and simplicity
- Ensure independent and robust quality annual performance assessments, which are not too costly or complicated to be sustained
- Communicate both the process and results of PBGs to garner political support.

Executive summary

Introduction

Much public expenditure critical for achieving SDGs is managed locally by SNGs. For example, *Gram Panchayats* and *Union Parishads*, the lowest SNG tiers in India and Bangladesh respectively, are usually responsible for building and maintaining village roads and bridges, water supplies, irrigation, early education, primary education and primary health facilities, and for managing various social welfare programmes. Vietnamese *communes*, Indonesian *kabupaten* and Mongolian *soums* have similar responsibilities. The range of SDG-critical public expenditure widens further when higher-tier SNGs are also considered.

Achievement of the SDGs and advancing sustainable development requires more and better public spending by these SNGs. However well-prepared are policies and plans, the SDGs cannot be met unless these policies and plans are operationalized into locally appropriate SNG budget spending priorities, and executed so as to make the best use of scarce resources; unless investments are made into assets and these assets are sustainably operated and maintained; and unless resources are allocated and spent transparently and accountably. In addition, SDG 10 envisages that resources are allocated equitably across SNGs.

Fiscal transfers to SNGs[1] are the major source of financing for SDG-related expenditures for SNGs everywhere, and certainly in Asia.

Fiscal transfers matter for achieving the SDGs in several ways. First, and most obviously, the volume of resources transferred will determine the levels of local spending on sustainable development priorities. Second, the manner of their allocation across SNGs will affect territorial equity in spending, and hence may promote – or undermine – progress on SDG 10. Third, and less obviously, fiscal transfers often also carry various incentives (sometimes designed, but also often unintended) which can shape both the SNGs' efforts to raise local revenue and also – perhaps more importantly – SNG budget priority-setting. These incentives can directly affect the levels and quality of local spending on SDG priorities.

The flipside to this is that, in many countries, fiscal transfers can and should be significantly improved so that they better help subnational governments to work effectively to make progress on the SDGs.

Objectives and types of fiscal transfers

The primary objective of all fiscal transfers is to address fiscal gaps and supplement local spending capacity. With the exception of large, wealthy metropolitan areas, the amount of revenues assigned to and collected by subnational governments is almost always much less than the amount of public expenditures needed at the subnational level. This asymmetry is due to a combination of economic and political reasons. The basic economic reason is that, in general, the major revenue sources are collected more efficiently under central control. The political reason is that there is often central resistance to decentralize even those revenues which are better placed under local control. As a consequence, there is a vertical fiscal gap between actual and desired fiscal resources at the subnational level, which governments seek to fill through intergovernmental fiscal transfers.

The basic types of fiscal transfers are Unconditional Grants and Conditional Grants (UCGs and CGs), Revenue-Sharing (RS) Transfers, and Performance-Based Grants. In addition to the objective common to all fiscal transfers – filling the financing gap at the subnational level – different types of transfers serve different policy objectives, such as addressing horizontal inequities between provinces or

1 Fiscal transfers are made by central governments to legally constituted subnational governments to whom responsibilities are devolved or delegated. Fiscal transfers are different from the flows of resources from central government ministries to deconcentrated local branches of these ministries, though fiscal transfers usually coexist with deconcentrated flows. This paper focuses on fiscal transfers; however, some of its recommendations are also relevant for deconcentrated flows of finance to subnational administrations.

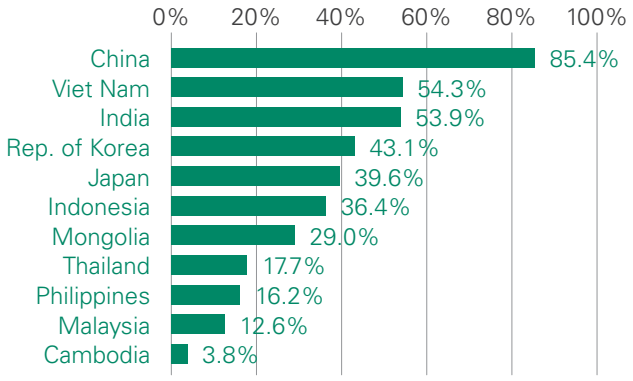
districts, encouraging local spending on national priorities, compensating some provinces and districts for spillover effects from economic activities in adjacent or upstream provinces and districts, giving incentives to subnational governments to perform better, and satisfying local political claims on land and natural resources.

Patterns and trends in fiscal transfers in Asia

There is a large diversity in Asia in the magnitudes of fiscal transfers to subnational governments. Indonesia carried out "big bang" decentralization reform in the 1990s; Cambodia, the Philippines and Viet Nam have been implementing more incremental intergovernmental policy reforms for well over a decade; while the Lao People's Democratic Republic, Malaysia, Myanmar and Thailand have opted to retain a much higher degree of centralized control over public spending. In consequence, the relative importance of subnational spending in total government expenditure varies greatly – from a mere 4 percent of government expenditure in Cambodia to 85 percent in China (OECD and United Cities and Local Governments, 2016). Figure 1 shows the share of subnational government spending – a measure of fiscal decentralization – for selected Asian countries.

Two major trends in Asia can be discerned over the past three decades.

Figure 1. Subnational government spending share in total national expenditures, selected countries in Asia, 2013



Source: Based on OECD/ United Cities and Local Governments (2016).

Over time, in some countries fiscal transfer systems have become more complicated, with a proliferation of different Conditional Grant transfers, each with their own allocation criteria and procedures, reducing – in some cases for better, but often for worse – the degree of local discretion in spending, and complicating local planning, financial management and reporting.

On the positive side, there are important trends in Asia to reform fiscal transfer systems. Some countries have moved towards establishing more stable, transparent and predictable rules-based arrangements for the financing of the allocable pools and for the allocation of transfers to individual subnational governments. For example, China has been implementing major reforms since 1994, placing transfers to provinces within a more stable and transparent rules-based framework, although there is still a way to go. In Indonesia, the Law on Fiscal Decentralization of 1999 requires allocation of a minimum of 25 percent of the Indonesian Government's national budget to subnational governments through Dana Alokasi Umum (DAU), an Unconditional Grant. India, where the fiscal transfer system is already well embedded in law, has recently embarked on a major reform of its fiscal transfer system following the 14th Finance Commission (CFC) recommendations, to both increase States' share in national revenues from 32 percent to 42 percent, and to shift the balance in local government transfers much more towards UCGs, in order to promote local discretion and leverage the benefits of decentralized decision-making.[2]

Challenges and opportunities with fiscal transfers

Better resourced, and better designed and implemented fiscal transfers are necessary for the realization of the 2030 Agenda for Sustainable Development and the achievement of the SDGs. One key problem with fiscal transfers in developing countries is that overall national budget constraints mean that they are never enough to meet local development needs – and yet, achieving the SDGs would require significant increases in investment and recurrent spending. That aside, problems related to their design and administration can also have serious knock-on effects which undermine the effectiveness, efficiency, sustainability, transparency and equitable allocation of local public spending on SDG priorities.

Better resourcing for fiscal transfers

Fiscal transfers are generally insufficient to meet the real fiscal gap, and in some cases they are woefully inadequate. This is a serious constraint on achieving local SDGs. To some extent, this inadequacy of central budgetary allocations for fiscal transfers is simply a reflection of the overall budgetary constraints faced by most Asian developing countries. But it is also often because of poor advocacy for SNG transfers in the national budgeting process – and this, in turn, is often due to lack of information about what is actually needed.

2 The recommendations are for a five-year period from 2015/2016 FY to 2020/2021 FY.

It is therefore recommended to support basic research on the service standards and delivery costs for decentralized SDG-critical responsibilities, to allow more informed advocacy for ensuring that SNG transfers receive due weight in the national budgetary process, and that the various fiscal transfer pools are resourced at levels closer to actual needs.

It is worth noting a common view that fiscal transfers promote "dependence" by SNGs and discourage local revenue effort. However, there is evidence that UCGs – when announced in good time and predictable – can encourage local revenue mobilization, so that the existence of unconditional transfers to subnational governments might in itself help increase their own sources of revenues.[3] For instance, recent data show that in Morocco, a 10 percent increase in UCGs was associated with a 6.9 percent increase in subnational governments' own revenue collection (Brun and Khdari, 2016).[4] In the Philippines, a 10 percent increase in IRA grants is associated with a 3.4 to 3.9 percent increase in fiscal efforts. In Indonesia, an increase of 10 percent in DAU grants was associated with a 1.2 percent increase of SNGs' own-source revenues (Troland, 2014; Lewis and Smoke, 2017).

Incentive issues in fiscal transfer systems

Implementing the local sustainable development agenda requires translation of policies and plans into actual budget spending priorities. Fiscal transfers can convey incentives which influence subnational governments' spending decisions, sometimes for better, but often for worse. In many countries, problems exist in all critical design elements of fiscal transfers. Two sets of incentive issues can be distinguished: issues arising from the design and issues relating to the administration of fiscal transfers.

Design issues

There are three main design elements of fiscal transfers, concerning:

1. How is the total allocable pool for this transfer instrument determined?
2. How is allocation of fiscal transfers made to individual subnational governments?
3. What is the degree of discretion allowed to subnational governments in using the transfers?

First, where the national pool is determined on an ad hoc basis, or from a percentage of only one or two potentially volatile revenues, then the size of the transfer pool may vary considerably year by year, causing unpredictability and undermining sound local budgeting. For example, in Mongolia, the Local Development Fund is very dependent on a few (mainly mining and oil-related) revenues. The decline in mineral and oil prices since 2013, coupled with the yearly changes made to the percentages of these revenues financing this Fund, has resulted in substantial yearly changes, with the backdrop of the overall decline of the national pool for these transfers. Such uncertainties make year-to-year planning and budgeting very hard for SNGs, and undermine the incentive for SNGs to take budget prioritization seriously. They can propagate "boom and bust" cycles at the subnational level – with unplanned, wasteful spending in some years, and last-minute damaging cutbacks in lean years.

Second, if fiscal transfers are allocated to subnational governments in an ad hoc manner, with no obvious criteria, the uncertainty also makes it very hard for subnational governments to establish budget priorities and target spending where most needed. A special case of this problem is seen in regard to the negotiated "gap-filling" transfers typical of many current or former socialist countries, such as the Lao People's Democratic Republic, Mongolia, Viet Nam and Commonwealth of Independent States (CIS) countries. These transfer arrangements require that SNGs first send up their spending and revenue proposals to central government, on the basis of which their "legitimate financing needs" are determined, often based on bilateral consultations by central government with individual SNGs, and the "gap-filling transfer" is approved. This encourages an inflated "wishlist approach" from SNGs and discourages any effort for local budget prioritization and hence for targeted SDG spending; it also promotes non-transparent deals and encourages patron–client relations between central and local politicians and officials. Many of these countries are implementing reforms of such "gap filling" transfers, but there are often major political obstacles to such reforms, including from subnational governments which would lose from these changes.

Where UCGs or CGs are allocated by a formula based on service delivery inputs – such as local staff or facilities (e.g. numbers of teachers or classrooms) – then this may encourage overspending by SNGs on these inputs in order to raise future transfer allocations, even where other spending priorities may be more important. To avoid such negative incentives, it is better that allocations not be made according to the stock or level of inputs, but instead

3 There is also a widely shared theoretical concern that fiscal transfers will "crowd out" local fiscal efforts, especially if the allocation formula aims to equalize allocations across SNGs by including actual SNG own revenues. However, this concern is not generally backed by evidence, especially with regard to UCGs.

4 The evidence from Morocco suggests that CGs do not stimulate own-revenue effort to the same degree as UCGs.

be made on some output-related basis (e.g. based not on classrooms or teachers, but on numbers of pupils and on the average annual cost of educating one pupil).

Third, proliferation or excess rigidity of earmarked or conditional grants can undermine the ability of subnational governments to flexibly tailor spending to local needs, although conditional grants are needed to protect critical public services which may otherwise be undervalued locally. Proliferation of Conditional Grants – or excessive earmarking – burdens subnational governments with excessive planning and reporting requirements and – crucially – limits the ability of local governments and stakeholders to tailor spending to the local context in the flexible manner that the sustainable development agenda requires.

Recommendations

- Make the rationale and objectives of fiscal transfers explicit, in order to be able to design the right transfer mechanism for the right purpose. It is especially important to be clear about the objectives of transfer mechanisms that also have downsides, such as Revenue-Sharing Transfers which typically exhibit regional inequity and volatility; and Conditional Grants which tend to proliferate, sometimes encouraged by donors.
- Establish clear rules for determining the overall fiscal transfer pools, to ensure that these pools are predictable and stable; these pools may be based on a fixed percentage of all or most national revenues, or a per capita-based norm.
- Allocate fiscal transfers to SNGs in a predictable manner, with clear criteria; phase out "gap-filling" transfers.
- Plan to move over time towards greater local discretion for subnational governments and hence a higher share of Unconditional Grants in the mix of fiscal transfers. Accompany this move with increasing capacity and accountability of subnational governments, restricting overspending on non-developmental expenditures, and providing clear guidance to subnational governments regarding the uses of transfers.
- Avoid using inputs, such as number of staff and stock of facilities, in allocating both UCGs and CGs, as this may encourage overinvestment in such staff and facilities to "game" future allocations at the expense of more important service delivery expenditures.
- While Conditional Grants will always be needed, use them sparingly, retaining a few such fiscal transfer instruments to finance devolved service responsibilities that are of high national priority and require tight compliance with national standards, such as health, education and social protection.

Administration issues

All too often, there are also incentive problems stemming from the manner in which transfers are administered.

A first issue concerns the timing of information to SNGs about their transfers in the upcoming fiscal year. In some countries, very little time is given to subnational governments to formulate their budgets after the next year's transfer amounts are announced. This leads to serious problems in deciding on spending priorities. For example, in Mongolia and Myanmar, after being informed of the size of their transfer allocations, subnational governments have only a few working days to select priority investments from the very long list of budget proposals and to finalize their budgets. The time is inadequate to do the necessary analysis or consultations to assess the merits of different spending options, as SNGs need to have a sufficient period to, for example, consult with different stakeholders and compare the costs and benefits of options. Consequently, the actual spending priorities selected in this rushed process are unlikely to be the most effective and efficient in attaining the SDGs.

A second issue concerns the actual release of funds to subnational governments. In some cases, the funds flow so slowly that subnational governments only receive transfer funds very late in the fiscal year. An extreme case is the Backward Regions Grant Fund in India, from which grants arrive sometimes at the end of the fiscal year or even one to two years late. In such cases, when funds actually arrive in the subnational government accounts, local officials will be compelled to spend funds hurriedly, often disregarding originally decided budget priorities – so that the resultant expenditures may be far from optimal in their benefits.

A third problem is related to carry-over rules. If subnational governments are not allowed to carry over unspent transfer funds into the next fiscal year, this can affect local spending. Although these rules have their rationale – to promote more efficient execution of budgetary resources – the reality is that subnational governments are often faced with serious implementation constraints due to no fault of their own. The delays in implementation are often due to funds arriving late in the fiscal year; seasonal

constrains such as monsoons in Myanmar or long winters in Mongolia, which limit investment activities in rural areas; and problems in securing suppliers and technical expertise in more remote areas. As a result of the inability to carry over unspent funds, local spending on legitimate needs and priorities is unreasonably limited. A second consequence is that this tends to introduce a bias in the budget prioritization process towards easily implementable "off-the-shelf" investments, rather than those requiring a lengthier process of preparation, but for which risk extends into the next fiscal year. A third consequence is that SNGs have little incentive to make efficiency savings in implementation, since in any event they will not be able to retain these savings for the next year, if unspent funds simply revert to the central treasury.

Recommendations

- Allow sufficient time for subnational budget preparation. Subnational governments should be informed about the amount of transfers in the upcoming year as far ahead of their budget approval deadlines as possible, to have enough time to review the fiscal envelope, and to appraise and prioritize budget proposals and options.
- Clearly communicate what are eligible and non-eligible expenditures to subnational government personnel and other local officials.
- Strengthen subnational planning and budgeting capacities.
- Streamline funds release procedures.
- Streamline reporting requirements and other treasury procedures.
- Develop robust information systems to track funds.
- Support independent expenditure-tracking research and advocacy organizations.
- Allow subnational governments to carry over funds from one year to the next, in an accountable manner, to encourage implementation efficiencies and to avoid spending in favour of easily implemented expenditures at the expense of others.

Equity issues in fiscal transfer systems

Implementing the principle of "leaving no one behind" of the 2030 Agenda for Sustainable Development and SDG 10 to reduce inequalities means that public spending should be geographically equitable across a country, while reflecting the varying needs of different localities.

Fiscal transfers comprise the major budgetary resource at the subnational level, complementing local own-source revenues.[5] The role of equalizing transfers (usually UCGs[6]) within the larger fiscal transfer systems is to promote "horizontal balance" and compensate for subnational resource disparities. To get a good picture of the level of equity in the allocation of fiscal resources between provinces and districts, all resource flows need to be considered – including different kinds of transfers from the central government, and also SNGs' own revenue streams.

Neither the overall spending per capita nor fiscal transfer levels per capita are expected to be equal across subnational governments. There are compelling reasons for differences in per capita transfer allocations between regions, such as differences in levels of poverty, or in the costs of inputs (for example in mountain areas of Nepal, the cost of cement is two to three times higher than in Kathmandu), or due to different economies of scale in service delivery between densely populated versus sparsely populated and remote regions. That aside, different SNGs will enjoy different levels of own-source revenue per capita, which should also ideally be factored into transfer allocations.

But the per capita variations should not be excessive and should reflect genuine differences in regional needs, rather than being the result of arbitrary factors. Yet it can be seen that horizontal variations in per capita fiscal transfers (which are the major determinants of variations in per capita spending) are much larger in many developing countries than can be justified by conceivable differences in need.

Such inequitable distribution of spending across provinces is due to two main factors: on the one hand, the amount of funds to be allocated as equalizing transfers is simply too small to compensate for the disparities caused by other streams of revenues to SNGs; and on the other hand, the formulae for allocation of equalization-intending transfers are not properly designed to reflect the relative needs of different SNGs. Large differences in per capita fiscal transfers between provinces may, in cases, be driven by political economy factors, while in other cases may simply remain unchanged by inertia.

5 This is in addition to the streams of deconcentrated spending through line ministries and other central programmes.

6 Unconditional Grants usually have equalizing objectives. In addition, Conditional Grants may also have narrower equalizing goals as they intend to ensure spending on specific services reflects the relative needs of the populations of different provinces or districts.

In some cases, own-source revenue assignments to SNGs or revenue-sharing arrangements with SNGs may be so large that the disparities generated by them cannot be offset by other "equalizing" transfers. Once such revenue assignments or revenue-sharing arrangements are in place, they may prove impossible to dismantle or reform. Furthermore, they may lead to ever-widening disparities.

Consequently, serious inequities can creep into fiscal transfer systems and the variation in per capita spending between provinces can be stark in developing countries. For example, in Myanmar the ratio between the SNGs with the highest and lowest total spending per capita was 12:1 in 2016/17; in Mongolia the same ratio was 6:1 for 2017 (though this rises to 14:1 in the case of social service-related expenditures); and in the Lao People's Democratic Republic for health sector spending it was 6.5:1 in 2017.[7] However, once such inequities take hold, reform can be very difficult since the SNGs which benefit from the current arrangements will oppose any move to arrangements where they will lose, as has been seen in attempts to reform similarly inequitable transfer allocations in Indonesia.

To address inequitable horizontal allocation of fiscal transfers, it is important to establish clear rules for determining allocations to subnational governments. These rules should also help ensure the stability, predictability and transparency of transfers.

Recommendations

- In the mix of transfers, more funds should be allocated via (equalizing) UCGs, to ensure that these transfer amounts are sufficiently large to equalize.
- Beware of revenue assignment or revenue-sharing arrangements creating inequities that other transfers cannot compensate for.
- The allocations should also consider own-source revenues and revenue-sharing transfers, to avoid giving large transfers to subnational governments which already receive large streams of other revenues. This requires national governments to see the "big picture" by analysing all streams of revenues received by subnational governments – whether through own revenues or through various types of transfers.
- Design equitable allocation formulas for UCGs, giving primary weight to relative SNG population size, the key driver of spending needs. The formula may also include other criteria related to needs (such as poverty, development levels, geography or composite development indices), which should be weighed by relative population. Such criteria should be simple, transparent, few in number, and based on robust, non-contested and frequently updated data sources.
- For CG transfers, allocate based on service outputs that reflect service needs and standards, based on robust, non-contested and frequently updated data.

Leveraging fiscal transfers for positive performance incentives for the SDGs

Fiscal transfers can also be designed to explicitly transmit positive incentives to promote better SNG performance for the SDGs. Historically, the focus of such incentives has been to encourage local revenue-raising efforts. This is usually done by including a variable in the grant allocation formula to provide additional resources to subnational governments with better performance in collecting own-source revenues, as seen in Mongolia.[8] However, to avoid generating inequities across SNGs, this requires appropriate baseline studies and calibration.

Recent years have seen the emergence of Performance-Based Grants (PBGs) with a broader focus, many of which were initially piloted through donor-supported programmes in Asia and Africa. These PBGs are built into existing grants (UCGs or CGs) and have explicit incentives to encourage better subnational government performance in service delivery and governance. Early lessons from implementation of such transfers show that they offer promising avenues to encourage better quality spending and service delivery for the local sustainable development agenda, although with caution and caveats.

The key characteristics of PBGs are that they are given as a reward "top up" on existing grant transfers based on the results of annual performance assessments to measure SNG performance. The assessment scores are then used to reward or sanction SNGs (by transferring more or less to them) depending on their performance.

7 By contrast, for the United Kingdom and the United States (excluding Alaska), the ratio of per capita spending between the highest- and lowest-spending regions was 1.27:1 (2015/16) and 2.1:1 (2014), respectively.

8 In the special case of (former) socialist/transition countries, subnational governments are encouraged to raise more revenue and move from budget "deficit" to "surplus", through the reward of greater budgeting autonomy and fewer *ex ante* controls and restrictions (based on forecasts rather than results. However, transfers simply to fill gaps discourage local tax or revenue-raising efforts.

Broadly, PBGs can be categorized into multisectoral PBGs and sectoral/thematic PBGs.

For multisectoral PBGs, the performance criteria are generally "process" indicators related to governance, planning, budgeting, public financial management and transparency. Such multisectoral PBG initiatives have been introduced in several Asian countries: Bangladesh, Bhutan, Mongolia, Nepal and India. Indeed, the 14th Finance Commission (CFC) in India has recommended the national rollout of a PBG mechanism, whereby 10 percent of UCGs in rural areas and 20 percent in urban areas will be allocated on a performance basis, informed by experiences in West Bengal and Kerala.

For sectoral and thematic PBGs, performance criteria are usually service delivery "output" indicators in a specific sector, although "process" indicators are also used in addition to "output" indicators. In the health sector, countries such as Argentina, Brazil, Pakistan, Tanzania and Uganda, as well as India under the 14th CFC have implemented performance-based transfers. Funds are transferred to subnational governments and then further to health service units, based on measures of both general process performance and of health service outputs delivered.[9] Ecological fiscal transfers are another type of sectoral PBGs. They have been implemented in Brazil, France and Portugal to reward subnational government performance in environmental protection, with performance measured against the size and quality of conservation measures by SNGs.

Experiences with PBGs point to many lessons in designing and implementing these transfers.

Recommendations

- Process vs Service Output or Outcome Performance: While it is tempting to link performance to service output or even outcome performance, this is very challenging and often not feasible. For multisectoral PBGs linked to UCGs, this would involve comparing very different service delivery compositions across SNGs (such variation being indeed a key rationale for decentralized decision-making). For sectoral or thematic PBGs, using "output" or "outcome" indicators of performance is possible, but requires much preliminary groundwork and can still be challenging: measuring the quantity and quality of service outputs requires a much greater, more costly and time-consuming fieldwork effort – while comparing outcomes across SNGs faces the challenge that the starting point for such outcomes will vary considerably across SNGs. Therefore, PBGs linked to output or outcome performance would require a considerable baseline study effort to calibrate rewards accordingly. In addition, many other extraneous factors come into play, outside the control of SNGs. Failure to make appropriate calibration will not provide the right rewards, and will cause inequitable allocations between SNGs.
- Ensure that basic preconditions are in place even for "process" indicators: Laws and regulations against which "process" performance is assessed should be appropriate, clear and consistent, and SNGs should be able to comply with these processes on their own initiative, independent of human or other resources outside SNG control – such as those provided by central governments or donors. Preliminary work needs to be done to determine reasonable standards and assess capacities.
- Choose appropriate performance criteria: Indicators to measure performance should be relevant, objective, verifiable and few in number. They should also be based on reasonable rather than "ideal" standards and relate to relatively recent subnational government activities (in the past two years).
- Design PBGs with appropriate size, selectivity and simplicity: It is doubtful that those (mainly urban) SNGs which have substantial own-source revenues, and for which fiscal transfers account only for a small part of overall revenues, will be encouraged to change performance by a PBG mechanism. For other SNGs, if the amount of PBGs is too small, they will not provide an incentive to improve performance (the usual rule of thumb is to calibrate PBGs to about 15 to 20 percent of the "parent" UCG or CG fiscal transfer). Similarly, if too many or too few SNGs are rewarded with PBGs, then the PBGs will also lose the ability to incentivize governments (here, the rule of thumb is to reward about 30 to 70 percent of SNGs). Lastly, the formula for PBG

9 "Outcome" measures were used in India for health transfers but were found to be inequitable, and so changed to "output" performance measures.

allocation should be simple so that subnational governments can see the link between performance and reward.

- Conduct independent and robust quality annual performance assessments: Performance assessments should be done by outsourced institutions or audit agencies. The timing of performance assessments needs to be planned carefully alongside the government budget calendar, to ensure that assessments are done in time and the results are available in time to feed into next year's transfer allocation decisions by the Ministries of Finance; time also needs to be allowed for queries and complaints by subnational governments. Care must be taken by donors not to set up an assessment mechanism so costly or complicated that it cannot later be sustained by the national government.
- Invest in capacity development of subnational governments: PBGs need to be accompanied by capacity development, especially if they aim to introduce innovative service delivery methods.
- Communicate and get political buy-in: The information about performance results and PBG allocations should be made public, for transparency reasons, to dispel suspicions of favouritism or influence in allocation of the extra grants, and also so that pressure can be put on poorly performing subnational governments by local citizens. PBG mechanisms will only work if politicians and central government policymakers back it up and are willing to resist the inevitable pressure from losing subnational governments.

1

Introduction: Putting Subnational Spending in Context

Public spending: Key for achievement of the SDGs

Progress towards achieving the 17 SDGs will be a result of wide-ranging efforts. In most cases, a key factor will be public action and, particularly, government expenditure on public goods and services. Figure 2 provides some illustrations of the types of spending which are essential for selected SDGs.

In each of these areas, not only the levels of these public expenditures but also their quality will be key to achievement of the 2030 Agenda for Sustainable Development – in other words they need to be:

- Effective: such that their sectoral composition matches local sustainable development-related needs and priorities.
- Efficient: such that budget resources are deployed to achieve the greatest output and impact.
- Equitable: such that they benefit people in a manner reflecting relative need and without discrimination.
- Sustainable: such that activities and assets can be operated and maintained so as to ensure continued generation of benefits over time.
- Transparent: such that spending is administered in an accountable manner.

Furthermore, the principle of "leaving no one behind" underlying the 2030 Agenda and, specifically, SDG 10 on "Reduced Inequalities" also require that these expenditures are geographically equitable across a country, in a manner reflecting the varying needs of different localities.

Responsibilities for many of these public expenditures critical for the SDGs are very often decentralized to subnational governments. This study does not recommend greater or lesser decentralization. Instead, it recognizes that the decentralization of responsibilities to SNGs occurs in and is shaped by different contexts. The rationale for decentralization is that at the local level, governments have better information on local needs and priorities. And there is more scope for participation and accountability, and thus people can more closely oversee public service delivery. This can lead to gains in effectiveness, efficiency, equity and transparency.

Figure 2. Examples of public expenditures needed to achieve the SDGs

Selected SDGs	Examples of local public expenditure needed
SDG 2: Zero Hunger	Social protection and employment programmes for the vulnerable Rural access roads, markets and storage Crop and livestock protection Irrigation and drainage infrastructure Agricultural research and extension
SDG 3: Good Health and Well Being	Preventive health services Primary and referral health facilities Health personnel Medicines and medical supplies
SDG 4: Quality Education	Teachers School buildings and facilities School supplies School meals Scholarships
SDG 6: Clean Water and Sanitation	Public and community drinking water supply systems Latrines Solid waste disposal Sewerage systems
SDG 11: Sustainable Cities and Communities	Public transport systems Water supply systems Solid waste disposal Sewerage systems Sanitation facilities Electrical energy power and transmission Public lighting Public parks and recreation facilities
SDG 13: Climate Action	Transport, water supply, drainage, flood protection and other public infrastructure adapted to local climate-change stress Public investments in livelihood opportunities less vulnerable to climate-change risks
SDG 15: Life on Land	Conservation of fragile ecosystems Natural resource management Watershed protection Mitigation of negative impacts of economic activity

However, the decentralization of responsibilities to SNGs occurs in very different contexts across Asia. The two important contextual dimensions which drive decentralization or the lack thereof in Asia are: (a) the political drive to decentralize and (b) the structure of subnational governance arrangements.

Political drive to decentralize responsibilities and resources

The policy commitment of the government to decentralize and the extent to which responsibilities and resources are actually decentralized will depend on political drive which, in turn, depends on deeper political factors such as (Eaton, Kaiser and Smoke, 2009, 2011):

- The nature of party politics and perceptions by the ruling party about prospects for retaining or losing control of SNGs, or gaining or losing local legitimacy
- Concerns about the integrity of the state and its territory, the risks of secession, and about accommodating ethnic groups, or other elites and interests in particular regions
- Accommodation between national and local ethnic, political, military and business elites
- The existence of an effective local government political lobby
- The extent to which macroeconomic and fiscal and budgetary considerations allow or constrain central governments' willingness to allocate fiscal resources or spending responsibilities to SNGs.

As a result of the interplay of such factors, the following can be seen:

- A strong drive by the political leadership to devolve responsibilities and resources in Indonesia, the Philippines, Viet Nam and certain Indian states
- A more reluctant inclination by the political leadership to devolve responsibilities and resources in Bangladesh, the Lao People's Democratic Republic, Mongolia, Myanmar, Sri Lanka, Thailand, and other Indian states

But these dynamics can change quickly, as politics and the political economy change. The move to decentralize in Bangladesh in the 1980s under military rule was reversed quickly in the 1990s, with the return of civilian government; the highly centralized arrangements which earlier prevailed under military autocracy in Indonesia were rapidly reversed by a decentralization "big bang" in the early 2000s, with the advent of democracy, and which still endures; and the rapid expansion of resources to SNGs in Mongolia from 2012 was abruptly halted by a national budgetary crisis which emerged in 2016, following a crash in mining revenues.

Subnational governance arrangements

Decentralization (or lack thereof) is also driven by the structure of subnational governance arrangements, specifically (a) the size of the areas governed by SNGs and the numbers of tiers of SNGs; and (b) the constitutional and legal bases for governments at the subnational level.

First, where there are larger SNG areas and/or larger populations under SNG governance, financing requirements are greater and a potentially greater range of devolved service delivery responsibilities is possible, dictated by the logic of subsidiarity, scale economies and externalities (Ferrazzi and Rohdewohld, 2015; Pritchett and Pande, 2006). Where there are multiple tiers of SNGs, as in countries such as China, India, Indonesia and Pakistan, the uppermost tiers (Chinese provinces, Indian states) often play the same role in public service delivery matters that central governments play in smaller countries. In addition, the cascade of mandates down from central government to lower-level SNGs may become much more complex and more often result in greater (unintended) inconsistencies in SNG mandates or financing arrangements across the national territory.[10]

Second, government entities at the subnational level may or may not have status and mandates vested in them by constitutions and national laws. Subnational governments – constituted in their own right – have a legal status distinct from that of central government; have an elected legislature and/or political leadership; have an executive to some degree accountable to that legislature; and have service delivery mandates and public expenditure responsibilities for which they (rather than central government entities) are politically and legally accountable. In this study, these subnational governments are referred to as SNGs. In contrast, subnational administrative entities without these powers simply constitute branches of the central administration at the local level – and hence in this study will be referred to as subnational administrations or SNAs. Only where subnational governments or SNGs are established can there be scope for devolving mandates and expenditure responsibilities, and hence for establishing fiscal transfer mechanisms to finance these mandates.[11]

10 While, of course, in federal countries, the highest-tier SNGs enjoy constitutional freedoms to define specific arrangements with their lower-level SNGs, similar asymmetries are also created in such unitary states as China and Viet Nam, where provincial-level SNGs enjoy – de facto – considerable latitude in such matters.

11 In the case of transfers to SNAs, such financing is done through internal arrangements within line ministries or central government agencies – deconcentrated flows of financing (See Box 1).

Box 1. Modes of fiscal decentralization

The decentralization of responsibilities for public expenditures may be realized through devolution, delegation or deconcentration.

Devolution or delegation to subnational governments (Mode A)

This is the case where responsibilities are mandated to a legally constituted subnational government[12] (SNG) through devolution or delegation arrangements.[13] Devolved expenditures are reflected in SNG budgets, not in the central government budget.[14] Such mandates to subnational governments should be clear, consistent, and non-duplicating, as well as adequately funded.[15]

Figure 3 provides a further illustration of some SDG-related spending mandates assigned to lowest-tier SNGs in a few countries in Asia:

Figure 3. Some devolved SDG-critical expenditures responsibilities of SNGs in Asia

Nepal *Village Development Committees*	**Bangladesh** *Union Parishads*	**Kerala State – India** *Gram Panchayats*	**Cambodia** *Communes*
– Drinking water – Primary education facilities – Primary health facilities – Village roads – Village irrigation – Pension allowances	– Rural roads, culverts – Wells, water pumps, tanks, ponds – Irrigation and drainage works – Social welfare and relief	– Pre-primary, primary and upper primary schools – Dispensaries and hospitals – Rural water supply – Waste disposal – Public toilets and bathing places – Child daycare centres	– Village roads and bridges – Village water supplies – Village irrigation – Primary school facilities – Primary health care facilities

Figure 4. SNG shares in total public expenditures, 2013

Country	SNG Share (%)
China	85.4%
Viet Nam	54.3%
India	53.9%
Rep. of Korea	43.1%
Japan	39.6%
Indonesia	36.4%
Mongolia	29.0%
Thailand	17.7%
Philippines	16.2%
Malaysia	12.6%
Cambodia	3.8%

Source: Calculations from OECD/ United Cities and Local Governments (2016)

If the mandates of higher-level SNGs in these countries (District Development Committees in Nepal, Upazila Parishads in Bangladesh, Block and District Panchayats in Kerala, and Districts in Cambodia) were also included then this would show a much larger set of total assigned SNG functions.

Figure 4 provides an illustration of the shares of national public expenditures devolved to all SNG tiers in a few countries in 2013: from a very modest 3.8 percent in Cambodia, to some 13 to 18 percent in Malaysia, the Philippines and Thailand, to 54 percent in Viet Nam and India, and to 85 percent in China.[16]

Worldwide, there is a clear trend for countries to devolve to SNGs a greater share of expenditure responsibilities as they become richer.

12 The term "subnational government" is preferable to "local government" since the latter is associated with specific institutional arrangements which do not pertain everywhere.

13 Hereafter, "devolved" responsibilities include both devolution and delegation, since the distinction between the two is somewhat fluid and a matter of degree.

14 Albeit that in many ex-socialist countries, SNG budgets may sometimes themselves be rolled up into one integrated "matryoshka" style national budget.

15 There is a set of accepted principles to aid determination as to which responsibilities are appropriately decentralized and which are not. See, for example, Ferrazzi and Rohdewold (2015). However, across Asia there are pervasive problems in the manner by which expenditure responsibilities related to the SDGs are – or are not – assigned to SNGs: responsibilities of subnational governments are often unclear or the legal and regulatory framework is contradictory; responsibilities are excessively "shared" between levels, making coordination in planning and budgeting very hard; very often the central government still retains responsibilities which would be much better handled locally; and in some cases there has been decentralization of responsibilities much better kept at the central level.

16 Of course, the significance of the SNG level in China and India – where the highest subnational tiers often themselves have far greater populations than many countries – is very different from that in most other, often much smaller countries.

Box 1. Modes of fiscal decentralization (continued)

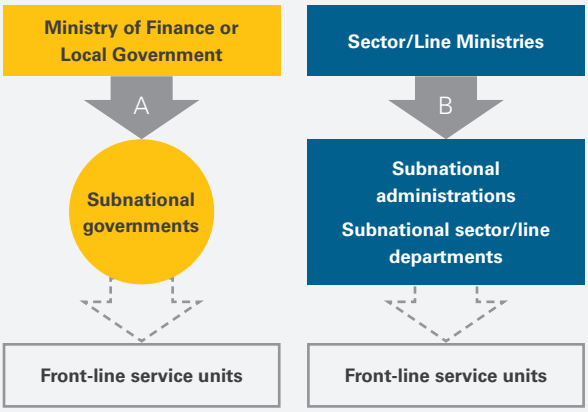
Deconcentration to subnational administrations (Mode B)

This is where sector ministries or other central agencies have deconcentrated administrative responsibility for expenditures to their subnational "branch" departments or other local agencies – subnational administrations (SNAs). Since SNAs are not legally separate entities, these expenditures are reflected in the central government budget. These deconcentrated responsibilities are financed through internal arrangements within the respective ministry or central agency.

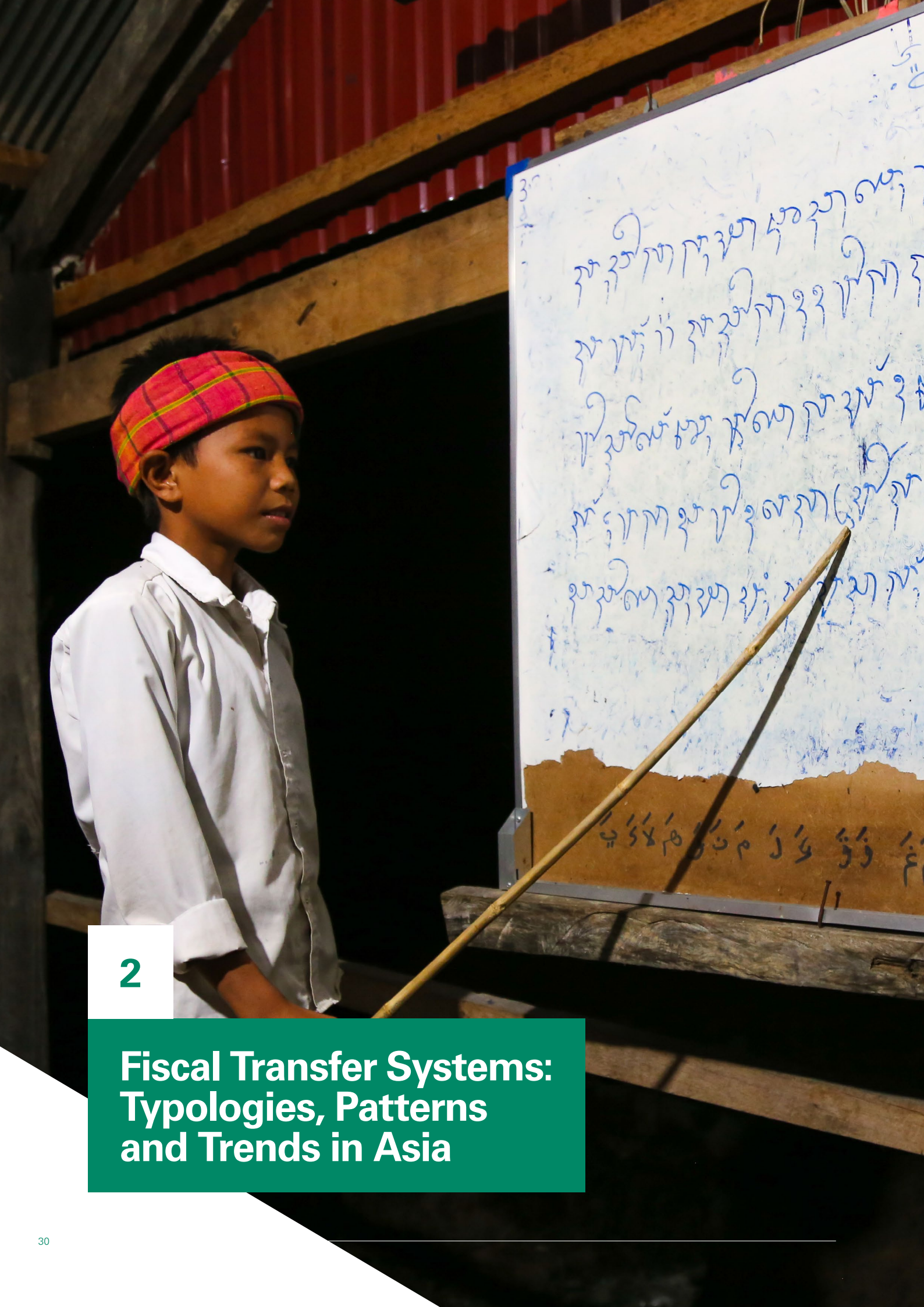
One further variant in decentralizing expenditure responsibilities is where some (usually routine) spending responsibilities are entrusted directly to front-line service delivery units such as schools or hospitals, or other entities (to be managed either by a school principal or hospital director, or by a local committee of officials and users). This decentralization may be mandated either by an SNG (under Mode A) or by a central sector ministry or agency (under Mode B), and is financed through some form of grant transfer to the facilities concerned.

Figure 5 illustrates the two different modes of decentralizing spending responsibilities.

Figure 5. Decentralized spending modes



This study focuses primarily on devolution and delegation (Mode A).



2

Fiscal Transfer Systems: Typologies, Patterns and Trends in Asia

The inevitable vertical fiscal gap

In most countries, the amount of expenditures needed at the local level is always much greater than the amount of revenues whose collection powers can be feasibly decentralized to SNGs, with the exception of SNGs in large, wealthy metropolitan areas. This asymmetry lies at the heart of intergovernmental fiscal relations. It arises both for economic and political reasons.

For economic reasons, the major revenue sources are generally more efficiently and equitably managed under central control. Politically, there is often central resistance to decentralize even those revenues which would be better placed under local control (Boadway and Shah, 2001; Prud'homme, 1995; and Schroeder, n.d.).

This asymmetry between the decentralization of expenditure and revenue-raising responsibilities is depicted in Figure 6. Figure 7 shows that subnational revenue shares in national revenues (light green circles) are consistently smaller than subnational expenditure shares in national expenditures (dark green circles).

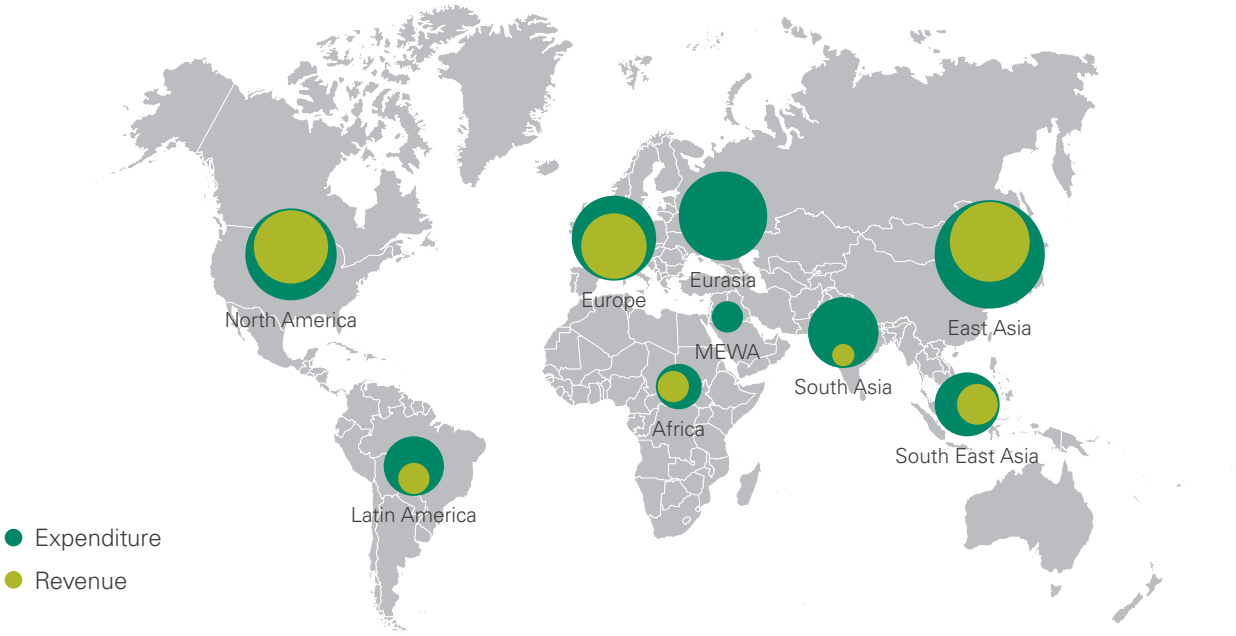
The resulting asymmetry creates a vertical "fiscal gap" for SNGs. It is this gap that central governments need to address through intergovernmental fiscal transfers (Figure 6).

Fiscal transfers usually comprise the predominant share of SNG revenues (except in large metropolitan SNGs), since own-source revenues of SNGs are typically very modest. Figure 8 illustrates the size of this vertical gap for a selection of Asian countries.

Despite showing large vertical fiscal gaps in countries, the figures in Figure 8 **actually understate** the real size of the fiscal gap. The subnational expenditures shown in this Figure are realized expenditures – those which could be financed by fiscal transfers actually provided to SNGs. But the volume of subnational expenditures ought to be generally much larger if SNGs fully carried out their decentralized service delivery mandates without financing constraints. The inadequacy of the amount of fiscal transfers is a major constraint on the achievement of the local sustainable development agenda.

Figure 6. The vertical fiscal gap

Figure 7. SNG shares of national expenditures and revenues by region



Note: While local expenditures as a proportion of public expenditure may be elevated in East Asia, Eurasia, and South Asia, this does not necessarily correlate with the existing level of decentralization.

Source: United Cities and Local Governments (2010)

Figure 8. SNG shares in total expenditures and revenues and resultant vertical gap for selected Asian countries, 2009[17]

Subregion and country	Share in total public expenditures (%)			Share in total public revenues (%)			Vertical gap: % SNG expenditures to be covered by fiscal transfers
	SNG total	Upper tier	Lower tier	SNG total	Upper tier	Lower tier	
South Asia							
India	66	33	33	33	30	3	**50%**
Pakistan[18]	na	na	na	58	na	na	**na**
Bangladesh	15	5	10	2	1	1	**87%**
Nepal	10	na	8	4	na	4	**60%**
East Asia							
China	70	20	50	40	15	25	**43%**
Japan	60	20	40	40	20	20	**50%**
Rep. of Korea	45	15	30	25	10	15	**44%**
South-East Asia							
Indonesia	35	7	28	8	5.5	2.5	**77%**
Philippines	25	11	14	10	2.5	7.5	**60%**
Viet Nam	45	30	15	35	25	10	**22%**
Thailand	10	5	5	2	1	1	**80%**

Sources: Martinez-Vazquez (2011) and United Cities and Local Governments (2010).

17 SNGs are distinguished by tier, "upper tier" being the highest level and "lower tier" being the level (or the sum of all levels) below that.

18 Pakistan data has been updated with 2017 data (Pakistan, Government of, National Finance Commission Secretariat, 2017). It shows percentage in total taxes, not total public revenues.

Objectives of fiscal transfers

Fiscal transfer mechanisms are established by central (or higher-level subnational) governments to complement SNGs' own revenues to finance local expenditures devolved to SNGs.

Fiscal transfers may serve several policy objectives. The primary objective is to provide extra resources to SNGs to address the vertical fiscal gap – the gap between expenditure needs and revenues at the local level. Transfers may also have additional policy objectives, such as addressing horizontal inequalities, encouraging local spending on national priority areas, compensating some localities for negative impacts of economic activities in adjacent ones, or to give incentives to SNGs to perform better. These policy objectives are related to various aspects of the sustainable development agenda (See Figure 9).

Figure 9. Objectives of fiscal transfers and their implications on the SDGs and the sustainable development agenda

Objectives of fiscal transfers	Relevant SDGs
To provide extra resources to SNGs to address the vertical fiscal gap	All SDGs for which subnational governments have expenditure responsibilities
To address horizontal inequalities by compensating for the differing needs and own revenues of different sub-national areas.	SDG 10, but affects most others indirectly
To encourage local spending on national priority areas which may not otherwise be given high enough priority by SNGs	Any of the SDGs for which spending risks being under-prioritised in SNG plans and budgets
To address externality or spillover effects of economic activities across SNGs, for example, by compensating one area located downstream for the costs imposed by water use or resource extraction upstream	Typically relates to SDGs 6, 7, and 11 to 15
To provide incentives for better SNG performance in local revenue mobilization, local public financial management (PFM) and service delivery	Relates to the level and quality of spending for the entire sustainable development agenda at the local level
To satisfy local political "claims" on resources (in the case of shared revenues from natural resources)	Indirectly relates to SDG 16

These policy objectives are not always clearly articulated in policies, laws and regulations establishing the transfers. The ability of fiscal transfers to meet these various policy objectives hinges on the design and administration of the fiscal transfer instruments. Inadequate design or administration or conflict with other fiscal transfer instruments can undermine these policy objectives.

Main types of fiscal transfers

Fiscal transfers can be categorized into the following main types (see Figure 10):

- **Grant transfers** are generally allocated to specific SNGs by formula, by other rules or in an ad hoc manner. Grant transfers are further classified into:
  - **Unconditional**, general, block or untied grant transfers that allow wide discretion to SNGs; or
  - **Conditional**, sectoral, categorical or tied grant transfers that allow little or no discretion to SNGs.
  - **Performance-Based Grants** are a specific type of grant transfer, given to SNGs to encourage good performance. SNGs can be given a high or low degree of discretion in using PBGs, and thus PBGs can be *unconditional or conditional*.
- **Revenue-Sharing Transfers** are allocated to specific SNGs as a percentage of fiscal revenues collected from those specific SNGs. In other words, revenues are allocated on a derivation basis – to SNGs where the revenues are derived or originate from.[19]

In the rest of this section, three broad transfer types are reviewed. Performance-Based Grants are reviewed in Section 5.

Unconditional Grants

Unconditional Grants (UCGs) are also called block grants, untied grants, general grants or Local Development Fund grants. The key policy objectives of UCGs are to provide local budget support to allow flexible financing of a general mandate and – usually – also to provide some equalization across SNGs.

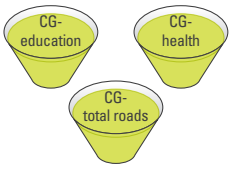
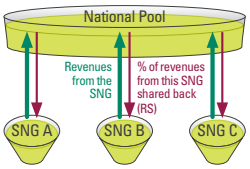
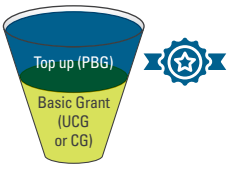
These are basic grants to SNGs which in principle allow a broad range of local expenditure discretion by SNGs. They are essential in SNG financing arrangements because (a) they provide broad budget support and thereby allow generally unconstrained local budgetary choices that can best leverage the advantages of decentralization, (b) they can, and sometimes do, play an important role in equalizing resources across SNGs, and (c) they

19 There are also transfers allocated to SNGs on principles other than derivation which are sometimes called Revenue-Sharing Transfers. However, Revenue-Sharing Transfers are, in essence, derivation-based; therefore, for the purpose of this paper, we will not consider revenues allocated on the basis of other principles as Revenue-Sharing Transfers..

are necessary for any broad participatory planning or budgeting process (otherwise, if use of revenues is fully predetermined and prescribed, there is little incentive for citizens or SNG officials to engage in lengthy discussions on intersectoral priorities and trade-offs).

UCG pools may be funded by ad hoc annual allocations in the national budget, but increasingly they are funded by a given percentage of national budget revenues. Some form of UCG mechanism can be found in most countries in Asia where SNGs are established.

Figure 10. Fiscal transfer instruments: Types, objectives and main features

	Unconditional Grants (UCGs)	Conditional Grants (CGs)	Revenue-Sharing (RS) Transfers	Performance-Based Grants (PBGs)
	Fill the fiscal gap at subnational level			
Policy objectives	Local budget support to allow flexible financing of SNG mandates	Promote spending on central priorities, and ensure adherence to central standards	Satisfy local territorial claims on fiscal revenue streams, and compensate for externalities	Promote good SNG performance: good service delivery or adherence to good governance processes
1. How the national pool is determined	 Often as a percent of fiscal revenues; the national pool is set as a common "bucket"	 Often as a percent of fiscal revenues; national transfer pools are set up as separate "buckets"	 Usually set as a percent of all or some streams of fiscal revenues, often fiscal revenues from natural resources	 Usually as a percent of or "top-up" on Conditional or Unconditional Grants
2. How allocations are made to subnational governments	Based on need or other considerations, often formula-based	Often based on service outputs or inputs to deliver services	As a percent of fiscal revenues derived from each province or district	Based on satisfactory or good service delivery or good governance performance
3. How much discretion do subnational governments have in using them	High discretion	Low discretion – funds are earmarked towards certain uses	Usually high discretion	Depends on whether attached to ('tops up') Conditional or Unconditional Grants

Box 2. Examples of Unconditional Grants in Asia

Indonesia: Dana Alokasi Umum (DAU) grants, funded by 26 percent of the national revenues.

Philippines: Internal Revenue Allotment (IRA) grants, funded by 40 percent of the national revenues.

India: Block grants to District, Block and Gram Panchayats, funded through the states, and fixed as a percentage of national domestic revenues by the five-yearly Central Finance Commissions – this percentage was recently raised from 32 percent to 42 percent of the national revenue pool.

Bangladesh: Block grants to Union Parishads – previously an ad hoc annual pool, but now funded by some 4 percent of the investment component of the national budget ('Annual Development Plan').

Myanmar: Formerly "deficit" or "gap filling" grants to states/regions in Myanmar funded on an ad hoc basis, but now funded from a stable national transfer pool, linked to GDP growth, under the national medium-term fiscal framework (MTFF).

Cambodia: Commune/Sangkhat funded by 2.7 percent of the national revenues respectively – and District/ Municipal Fund grants set initially at 0.8 percent national revenues, but set to grow steadily over time towards 1.2 percent.

Mongolia: "Deficit" grants, now from a pool established under the MTFF, and the Local Development Fund grants to aimags and soums, based on percentages of several national revenues specified (and often changed) each year. specified (and often changed) each year.

The key feature of UCGs is that SNGs are allowed wide discretion in their use. However, Unconditional Grants are never completely unconditional. Most obviously, UCGs may only be used for those sorts of expenditures which SNGs are mandated or permitted[20] to undertake by law, and are usually subject to sanctions for non-permissible use. But beyond that, there are usually other greater or lesser restrictions.

Firstly, they are often designed to encourage "development investment" spending, by partitioning or even limiting what can be spent for recurrent or administrative expenditures.

Box 3. Earmarking Unconditional Grants for development use – some examples

Nepal: Village Development Councils (VDCs) and District Development Councils (DDCs) receive a grant with two windows – one to cover capital expenditure, and one for recurrent expenditures. Note that the definitions of "capital" and "recurrent" have caused problems.

India: In Kerala, Gram Panchayats (GPs) receive a General Purpose Grant (for salaries and operating costs), a Plan Grant (for development expenditures), and a Maintenance Grant (for the upkeep of facilities transferred to GPs).

Cambodia: District and Commune grants can only be used up to 33 percent for administrative expenditures – at least 66 percent must be for development purposes.

Mongolia: Local Development Fund grants may only be used for development investments, although the regulations are somewhat unclear.

Secondly, despite their notional establishment as "unconditional" transfer instruments, they may also sometimes become increasingly earmarked over time, especially where there is no strong constitutional or legal backing for SNGs to enable them to protect their local discretion in use of funds.

This "creeping earmarking" of UCGs by central governments may often be in apparent contradiction with the legislation that first established the UCGs. It is typically a source of much frustration and complaints by SNG officials and representatives due to the constraints to budget spending.

Box 4. Creeping earmarking of UCGs by sector or beneficiary – some examples

India: In Kerala, the development grants received by rural Gram Panchayats must be spent within the following limits: a maximum 40 percent for infrastructure, a minimum 40 percent for local economic development, and a minimum 20 percent for social services; at the same time GPs must spend 5 percent of the Plan grant budget for activities benefiting children, 10 percent on women, and then a pro rata percentage for Scheduled Castes/Tribes depending on the percentage they represent of the total GP population. In Bihar, State authorities have issued instructions to GPs that the nominally unconditional Backward Region Fund grants should be used for pre-school child care/ Anganwadi centres.

Nepal: Village Development Committees (VDCs) were required to allocate 10 percent of development grants for child-related priorities, 10 percent for dalits and 15 percent for disadvantaged groups.

Bhutan: Gewogs may only use block grants for sector priority investments which have been inscribed in the national Five-Year Plan.

UCGs may be allocated to SNGs in several ways. In some cases, they are allocated to reimburse SNG expenditures; in others, allocated equally to all SNGs without regard to differences; and yet in other cases, allocated based on ad hoc central government decisions. The deficit grant transfers typical of socialist economies are aimed to fill the gap for a budgeted SNG revenue shortfall. But following recommended practice, these countries are increasingly allocating UCGs by formulas aiming to reflect the relative need of different SNGs. This move towards allocation by formula represents a profound shift in the objective of the transfer: from filling budget gaps claimed by SNGs to aiming to equalize fiscal capacities (Bird, 2002).

Issues around UCG allocation arrangements, variables and formulas and their incentive and equity implications are further discussed in Sections 3 and 4.

20 This corresponds to the important distinction between those responsibilities which SNGs are obliged to undertake, and those which they may undertake, if they so wish.

Box 5. Trends in allocation formulas used for UCGs

Myanmar: Until FY 2015/16, UCG transfers to states/regions were based on negotiations around projected SNG budget deficits – this has now been changed to a formula-based allocation with six "needs indicators" – three based on relative expenditure need and three on relative local fiscal capacity.

Indonesia: The DAU is allocated by a formula, which aims to reflect the difference between relative fiscal need, through proxy measures of expenditure, and own-source and shared revenues; but previously also included a "basic" element based on civil servants' salary costs based partly on numbers of civil servants, and partly on the projected "fiscal gap".

Nepal: After many years when District and Village Development Committee Grants were simply allocated equally, despite massive variations in populations and needs, these were changed to a formula-based allocation using population, land area, poverty index, and a construction cost index. With the recent change to a federal structure these arrangements are being changed again.

In constructing UCG formulas, a variety of indicator variables are found across Asia, which attempt to measure relative need:

- Relative expenditure need: Population size; land area; poverty headcount or incidence, or development level (inverse); population density; remoteness; service delivery costs; numbers of elected representatives, wards or villages, or other local administrative units; SNG staff numbers.
- Relative fiscal capacity: Actual or potential local revenues; percentage of population in urban areas; GDP per capita.

Conditional Grants

Conditional Grants (CGs) are also called categorical, specific, sector or tied grants. They are grants to SNGs which are restricted or earmarked in one way or another. The policy objectives of CGs are to promote spending on national priorities, ensure adherence to unified standards, and to address externalities.

Conditional Grants are allocated for specific expenditure responsibilities or other policy priorities which have been mandated to SNGs. These same expenditures might in principle also be funded by a UCG, but central governments often prefer to earmark funding through a CG transfer to encourage spending in areas which are felt can be neglected otherwise.[21]

Earmarking may be done in several ways:

- **By sector**: CGs can be earmarked by sector or by subsector, for example, to education or to primary education. They can also be earmarked by specific expenditure type, such as teachers' salaries or school improvements, or even for a specific project, such as a teachers' training facility. The specificity of earmarking of CGs ranges from the DAK in Indonesia (earmarked for investment expenditures in 19 priority sectors) to tightly specified transfers for school meals in India.
- **By theme**: CGs can be earmarked for a cross-sectoral thematic area or to finance a target programme, such as addressing climate change, promoting broad social welfare, local economic development and employment. Examples are target programme funds in Viet Nam.
- **By area**: Earmarking can be done for specific regions – areas that are economically deprived or suffering from natural disasters – such as various regional grants in Indonesia, or specific types of jurisdiction, such as constituency funds for members of parliament.
- **By beneficiary**: CGs can also be earmarked by intended category of beneficiaries, such as children, women, widows, scheduled castes and the unemployed, or as pensions to retired civil servants. Such earmarking is especially common in South Asia.

CGs may be allocated in various ways: ad hoc year-to-year decisions, or based on historic funding precedents or, as is the case now for most sector-specific CGs, by a set of norms or formula specific to the sector, which aims to reflect the relative expenditure needs for the specific sector or activity being funded by CGs.

In the case of CGs for health or education, there is often concern to ensure that service delivery expenditure patterns are consistent with central policy and service

21 Since UCGs are themselves always subject to some degree of earmarking, the distinction between UCGs and CGs is very often just one of degree.

standards and that there is little scope for local variation in them. CG transfers are therefore often allocated based on existing configurations of staff and facilities (input-related) or to measures of the actual or potential numbers of beneficiaries (output-related).

Box 6. Examples of Conditional Grant transfers in Asia

Indonesia: DAK transfers to Kabupaten for use on up to 19 priority sectors (e.g. education and infrastructure), and also based on matching arrangements

Bangladesh: Grants to Union Parishads for water and sanitation and a range of other CGs for various national social welfare and relief programmes

Nepal: Pensions and widows allowances to VDCs and a multitude of scholarship grants for dalit children, girl children, children below the poverty line, conflict-affected children, endangered janjati and highly marginalized children, or disabled children

Mongolia: CGs to aimags and soums for education, health and social welfare.

Viet Nam: Grants for an array of 16 target programmes for nutrition and family planning, vocational training, climate change, and area-specific development programmes.

India: A wide array of CGs to Gram and other Panchayat tiers, corresponding to major central government schemes, of which the main ones have been:

- National Rural Employment Guarantee Act (NREGA) – for seasonal employment on public works investments
- Sarva Siksha Sabayan (SSA) – for basic education
- National Rural Health Mission (NRHM) – for basic health
- Integrated Child Development Scheme (ICDM)
- Total Sanitation Campaign (TSC)
- National Rural Drinking Water Programme (NRDWP)

Note: Many of these CGs will be folded into expanded UCGs as the 14th CFC recommendations take effect.

Revenue-Sharing Transfers

The main feature of Revenue-Sharing (RS) Transfers is that a share of revenues collected from a particular subnational government territory is transferred by the central government to that particular subnational government where these revenues originated from. In other words, Revenue-Sharing Transfers are allocated by the principle of "origin" or "derivation".[22] Revenue-Sharing Transfers can either be tax revenues collected by the central government and shared "downwards" to SNGs, or revenues collected by SNGs on behalf of central government and shared "upwards". The main policy objectives of Revenue-Sharing Transfers are meeting local political claims over streams of fiscal revenues and/or compensating for externalities arising from economic activities in the territory of the subnational government.

Generally, SNGs are allowed broad discretion in spending shared revenues, within the bounds of their expenditure mandates. In this regard, they are similar to UCGs.

The revenue pool, which is allocated to SNGs, is usually formed by predetermined percentages of fiscal revenues. These percentages may be stable over the years or changed frequently. For example, in India, the revenue pool is set for five-year periods by the Central Finance Commission, whereas in Mongolia these are often reset in changes to the annual Budget Law. A variety of revenue sources may be shared, such as income, sales, land and property taxes.

A subset of Revenue-Sharing Transfers is natural resource-related revenue sharing. This refers to arrangements where natural resource revenues (NRR) – such as royalties, taxes and fees from oil, gas, mining, forestry or hydropower – are shared between central and subnational governments, usually on the basis of derivation, or origin. Natural resource revenue sharing is largely motivated by strong political claims made by local communities and local governments on natural resources from their areas (Bauer et al., 2016).

Revenue-Sharing Transfers, particularly of natural resource revenues, can generate serious problems. The problems can include:

- Major revenue inequities between SNGs, since natural resources may be very unevenly distributed across the national territory.

22 Revenues may be allocated to SNGs either (a) by area of revenue collection origin or "derivation", or (b) by another indicator which may be related to expenditure needs. In the latter case, Revenue-Sharing Transfers then equate to an Unconditional or Conditional Grant transfer. For consistency of terminology, from this point, the report will only consider revenues allocated by derivation as "Revenue-Sharing Transfers". Revenues which are shared through a formula or through rules or norms, rather than by derivation, are considered as grant transfers (and may be UCGs or CGs, depending on the discretion allowed to SNGs), even if they are called Revenue-Sharing Transfers.

- Major year-to-year variations in revenues for SNGs, since natural resource revenues are typically subject to large fluctuations in the demand and prices for the commodities concerned – causing boom-bust tax revenue cycles which can have extremely undesirable knock-on effects on SNG planning, budgeting and service delivery.
- Due to the difficulty in identifying the "area of origin" for certain tax revenues, areas where resource extraction take place may not receive their "due" share of transfers. The reason is that companies usually pay taxes in the SNG jurisdiction where they are registered, but which may not always be the jurisdiction where the resources are located or resource extraction take place. This is a particular problem, for example, in countries such as the Lao People's Democratic Republic, Myanmar and Viet Nam, which have just one or two special tax payment offices for large corporate taxpayers, regardless of where the corporations actually operate and where the economic activities being taxed take place.

Classifying fiscal transfer instruments

Figure 10 shows simplified typologies of fiscal transfers. More comprehensively, fiscal transfers can be classified based on three main attributes:

Box 7. Examples of Revenue-Sharing Transfers in Asia

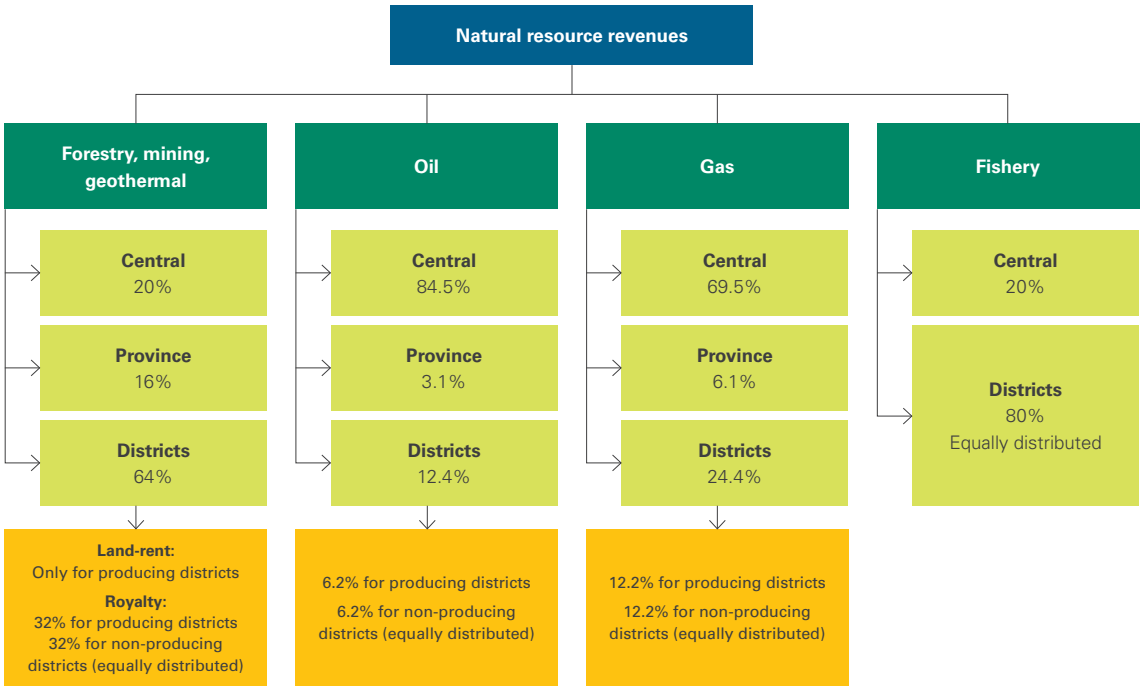
Myanmar: Currently, 15 percent of commercial and special goods tax revenues are returned to the states/regions where they were collected, although it is now planned to separate out revenues from "large taxpayers" and allocate these revenues by formula as UCGs.

Mongolia: Currently, 5 percent of domestic VAT, 30 percent of petroleum royalties, and 5 percent of mining royalties are pooled and allocated to aimags and soums by formula as part of the UCG mechanism, while another 10 percent of mining royalties[23] and 50 percent of mineral exploration fees were allocated to those aimags and soums where they were collected (by origin).

Indonesia: the Dana Bagi Hasil is a major, complex fiscal transfer instrument for allocating NRR to SNGs through a mix of "revenue sharing by origin" and "equal grant allocations", as depicted in Figure 11 (Agustina et al. 2012):

23 Excluding royalties from strategic, large-scale mines.

Figure 11. Indonesia: Natural resource revenue sharing



I. The way the national allocable transfer pool is determined
II. The way allocations from the national transfer pool are made to individual SNGs
III. The degree of discretion in using fiscal transfers by SNGs

First, the size of the national allocable transfer pool can be determined by:

- Ad hoc decisions or negotiations, made each year
- Rule-based allocation:
  - by a given percentage share of specific central revenues
  - by a given percentage share of all central revenues
  - on the basis of some "per capita" measure, where the population units may be overall population size, or the size of the specific segment of the population to be served by that transfer (e.g. for education, numbers of school-age children or enrolled students).

Second, the national transfer pool can be allocated to individual SNGs by:

- Ad hoc decisions or negotiations, each year.
- Rule-based allocation:
  - by area of tax revenue derivation (which, by definition, are Revenue-Sharing Transfers)
  - by some formula, norm or other pre-established rule
  - by equal allocations to all SNGs at the same level

Third, fiscal transfers may be used by SNGs:

- with a high degree of discretion (unconditional)
- with a low degree of discretion (conditional).

Patterns and trends in Asia

Across Asia, there is a wide variety of fiscal transfers; it is common to find fiscal transfers of mixed, "hybrid" types. For example, transfers can mix features of both Conditional and Unconditional Grants. In many cases, what started as an Unconditional Grant can increasingly acquire characteristics of a Conditional Grant. As a result, local governments might find that grants that may be named unconditional in reality cannot be used with wide discretion. Figure 12 provides an illustration of Revenue-Sharing Transfers (as shared taxes), Unconditional Grants and Conditional Grants for selected Asian countries.

Figure 12. Fiscal transfers in selected Asian countries

	Shared taxes	Unconditional transfers	Conditional transfers
Bangladesh	No major individually shared taxes	Annual Development Program Block grant is a modest programme based on a formula	Most transfers are earmarked for salaries, ministry activities, and development projects (including aid)
Cambodia	No major individually shared taxes	Formula-based commune and district block transfers; low share of national revenues; system evolving	Provinces receive line ministry allocations, not transfers; conditional transfers allowed but not widely used
India	Limited individual tax sharing (state to local varies); shared goods and services tax under development	Federal government shares with states by formula a large revenue pool; state finance commissions allocate to lower levels; federal transfers to locals go through states	Conditional transfers have been growing (most from ministries, some through major schemes); allocated invarious ways; use of Performance-Based Grants is on the rise
Indonesia	Selected taxes/state-owned enterprise revenues shares with subnational levels	Formula-based *Dana Alokasi Umum* revenue-sharing accounts by law for at least 26% of domestic revenues	*Dana Alokasi Khusus* initially limited, but funding has grown, with required matching and performance conditions
Philippines	National wealth composite (national revenues from certain bases) and tobacco excise tax shared	Internal Revenue Allotment (>90% of transfers) allocates by formula 40% of internal revenues: 23% each to provinces and cities, 34% to municipalities, 20% to *barangays*	Minor categorical but not highly conditional grants, including the Municipal Development Fund, the Local Government Empowerment Fund, and the Calamity Fund
Sri Lanka	No major individually shared tazes	Finance Commission allocates ad hoc grants to local bodies	Earmarked central transfers fund local salaries
Viet Nam	Some taxes shared fully (e.g., natural resource); others (e.g., VAT) partly	Equalization transfers fund jurisdictions if expenditures based on minimum standards exceed resources from shared taxes	Resources once provided through sectoral budget allocations (through unified budget system) now provided as conditional transfers

Source: Smoke and Kim (2003)

Mix of transfer instruments

While fiscal transfers are the dominant source of finance for expenditures by most SNGs (except in large metropolitan areas) in most countries in Asia, there is considerable variation in the mix of transfer instruments. Figure 13 illustrates these variations between countries across Asia.

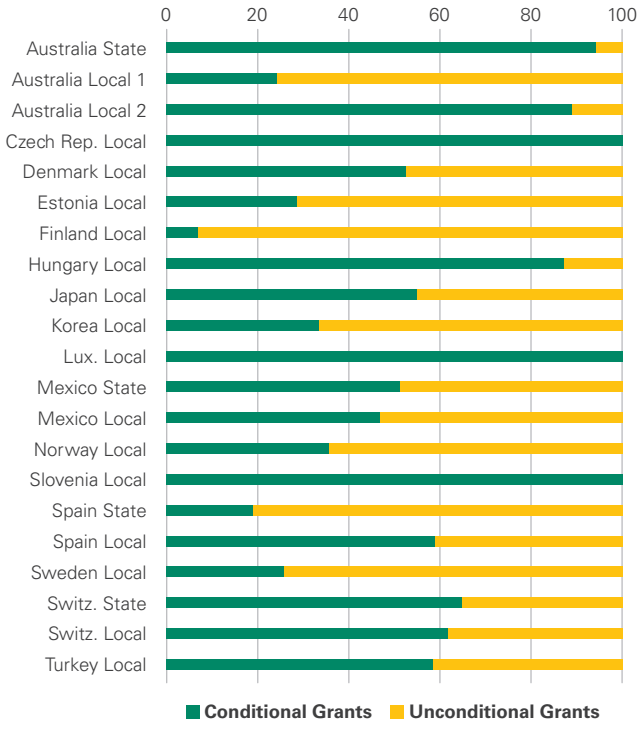
There are no obvious patterns here, other than that SNGs in wealthier Asian countries tend to have (a) larger shares of total government expenditure and (b) less reliance on fiscal transfers than in poorer countries (although even here there are exceptions to this trend: Viet Nam, where for historic reasons SNGs enjoy very substantial own-source revenues, and India, where the overall data include expenditures of the very large states which in many ways equate to what would be central government expenditures in smaller countries).

The composition of fiscal transfers also varies greatly. In Bangladesh, India, Mongolia and Thailand, the bulk of transfers are earmarked CGs, allowing little local discretion.[24] In China, Indonesia, Japan, the Philippines and Viet Nam, fiscal transfers are dominated by either shared revenues or UCGs, both of which allow much greater local discretion.

24 Although this is set to change in India with the balance shifting towards UCGs, as outlined in Box 2.

Similarly, in OECD countries, there is also a great variety in the mix of grant instruments, as depicted below:

Figure 14. Conditional and Unconditional Grant ratios for selected OECD countries, 2010



Source: OECD online intergovernmental fiscal database.

Figure 13. Patterns in fiscal transfers in Asia

Country (fiscal year)	SNG shares in total government expenditure %	Share of transfers in total SNG revenues %	Relative importance of transfer types		
			UCGs	CGs	Revenue-Sharing Transfers
Cambodia (2016)	5	93	High	None	Low (except Phnom Penh)
China (2012)	85	60-66	Low	Low	High
India (under 13th CFC)	54	90	Low	High	Medium
Indonesia (2012)	36	90	High	Low	Medium
Japan (2012)	40	40	Low	Medium	High
Mongolia (2012)	9	60	Low	High	Low (suspended)
Myanmar (2016/17)	10	80	High	None	Low
Nepal (2017, under new federal setup)	Not yet determined	Not yet determined	High	Medium	Not yet determined
Philippines (2012)	16	70	High	Low	Low
South Korea (2012)	43	40	Low	Medium	High
Thailand (2012)	18	85	Low	High	Low
Viet Nam (2012)	54	50	Medium	Medium	High

Source: Developed by authors from data in OECD/ United Cities and Local Governments (2016) and other sources.

Generally, the lack of discretion in use of fiscal transfers fuels complaints by SNGs across Asia that their hands are excessively tied in responding to local needs and priorities.

Trends in fiscal transfers in Asia

Despite great variety, there seems to be a positive trend in Asia away from ad hoc arrangements and towards increasingly rule-based arrangements, whereby

- The national transfer pool is based on a specified share of some or of all national revenues, rather than annual ad hoc decisions
- Allocations from the national pool to individual SNGs are made according to technical norms or to a formula, rather than being made on an ad hoc basis or equally.

Multi-tier SNG systems

In some countries there are several SNG tiers: in India – states, districts, blocks and village (*gram*) levels; in China – province, county, township commune and village levels; in Indonesia – provinces, *kabupaten* or *kota*, *kecamatan* and *desa*. At the other end of the spectrum is Bhutan with two SNG levels (See Figure 15).

Figure 15. Subnational government and administrative tiers across Asia

Country	Population (millions)	Government system	Subnational levels of government and administration
Bangladesh	168.9 (2015)	Unitary	Rural local: *Zila Parishads* (districts, 64); *Upazila Parishads* (subdistricts, 510); *Union Parishads* (4,550); Urban local: city corporations (11); *pourashavas* (municipalities, 315); Hill district authorities (3)
Bhutan	0.7 (2012)	Unitary	*Dzongkhags* (districts, 20) and class A *thromdes* (self-governing municipalities, 4); *Gewogs* (blocks, 205) Chiwogs (villages, 1044) and small *thromdes* (municipalities under district administration, 16)
Cambodia	15.7 (2015)	Unitary	Provinces (23, including 3 municipal) and capital; Districts (159) and municipalities (26); Communes and *sangkat* (municipal communes,1621) divided into villages
China	1,402 (2014)	Unitary	Provinces (31) and Centrally administered Cities (4) Counties (2,852) [incl. County-level Cities (345)] Townships (41,034) [incl. Towns (9,660)] Villages (662,393)
India	1,295 (2014)	Federal	States (28) and Union Territories (7) Urban areas: Municipal Corporations (205) and Municipal Councils (877) Other areas: District, Block and Gram Panchayats (> 250,000)
Indonesia	256.0 (2015)	Unitary	Provinces (34, of which 5 are special regions) Local governments: *kota* (cities, 98) and *kabupaten* (regencies, 410); *Kecamatan* (districts, 6,543) *Desa* (villages, 75,244)
Mongolia	3.027 (2016)	Unitary	*Aimags* (21 incl. capital city Ulaan Baatar) *Soums* (333) *Baghs* (1,602) hamlets or wards, as administrative units within the Soum
Nepal	31.6 (2015)	Changed from Unitary to Federal	Previously: District Development Committees (75) Urban: Municipalities (191) Rural: Village Development Committees (3,276) Now: Provinces (7) Local Governments (753)
Pakistan	209.7 (2014)	Federal (new in 2015, details emerging)	Provinces (4) and Territories (4) Districts (*Zillas*, 96) Tehsils (337) Unions (6,022)
Philippines	101.0 (2015)	Unitary	Provinces (79) Cities (112) Municipalities (1,496) *Barangays* (villages, 41,944)
Sri Lanka	22.1 (2015)	Unitary	Provinces (9) Urban: Municipal Councils (large urban, 23), Urban Councils (small urban, 41), Rural: *Pradeshiya Sabhas* (rural, 257)
Viet Nam	94.3 (2015)	Unitary	Provincial level: Provinces (58) and centrally controlled municipalities (5); District level (700): Provincial cities/urban districts, towns and rural districts; Commune level (> 11,000): townships, communes (rural) and wards (urban)

Source: Developed from table in Smoke (2015).

Different arrangements can be seen in the cascade of fiscal transfers down from tier to tier in these countries. A few clear patterns can be discerned:

Uniformity vs diversity:

- In federal states, the upper SNG tier generally has a degree of constitutional freedom to define its fiscal relations with lower-level SNGs, and consequently to determine its own specific fiscal transfer arrangements. Consequently, differing patterns are found between Indian states and Pakistani provinces in transfers to lower-tier SNGs. Here, lower-tier SNGs may receive both transfers determined at the federal level and also at the higher SNG tier level (states or provinces). Consequently, countries with a federal system of government tend to have greater variations in fiscal transfer arrangements to lower-tier SNGs than most unitary states.
- By contrast, in most unitary states, like Indonesia, Myanmar and the Philippines, these arrangements are standardized nationwide by national policy and legislation, with allocations determined by central government.
- However, some unitary states such as China and Viet Nam also display a remarkable degree of variety in arrangements, and in that regard appear almost federal; Mongolia, another unitary state, also allows the higher SNG level (*aimag*) a large degree of flexibility – within given parameters – in the allocation of UCGs to the lower SNG level (*soum*).

Range and mix of transfers

- Grant Transfers: As a rule, since higher-tier SNGs tend to be assigned a wider range of expenditure responsibilities than lower-tier SNGs, they usually receive a wider range of transfer types. Lower-tier SNGs tend to have much more modest expenditure responsibilities and may not undertake significant staff-related recurrent budget spending, and so may often only receive a basic UCG, primarily for investment spending.
- Revenue-Sharing Transfers (by derivation): Revenue-Sharing Transfers can be made to SNGs at all levels. However, such sharing is administratively easier to SNGs at higher levels, since tax revenue offices are often only located at these levels, and there may be no easy basis for any further downward sharing by area of derivation to lower-level SNG areas. However, if a revenue-sharing arrangement is made in response to strong local political claims from lower-tier SNGs, transfers may be made to this tier, even if not optimal.

Channeling of transfers

There are broadly two models for channeling central funds to SNGs:

- Single treasury system: This is a system where SNGs rely on subnational treasury offices under the authority of the central Ministry of Finance, where each SNG will have a sub-account, to which transfers are channeled by the central treasury office – either directly or via the treasury offices of higher SNG levels – and to which SNG authorities submit payment requests. In Asia, this system is found typically in socialist or transition countries, and countries which have inherited a public financial administration model from France or Portugal.
- SNG bank accounts: This is a system whereby SNGs are allowed to open their own bank accounts in a private or state bank which they operate themselves, and to which transfers are channeled by the central treasury office either directly or via the accounts of higher-level SNGs.

Some patterns in fiscal transfer mechanisms

In discussing country patterns in Asia, it is instructive to examine three special cases: those of India and China (because of their sheer size) and that of countries with a history of socialist economic management.

The case of India

Fiscal transfer arrangements in India are complex, especially due to the federal setup, where over 250,000 SNGs (Gram Panchayats) are located in 29 states and 7 Union Territories, each of which has some latitude to define and adjust its own financing arrangements. For many years, there were three broad types of fiscal transfers:

- Transfers mandated by the Central Finance Commission, a body appointed by the President for a five-year term, responsible for defining Union-State sharing of tax revenues and special grants to states with particular needs.
- Transfers issued by Union (national government) ministries as CGs for various national sector programmes – central government-sponsored flagship schemes. For many years, there has been a trend for the Union to allocate ever-greater resources to such transfers ("grants-in-aid") for an ever longer list of central schemes, which SNGs are mandated to implement. As a result, UCGs allocated to SNGs have been dwarfed by a complex array of CGs.
- Transfers mandated by the now defunct Planning Commission – usually various grants for investments ("Plan" spending). In contrast, "non-Plan", recurrent budget management typically remains much more

with the central government or with the state level. This reflects a longstanding Plan vs non-Plan dichotomy in India.[25]

However, reforms are underway in these fiscal transfer arrangements, following the recommendations of the recent 14th Finance Commission (India, Government of, 2015).

- The Plan vs Non-Plan distinction is being phased out, so transfers for capital and recurrent budget expenditures will be better integrated.
- There is now a large increase in the shareable pool from the federal Union to states – increased from 32 percent to 42 percent of Union revenues.

The balance will move towards a greater share of UCGs, and reduced volume and number of CGs; a larger proportion of UCGs will also be directed towards the lowest level SNGs – Gram Panchayats (See Figure 16).

- UCGs themselves will be structured into basic UCGs (90%) and a top-up UCG (10%) to be allocated based on SNG performance – to be dependent upon audit results, local revenue collection, and benchmarking of local service delivery.
- Formula allocations will also use more recent population data, from the 2011 census – until now, the 1971 census has been used.

These changes have emerged from concern expressed by the 14th Finance Commission that SNGs have been both underfunded and have been increasingly diverted from focus on their core service mandates due to the proliferation of CGs and the underfunding of UCGs.

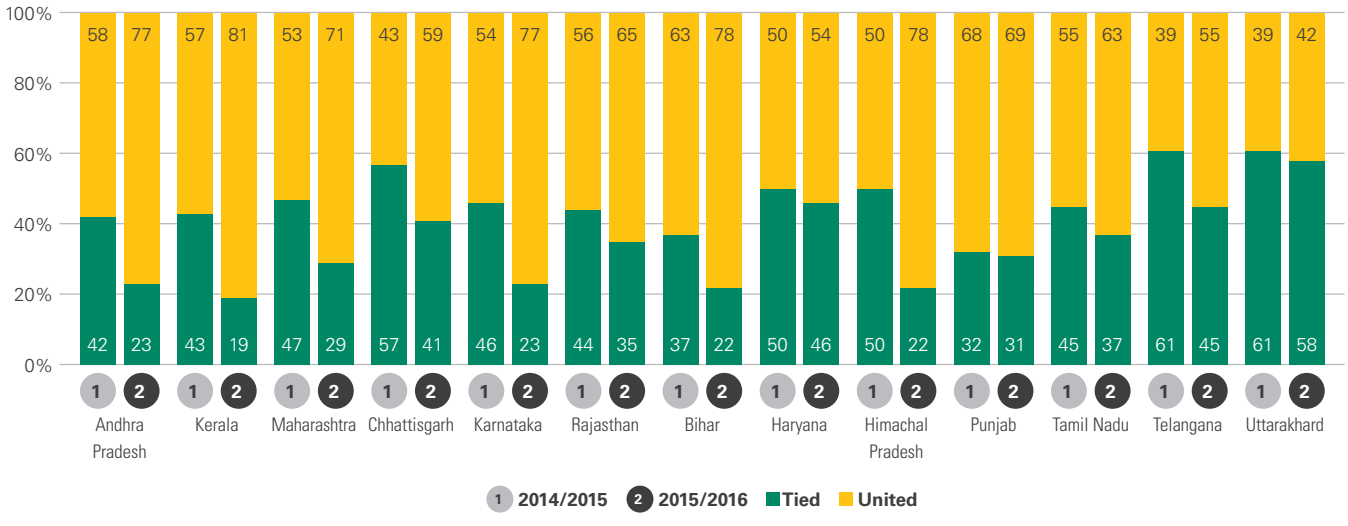
The case of China

In 1994, tax-sharing reforms were launched to address mounting problems in intergovernmental fiscal relations, based on very complex and annually changing negotiated revenue-sharing arrangements between central and provincial governments. These reforms aimed to clarify and regulate subnational expenditure and revenue assignments, and to establish more stable, equitable and rule-based fiscal transfer mechanisms. As a result, a new system of centre-to-province fiscal transfers was introduced, comprising:

- Unconditional Grants: Various grant instruments allocated in different ways to all or selected provinces:
  - General purpose grants aimed at horizontal equalization, allocated by formula based on a complex set of "normalized" expenditure and revenue variables
  - Various grants to compensate for the abolition of various commercial, agricultural and market fees and taxes, earlier levied by provinces

25 This is also seen elsewhere across South Asia, and also in the Lao Democratic People's Republic. This reflects a tradition of economic management which separates "Plan" activities (development project investments) from "Finance" activities (revenues and administrative and recurrent expenditures). Whereas the former activities are overseen by Ministries of Planning or Planning Commissions, the latter are overseen by Ministries of Finance. There is therefore an institutional divide between the subnational PFM and corresponding fiscal transfer arrangements for investment (Plan) and recurrent (non-Plan) expenditures. This has also led to a proliferation of separate Plan and non-Plan transfers. Typically, decentralization of spending responsibilities has been mainly on the Plan side, and so fiscal transfers to local government have been generally for investment expenditures.

Figure 16. India: Significant increases in untied funds available to states from FY 2014/15 to FY 2015/16



Source: livemint.com analysis of Indian state budgets

    - Tax rebate grants aimed to compensate provinces which would otherwise lose from the reforms, over a period of years, but which have now greatly declined in size.
- Conditional Grants: A large number of earmarked grants to finance specific programmes, address emergencies, or stimulate local development in different sectors. Many of these grants are provided on a matching basis. These also include various grants to minority regions (funded from the central government share of VAT revenues) and transfers to poorer provinces to supplement civil servant salaries to enable provinces to comply with national remuneration standards. As of 2013, there were about 220 CGs, although the aim is to reduce the numbers. There are widespread concerns that the large number of CGs poses considerable administrative burden on provinces, and that the matching arrangements sometimes encourage alignment of the same local revenues in creative "multiple matching" arrangements.
- Revenue-Sharing Transfers: A substantial number of revenue-sharing arrangements (primarily on sales and value-added taxes) between the centre and provinces were still left in place.

Fiscal relations between provinces and local governments (counties and townships) have been largely left to individual provinces to define, resulting in a wide variety of expenditure and revenue assignments and transfer arrangements across the country, more typical of a federal than a unitary state.

Although there is agreement that these reforms have created a more stable and transparent framework, there are still concerns over both public spending disparities between provinces and, especially, between local governments, and the negative effects of the complexities of fiscal transfers (Liu, Martinez-Vazquez and Wu, 2014; Program, 2010; Wang and Herd, 2013; and Wong, 2000).

The case of the "socialist intergovernmental finance paradigm"

In countries which had a history of socialist economic management (in Asia, these are China, the Lao Democratic People's Republic, Mongolia, Myanmar, Sri Lanka and Viet Nam), significant similarities can be seen in the intergovernmental fiscal arrangements they have inherited (Bahl, 2000; Dabla-Norris and Wade, 2006; Ebel, Wallich and Bird, 1995; and Martinez-Vazquez and Boex, 1999).

Revenue sharing by derivation between central and subnational governments has historically been the most important form of fiscal transfer. These arrangements can be especially complex, as in the Lao People's Democratic Republic and Viet Nam, and also inequitable. In contrast, formula-based UCGs and CGs grant transfers are relatively recent introductions in these countries.

- Subnational governments are frequently classified according to whether they are "deficit" or "surplus" SNGs. "Deficit SNGs" are those where the sum of own-source revenues and transfers is not enough to cover their expenditures, while in "surplus SNGs", they are usually sufficient. "Gap filling" or "deficit" grant transfers are then provided on some negotiated basis to partly fill the gap. SNG recipients of such transfers are then subject to tighter controls and enjoy less discretion than surplus SNGs. There is ample documentation that this mechanism is replete with many negative incentives which undermine local budget priority-setting and revenue raising, is inequitable, and promotes non-transparent patronage relationships between different levels of government.
- It is also common that the budgets of each level are nested, in "matryoshka" fashion – which leads to the need for a much more lengthy and cumbersome budget preparation and approval process and timetable for subnational governments.
- Lastly, it appears common that the expenditure responsibilities of different levels are often shared, so that is not clear which level of government is responsible for what, which also entails negative incentives.

Fiscal transfers in Asia: General conclusions

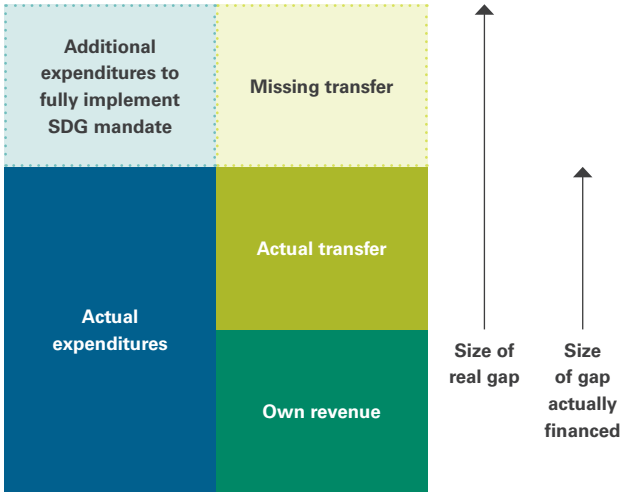
Fiscal transfers are essential for the implementation of the sustainable development agenda at the local level. Indeed, given the large mismatch between subnational expenditures and revenues throughout Asia, SNGs heavily rely on various fiscal transfers. However, there are a number of problems in these fiscal transfer arrangements across Asia (Martinez-Vazquez, 2011; Smoke and Kim, 2003; and White and Smoke, 2005).

Persistent inadequacy of resources

The volumes of resources budgeted for SNG transfer pools are generally inadequate. Given the critical nature of most of the devolved services at risk of underfunding, this will be a serious constraint on achieving local SDGs. To some extent, this inadequacy of central budgetary allocations for fiscal transfers is simply a reflection of the overall budgetary constraints faced by most Asian countries. But it is also a result of two other factors:

- First, the typically weak advocacy for SNG budget interests – as compared to that for central sector ministries and national programmes – in the very competitive national budget allocation process.
- Second, a lack of cost estimates to determine the volume of resources that SNGs would require to properly fulfil their service delivery expenditure mandates, due simply to lack of basic "groundwork" research on service standards and delivery costs – in other words, the size of the real vertical fiscal gap is often an unknown.

Figure 17. The real funding gap at the subnational level



There is scope for much more research on the costs of decentralized mandates related to the SDGs and for much greater "informed advocacy" at the national level.

Moreover, even the budgeted levels of transfers are sometimes not fully released to SNGs. This may be due to one or more of the following reasons:

- The actual central revenues allocated to the national pool are less than those estimated in the original central government budget – which itself may be due to an unforeseen economic downturn or to bad revenue forecasting, or both
- National budget priorities change in the course of the year (this is more of a problem where the arrangements for financing the national transfer pool have not been specified in law)
- The central government is simply unable to approve the release of all the budgeted transfers within the fiscal year, due to SNG capacity, reporting or related treasury blockages

All these problems have an undesirable impact on SNG budgeting and service delivery, as will be seen in Section 3; they may also encourage problematic and even illegal revenue-raising, often off-budget, or borrowing by SNGs to offset the shortfall, as in China. In the Lao People's Democratic Republic and Viet Nam, SNG authorities, in order to cover the shortfall in fiscal transfers, sometimes enter into opaque arrangements with local contractors whereby the latter pre-finance investment projects on the understanding they will be reimbursed later on, opening the door to possibly undesirable and untransparent arrangements.

These problems result in insufficient fiscal resources at the subnational level – because of the overall inadequacy of fiscal resources in the country, and because of multiple bottlenecks and failures in the process of budget release and execution – and undermine the level and quality of service delivery crucial across the SDGs.

... but greater stability and predictability

On the positive side, some countries have made efforts to guarantee stable sources of revenue for fiscal transfer pools. Improved stability and predictability of fiscal transfers to SNGs is conducive to better service delivery at the subnational level.

Some examples of more predictable transfers include:

- The Internal Revenue Allotment (IRA) mandated by the Local Government Code (1991) of the Philippines, for example, shares 40 percent of gross national internal revenues to SNGs.
- The Dana Alokasi Umum (DAU) in Indonesia represents a minimum of 25 percent of the Indonesian Government's national budget as required by Law No. 25 of 1999 to fiscal decentralization.
- Following the 14th Finance Commission recommendations, the Indian government has increased from 32 percent to 42 percent the share of Union (federal) domestic revenues to be transferred to the state governments, to allow them in turn to finance transfers to the Panchayati Raj Institutions.

Growing complexity of fiscal transfer systems

In many countries, SNGs receive multiple streams of transfers. This complexity can create two major problems:

First, the profusion of transfers, each with its own targets, conditionalities and reporting requirements can create problems for the SNGs:

- Complicating and compartmentalizing SNG planning, budgeting and budget execution processes
- Often undercutting the scope for the sort of flexible, local context-driven budget choices which are the very reason for decentralizing expenditure responsibilities in the first place
- Opening scope for interference by central officials and politicians
- Creating a huge monitoring and reporting burden on SNGs and on the central government departments charged with oversight, which does not always add any value
- Undermining participation of citizens in planning and budgeting, which limits opportunities for "whole of society" engagement in advancing the sustainable development agenda

Second, a multiplicity of fiscal transfer instruments, which are not well coordinated and monitored at the centre, can lead to substantial disparities between SNGs in the total resources available to them. This is detrimental for achieving the ambition of the 2030 Agenda for Sustainable Development of "leaving no one behind" and for SDG 10 on reducing inequalities.

3

The Incentive Effects of Fiscal Transfers

Overview of incentive effects

All fiscal transfer instruments implicitly convey certain incentives which influence SNG decisions positively or negatively, even if it is not always the policy intent.[26]

Fiscal transfers may exert incentives on local revenue-collection efforts, and on local budget prioritization and spending decisions. Both areas will directly impact on the local SDG agenda – the local revenue-collection efforts affect the volume of resources for local spending, while

26 Where transfers are explicitly designed to encourage better SNG performance, it can be expected that these transfers carry positive incentives, though they may be more or less effective. These explicitly designed performance-based fiscal transfers are explored in Section 5.

Box 8. Conventional concerns about the undesirable effects of fiscal transfers

There is a concern in the abundant academic literature on public finance, public choice and political science that fiscal transfers have possible undesirable effects on the recipient SNGs (Bird, 2000; Eyraud and Lusinyan, 2011; Rodden, 2003; Spahn, 2012; and Weingast, 2009). The most common such concerns are:

- **Reduced local fiscal effort**: SNGs will reduce efforts to collect own-source revenues, in light of the political and administrative costs associated with these, such that transfers are a substitute rather than additional resources.
- **The common-pool or "other people's money" effect**: Generally, when spending is financed through transfers, SNGs will not fully internalize the costs and tend to overspend.
- **The "flypaper effect"**: SNGs receiving transfers will tend to spend more than they would if spending were financed solely by local tax revenues, because local officials prefer larger budgets, thus leading to higher than optimal public spending (i.e. transfers are supposedly "stickier" than local revenues).
- **Soft budget constraints**: SNGs will tend to overbudget and overspend if they believe that central government will provide fiscal transfers to bail them out.
- **Weakened local accountability and governance**: The more SNG spending is financed by fiscal transfers rather than by tax revenues collected locally, the weaker will be the ability of, and the efforts by, local citizens and local taxpayers to press for accountability of their SNGs, and the weaker will be the quality of local governance.

However, many of these concerns are largely theoretical and not always empirically well-tested; they are mainly focused on the United States; and often stem from an ideological bias against "big government".

With regard to local revenue-collection efforts, for example, research shows rather a "crowding-in" than a "crowding-out" effect of fiscal transfers, even where allocation criteria are not linked to local fiscal effort. For example, in Morocco, a 10 percent increase in UCGs was shown to be associated with a 6.9 percent increase in SNG own-revenue collection, in the Philippines, a 10 percent increase in IRA grants with a 3.4 to 3.9 percent increase in local fiscal effort; and in Indonesia, a 10 percent in DAU grants was associated with a 1.2 percent increase in SNG revenues (Brun and Khdari, 2016; Lewis and Smoke, 2017; and Troland, 2014).

On the whole, such concerns with the undesirable effects of fiscal transfers are not of obvious relevance for developing country contexts, where the issue is often inadequate public spending by SNGs.

local budget prioritization and spending processes affect the manner in which policy and planning priorities get translated into public spending.

SNG budget preparation and execution processes are the crucial "last mile" in the implementation of SDG-related policies and plans. At the end of the day, any policy or plan can only be implemented insofar as they are reflected in annual budget spending priorities. In other words, if SNG budget and expenditure outcomes are to advance the local sustainable development agenda, it is necessary, but not sufficient, that sustainable development policies and planning procedures generate appropriate sets of spending proposals. It is the quality of the capital and recurrent budgeting procedures, and the explicit or default priority-setting arrangements within them, which determine the quality of the expenditure priorities, which in turn determine the quality of the public services delivered.

Local budget prioritization and spending decisions

Most obviously, the conditions placed on how transfers must be spent, especially for CGs, constitute an overwhelming incentive for SNGs to spend those funds in the designated manner, or else face the sanctions for failure to comply.

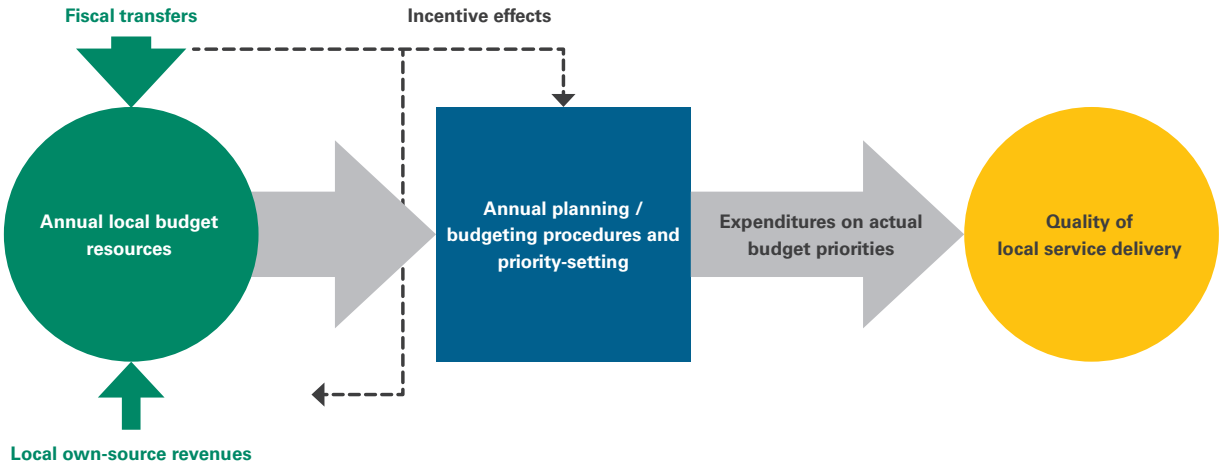
Another key, but less obvious, incentive issue lies in the extent to which such conditional financing crowds in or crowds out spending in specific areas, in other words, whether SNGs use these resources to **substitute** for spending that they would have undertaken anyway or, alternatively, to **complement** that type of spending such that it increases in total.

Depending on how such incentives play out, the overall pattern of budget spending by SNGs may differ from the pattern of spending if there had been no such restrictions on the use of fiscal transfers. In other words, the restrictions may reflect central priorities more than those of the SNGs.

That aside, the nature of the transfer arrangements may also shape the extent to which SNGs feel they face a "hard budget constraint", and hence the extent to which they have an incentive to make serious budget priorities at all.

Furthermore, the rules which govern how SNG budgets are to be executed, how procurement is to be managed, and how expenditures are to be reported may also carry incentives and thereby shape expenditure patterns. For example, rules can favour fewer modifies larger investment sizes for which procurement might be simpler, rather than more modifies smaller, more dispersed investments which are harder to implement; or they can affect the efficiency with which funds are managed by SNGs.

Figure 18. Transfers: The two areas where incentives may impact the sustainable development agenda



In exploring these incentive effects, it is important to relate them to the specific features of fiscal transfers. Some of these features lie in the explicit transfer policy design, but others simply emerge, by default, through implementation. In either case, they can carry positive or negative incentive effects for the local sustainable development agenda.

Incentive effects of design features of fiscal transfers

The three key design attributes of fiscal transfers were introduced in Section 2:

IV. The way the national allocable transfer pool is financed
V. The way allocations from the national transfer pool are made to individual SNGs
VI. The degree of discretion in using fiscal transfers by SNGs

Each of these design attributes of fiscal transfers may affect local SDG spending.

Determination of the national allocable pool

Here, the key issue lies in how the national pool for each transfer instrument is determined each year. Where the national pool is determined on an ad hoc basis, then the size of the pool may vary considerably year by year.

In consequence, allocations from the pool to individual SNGs will also vary and will be hard to predict. Insofar as such transfers are a major revenue source for SNGs, this will make the annual budgeting exercise very difficult and may undermine efforts to make any serious budget priorities. Further, it will also make medium-term planning very hard for SNGs and undermine efforts for more strategic multi-year spending plans.

This volatility will be greater still where the national pool is determined as a percentage of only one or two revenues, rather than from the entire national revenue base which is inherently more stable. The volatility of the total allocable pool is particularly large if they are tied to revenues from other economic activities subject to world market fluctuations, such as the mining of minerals, oil and gas. Where this annual volatility is extreme, the incentive effects can be especially undesirable. In "boom" years the high revenues can encourage wasteful showcase spending simply to use the funds; while in "bust" years, the SNGs may have to renege on commitments and cut back on essential services. All of this undermines efficiency and effectiveness. In Mongolia in boom years, the generous social spending undertaken by aimags and soums encouraged an influx of migrants from elsewhere, but then in later bust years, this spending had to be drastically cut back, causing serious social problems (Bauer et al., 2016).

Recommendations

Where the national pool for UCGs or CGs is rule-determined, this helps ensure stability and predictability over the years. In consequence, SNGs can undertake medium-term planning and can take the annual budget priority-setting process more seriously. More stable and predictable transfers can be achieved through several options:

- *Setting the national pool size as a percentage of all national revenues or some revenue streams. There are examples of good practice in this regard in Asia: in Cambodia, 2.7 percent of national revenues finance the Commune/ Sangkat Fund; in the Philippines, 40 percent of national internal tax revenues finance IRA grants to all SNGs.*
- *If stability and predictability of fiscal transfers is a preferred objective, it is preferable to set the national transfer pool as a percentage of all or several relatively stable streams of fiscal revenues, rather than one or two volatile revenue streams. Also, avoid making revenue-sharing transfers a sizeable proportion within the overall mix of fiscal transfers to SNGs.*
- *Setting the size of the national transfer pool at an absolute level over the medium-term period, by embedding this within medium-term fiscal frameworks, as in a number of countries in the region: Bangladesh, Myanmar and Viet Nam. In consequence, SNGs are faced with a predictable year-to-year revenue stream from the transfer(s), and so are encouraged to undertake medium-term planning and to take the annual budget priority-setting process seriously.*
- *Setting the national pool size on an absolute "per capita" amount, as was initially done in Bangladesh for the Union Parishad grants – the so-called "capitation-based" principle. This is stable, but may be less buoyant and lag behind other public spending.*
- *Stability and predictability is greater still if these arrangements are formally embedded in law, as in Cambodia, India, Indonesia and the Philippines. Determination of the transfer pool on an annual, ad hoc basis should be avoided, as in Mongolia.*

Horizontal allocation across subnational governments

A key issue is how national grant transfer pools are allocated across SNGs and what are the possible incentive effects in these arrangements (the equity impact of these allocation arrangements is examined separately in Section 4). It should be noted that in horizontal allocation, the debate tends to focus on allocation formulas. However, formulas are only one among several features of fiscal transfers.

Non-formula-based allocations

Ad hoc allocations. Where grants are allocated with no obvious criteria, the resulting uncertainty in the amounts to be received will make it impossible for SNGs to establish budget priorities within known resource availability ceilings. This tends to undermine the SNG budget process. In addition, ad hoc allocation lacks transparency.

Equal allocations. This way of allocations may encourage local political elites to press for the break-up of SNGs into separate SNG units, in order to receive the "guaranteed" grant transfer. There is some suggestive evidence from Nepal, where for many years, Village Development Committees (VDCs) were allocated equal-sized grants for many years. Consequently, the number of VDCs grew from 3,157 to 3,915 by 2015, of which many have small populations numbering in the hundreds only, too small to be viable units. This incentive effect also applies to formula-based grants which include a substantial "equal share" component.[27]

Gap-filling grant transfers. This grant allocation method is typical of many socialist and transition countries. The central government reviews SNG initial revenue and expenditure budget proposals and then negotiates transfers to partially cover any gap. Gap-filling fiscal transfers are replete with well-documented negative incentives (Bird, Ebel and Wallich, 1995; Dabla-Norris and Wade, 2006; Martinez-Vazquez and Boex, 2001; Shotton, Yee and Oo, 2016):

- The lack of a clear *ex ante* budget constraint encourages SNGs to overplan expenditures and discourages them from making hard budget priorities.
- At the same time, these transfers discourage local fiscal efforts by SNGs since the greater the negative gap they can demonstrate, the greater the size of the transfer they hope to receive.
- Moreover, they tend to encourage non-transparent deals and patron–client relations between central and local politicians and officials.

Formula-based allocations

Formula-based allocations for UCGs are comprised of indicators to measure expenditure needs and sometimes also indicators of relative fiscal capacity and fiscal performance. The needs can be either general spending needs, in the case of UCGs, or sector-specific spending needs, in the case of CGs.

Expenditure need indicators aim to reflect the factors driving relative spending needs, such as population

27 Many in Uganda claimed that the more than doubling in number of districts after they were created in the 1997 Local Government Act is due to this feature of the grant allocation formula.

Box 9. Lao People's Democratic Republic: Negotiated deficit transfers

These problems are exemplified in the subnational budgeting process in the Lao People's Democratic Republic. Since the gap-filling transfer system does not allow any advance indication by the Ministry of Finance to provinces and districts of their next year's budget ceiling, each subnational level tends to prepare an annual budget proposal which is far more than can be financed and where priorities have not been determined. As a result, the budget proposals submitted by provinces may be several times larger than the size of the budgets approved by the Ministry of Finance. Then the cutting down of the wish list into expenditures to be funded and those to be excluded is undertaken by the Ministry of Finance in hurried meetings, based on little or no knowledge of the real local needs and priorities in the provinces and districts. The process ends up with real budget prioritizing not done at the local level – where local context knowledge and information reside. This practice of budget priorities emerging from a central cutting back of local wish lists is common in countries following the negotiated gap-filling system.

size and the poverty rate (these formula indicators are discussed in more detail in Section 4).

There is a concern expressed that this may lead to "gaming" by SNGs. For example, if the formula is calibrated to increase allocations to SNGs with higher incidence of poverty, then SNGs may be encouraged to adjust their data to get more funding. Firstly, in large or federal countries, like China or India, where first-tier SNGs may have some of these data-collection responsibilities, such opportunities may exist. Secondly, certain CGs, for example for health or education, may be based on service-specific data such as enrolled students or numbers of beds, which are reported by SNGs or even lower levels, which again may offer some opportunities for gaming.

However, such concerns are generally not founded, since most indicators used do not allow for manipulation, such as land area or remoteness indicators; or use indicators such as population and poverty, collected by central government statistical or similar agencies, rather than SNGs. That aside, even if data manipulation were possible, it is questionable whether SNG representatives and officials would see it worthwhile to risk worsening their "image" in the eyes of local citizens and the central government in order to attract marginally more funding.

A more serious incentive concern lies in allocation formulas which use the **stock of existing facilities or personnel** as a measure of relative expenditure need. In Indonesia, the Unconditional Grant, DAU, is allocated partly as a function of numbers of SNG staff. There is evidence that this has led to more-than-optimal budgeting for staff, at the expense of SNG services (Lewis and Smoke, 2017).

This issue applies especially to **CG allocation formulas**. For example, for a long time in Viet Nam education grants were allocated to provinces according to the number of school facilities, and health grants according to the number of hospital beds. There was evidence that this encouraged SNGs towards more-than-optimal spending on accumulating these facilities, rather than on recurrent expenditures, to the detriment of service delivery. Currently in Viet Nam, education grants are now allocated on an output basis – based on the size of the eligible student population, weighted by differing regional cost factors[28] (Martínez-Vázquez, 2005 and World Bank, 2015b).

Local revenue (fiscal capacity) indicators aim to reflect relative fiscal resources enjoyed by different SNGs, so that UCG transfers can be calibrated to favour SNGs with weaker fiscal capacities and greater expenditure needs. However, in the case of own-source revenues, there is some concern that such measures can create undesirable incentives and discourage local fiscal efforts.[29] For this reason, instead of actual revenues collected, proxy measures of local revenue capacity (or fiscal capacity) are sometimes used, rather than actual revenues collected.[30]

Revenue-Sharing Transfers are also taken into account in some UCG allocation arrangements (for example in the DAU allocation formula in Indonesia, and in the "clawback" system in Myanmar)[31], but in some other cases are not (e.g. Mongolia). Since Revenue-Sharing Transfers are collected by the central government or its local tax revenue offices, rather than by SNG officials, it is unlikely that factoring in actual shared revenue numbers into the estimation of UCG transfers would discourage the shareable-revenue collection effort, so undesirable incentives are not likely to apply here.

Fiscal performance indicators. Lastly, there are some countries, such as Mongolia, where UCG allocation formulas include measures of SNG fiscal effort, whereby SNGs that more efficiently raise revenues from their given tax revenue bases are rewarded with a higher UCG allocation.[32] This is a potentially important use of positive incentives, to mobilize extra resources for SNG spending on the local sustainable development agenda, although the evidence on impact is limited. The scope for more generally introducing such positive incentives into grant allocations is explored in Section 5.

28 Although health grant allocations are still made on an "input" basis of factors such as health facilities and numbers of beds.

29 Although the evidence is very mixed on this, and many studies actually suggest a positive impact of transfers on local fiscal efforts.

30 However, there are also problems with such "fiscal capacity" proxy indicators. One commonly used indicator is SNG "GDP per capita" but: (a) this is very often much more related to the relative volume of central government revenues collected in different SNG areas than to SNG own-source revenues; and (b) subnational GDP indices suffer from considerable statistical unreliability. The more sophisticated option is to use a "representative tax system" approach. However, this approach is complex and requires a large investment in nationwide baseline research on SNG revenue bases and collection efforts, and regular updates to these, and in fact is undertaken in very few countries other than Canada, where it was first introduced.

31 "Clawback" is an arrangement whereby the estimated shared revenues to be transferred to different SNGs are deducted when computing their formula-based UCG transfer allocations.

32 It should be noted that there is often some confusion between the very different approaches based on fiscal capacity vs based on fiscal performance.

Recommendations

A move from ad hoc, equal or gap-filling allocations to allocating transfers by clear norms or by a formula is clearly highly desirable. In constructing allocation formulas, it is important to:

- *Ensure that where possible both own revenues and shared-revenue transfers are factored into the allocation formula of UCGs (through clawback arrangements). However, where these revenues are actually collected by the SNGs concerned, there is a risk that clawback arrangements undermine local fiscal effort incentives by penalizing those SNGs that have done well in collecting revenues.*
- *In practice, the effect of clawback arrangements on reducing local revenues is often overstated. In the case of own-source revenues, explore opportunities to embed proxy measures for tax-collection efforts in the formula, rather than actual taxes collected, as incentive to greater collection effort. However, this requires a baseline study of tax bases and potentials.*
- *Avoid allocating UCGs or CGs on the basis of the stock of inputs, such as staff and facilities, which will encourage SNGs to overinvest in these facilities or staff. In the case of sector CGs, allocations based on service delivery output (for example, the number of school-age students to be schooled times the average cost per student) provide more positive incentives for efficient service delivery.*
- *Since Revenue-Sharing Transfer arrangements are inevitably inequitable, clawback arrangements can be considered, whereby Revenue-Sharing Transfers to SNGs are taken into account before determining the allocation of Unconditional Grants to SNGs.*

Matching arrangements

Some fiscal transfers require SNGs to provide matching financing for specific types of expenditures. Typically, this feature applies to CGs aiming to encourage expenditure on specific sectors or services.

These arrangements may either be open-ended or with a cap on the maximum size of the transfer, and they may include either advance SNG budget allocations or reimbursement of SNG expenditures already undertaken.

One of the few such instruments with evidence of incentive effects is the DAK in Indonesia, which provides grants to selected SNGs to promote capital investment spending in several sectors on a matching ratio of 10:1, where for every 10 rupiah of transfers, SNGs are required to mobilize 1 rupiah in own revenues. The evidence suggests that this has leveraged far more than required by the matching condition, and that for every 10 rupiah of transfer an additional 12 rupiahs of SNG revenues were mobilized (Lewis and Smoke, 2017). This appears a positive finding, but it needs two important qualifications:

- If a matching grant is provided for expenditures that SNGs intend to finance anyway, at least to the level required by the matching ratio, then there will be no real leverage incentive effect to change resource allocation and expenditure patterns.
- Conversely, the incentive to pull in more matching transfer resources may encourage SNGs to draw budgetary resources away from other SNG priority areas.

Lastly, matching grants do allow for the possibility of "gaming". Where there are several matching grant transfers and where SNGs are only required to show *ex ante* budget intentions rather than provide *ex post* proof of expenditure, then it may be possible to "satisfy" matching requirements for several transfers with the same fungible own-revenue resources or with other UCG transfer resources. This problem has been documented in China and is also faced by very many donor-funded programmes which required "counterpart" contributions.

Recommendations

In establishing matching grants it is important to:

- *Ensure that the ratio is not an incentive to draw SNG funding away from other equally important spending areas.*
- *Ensure that "matching funds" are defined in a way which precludes scope for "gaming", where SNGs are able to match several transfers with the same own-resources.*

Discretion in use of fiscal transfers: Discretionary or earmarked?

This is the major policy feature of any transfer instrument: whether the transfer allows SNGs wide discretion, as is the case with most Revenue-Sharing Transfers and UCGs, or whether centrally determined priority areas of expenditure are hardwired as eligible uses of the transfer through earmarking, as with CGs. The greater the earmarking, the greater are the conditionalities in the permitted use for the transfer.

The rationale for such earmarking or conditionality lies in the view that **otherwise** SNGs may be inclined to underspend on the areas in question. Where transfers are earmarked, there is therefore an overwhelming incentive[33] for SNGs to spend those funds in the designated manner, **or else** face the sanctions for failure to comply.

As seen in Section 2, almost all fiscal transfer systems comprise some mix of earmarked CGs alongside more discretionary UCGs and revenue-sharing instruments, although the balance varies greatly between countries.

It is not possible to draw *a priori* blanket conclusions about the advantages or disadvantages of incentive effects inherent in discretionary versus earmarked transfers for the local sustainable development agenda, since this policy choice is intimately linked to the specific context. Whether imposition of earmarking is positive or negative for the sustainable development agenda depends on which set of priorities is more appropriate for local socio-economic development:

- On one hand, if transfer use conditions reflect a central expenditure blueprint which does not recognize variations in local context or which precludes desirable local flexibility, then this would have a negative effect.
- On the other hand, if, without such restrictions, SNGs are tempted to undervalue certain national priorities, or undermine service standards, then earmarking would be positive. To take two examples:
    - For UCGs, if there is no earmarking of part of the transfer for "development" expenditures, then SNGs may find it hard to resist local pressures to spend resources on basic administration costs beyond optimal levels.
    - For CGs for education, if there is no earmarking of funds for school meals or for in-service teacher training, then SNGs may be tempted to neglect these, and focus too much on more politically appealing school-building investments.

Nonetheless, certain conclusions can be drawn as to both the disadvantages and the merits of imposing conditionalities on fiscal transfers.

Excessive conditionalities

While earmarking – or conditionality – may be necessary for some types of transfers, a transfer system dominated by CGs may have two undesirable effects for the sustainable development agenda.

Rigidities. Firstly, the local sustainable development agenda requires substantial flexibility of spending between and within sectors, to allow tailoring of overall policies and plans to specific local contexts. An excessive degree of earmarking in the overall transfer system can limit – or even prevent altogether – the sort of discretionary choices that UCGs are able to make, and the budgetary flexibility they enjoy. The benefits of decentralization are considered to stem from better local knowledge about local needs and realities, and the ability to adapt spending priorities accordingly. In other words, excessive earmarking is likely to undermine the local sustainable development agenda.

Rigidity in fund use through excessive earmarking will undermine this flexibility, and hence the effectiveness and efficiency of local spending. One example of this is seen in countries (such as Bhutan, the Lao People's Democratic Republic and Viet Nam) where public investments must be consistent with those outlined in the five-year plan, perhaps prepared several years earlier – precluding local ability to respond to unforeseen emergencies or opportunities which arise in the short term. Another example is seen in Indonesia, in the DAK grants. These are earmarked for investment spending, especially for capital budget expenditures. There is some evidence that SNGs are encouraged to invest in new facilities, even where rehabilitation of existing facilities is needed more and represents a more efficient use of funds, simply because the latter may not always qualify as "capital" expenditure (Lewis, 2013; Lewis and Smoke, 2017). Similarly in Mongolia, the emphasis that Local Development Fund grants be used only for capital budget expenditure has encouraged SNGs to make infrastructure investments which they cannot then sustain in the long run since they are not able to make the corresponding recurrent budgetary allocations for the operation and maintenance of existing facilities (author, personal field observation).

An extreme case of this rigidity is seen in the problems faced by SNGs in India. Figure 19 illustrates how Indian

33 The strength of the incentive to spend accordingly will be dependent on the perceived likelihood that the central government will indeed monitor use of the transfers, and exert sanctions in case of non-compliance. In this regard, there is considerable variation between countries in the degree of supervisory control and sanction.

SNGs (even in states with the most advanced devolution policies) have been faced with transfer flows dominated by an array of highly conditional or tied grants, before the recent reforms of the 14th CFC were introduced.

Figure 19. India: Conditional versus Unconditional Grants at the state and PRI levels

India – State and PRI Level	Transfers per capita – 2014/15 (Rupees)	
	UCG untied funds	CG tied funds
Kerala		
Gram Panchayat	257	970
Block Panchayat	0	379
District Panchayat	0	28
Karnataka		
Gram Panchayat	97	488
Block Panchayat	68	3,311
District Panchayat	34	2,249

Too many local planning procedures. Secondly, a plethora of earmarked transfer funds encourages or even obliges SNGs and communities to engage in separate planning exercises for each of the funds, through various sector-specific community group and committee arrangements. This undermines the overall integrity of SNG planning and budgeting, and thus the general effectiveness and efficiency of spending; it may also simply lead to "participation fatigue".

This is also a problem faced by SNGs in India, which have often had to organize parallel community-planning arrangements for the large number of centrally sponsored programme grants in sectors such as water and sanitation, education and health (Government of India and Tata Institute 2015).

Too many local reporting requirements. Thirdly, since each CG is associated with its own specific reporting requirements on the use of funds and fund-request procedures, a proliferation of CGs may add to the administrative burden not only on SNGs, but also on sector ministries and on treasury officials administering the different fund flows, without necessarily adding much value in resource allocation effectiveness or efficiency.

As noted earlier, the undesirable effects of an excessive number of CGs in India were recognized by the 14th CFC and the transfer system is now being reformed to consolidate the multiple CGs into single UCG transfers which allow much greater local discretion. It is too early to determine the impact of these reforms (Centre for Global Development, 2015; Rao, 2017).

Excessive discretion

Conversely, excessive discretion can also be problematic. SNGs may face local pressures to make budget priorities which do not always fully match local developmental needs, especially where local planning and budgeting capacities and accountability mechanisms are weak. Specifically, there may be in-built bias to spending on the local administration staff and facilities.

For this reason, limitations are frequently placed on the use of UCGs (as in Cambodia, Mongolia and Kerala state in India) to ensure that a minimum part will be spent on development rather than administration. By contrast, in Indonesia, where there has been no such limitation on the use of DAU grants, there is some evidence of excessive spending on administration (Lewis and Smoke, 2017).

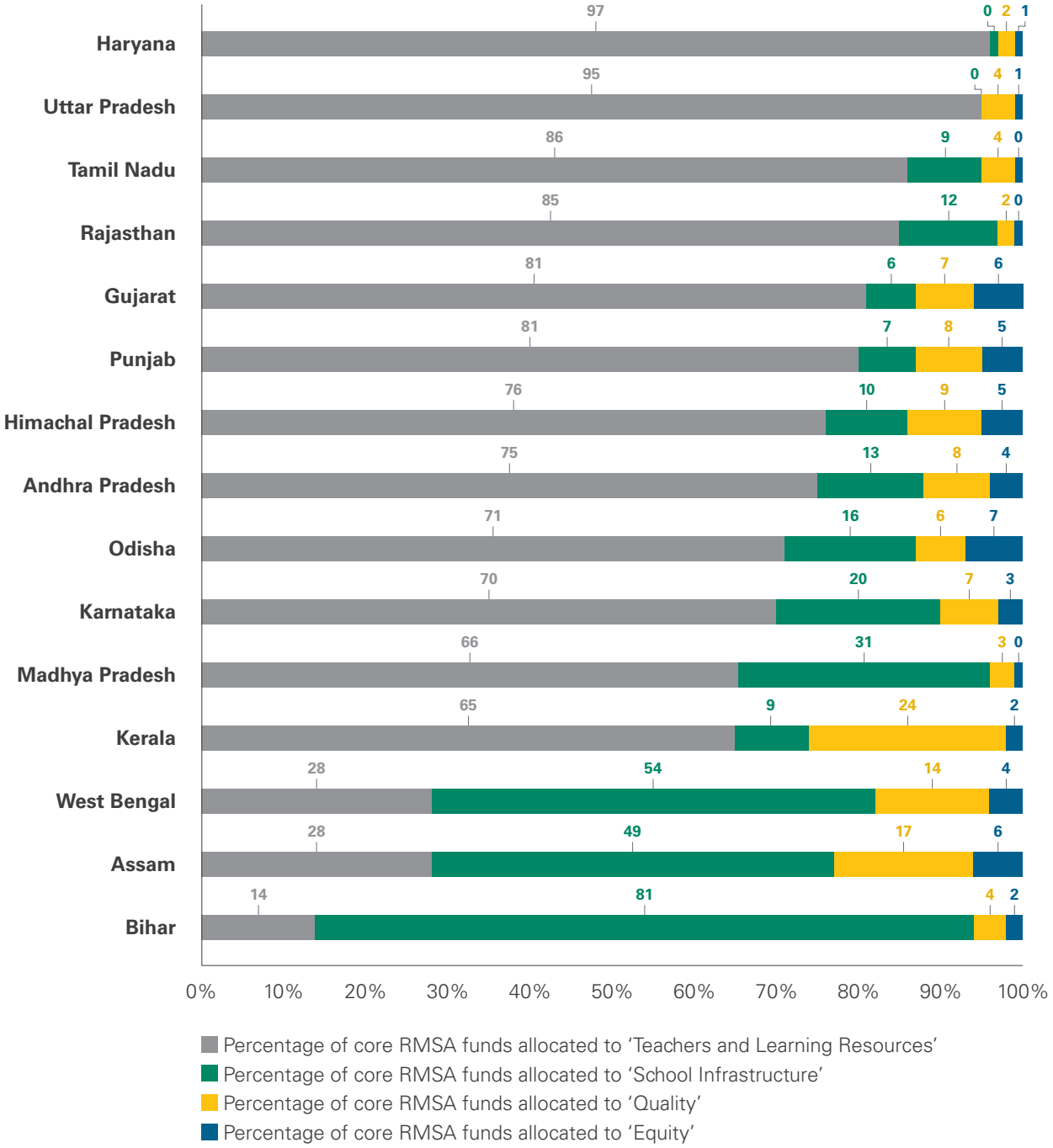
Similarly, where there is no clear earmarking by expenditure component for CG transfers for key sectors such as education and health, there can be a risk of excessive variance in spending patterns which can undermine national service quality standards, if there is insufficient guidance to SNGs. The Indian experience is instructive – the extreme interstate variance in component expenditure for secondary education CGs raises questions, although it can perhaps partly be justified by different state contexts (See Figure 20).

Guidance and clarity

Lack of clarity and detailed guidance in regard to what is and what is not eligible under the broadly stated conditions can distort budgetary decisions – this applies primarily to CGs but also in some cases to UCGs. For example, in Mongolia, the ambiguity in the regulations – the lack of clarity around the eligibility menu for LDF grant expenditures – has encouraged some SNGs to avoid investing in health and education facilities.[34] Local officials fear that these are off-limits and that they may incur negative audit reports and sanctions, even though some other SNGs have made such investments without sanction (author, personal field observation).

34 Some regulations seem to imply that LDF funds may not be used to invest in facilities belonging to sector ministries, but elsewhere this seemed to have been a possibility.

Figure 20. India: Differing spending patterns in use of Secondary Education Grants, 2017/18



Note: RMSA – Rashtriya Madhyamik Shiksha Abhiyan scheme for secondary education
Source: Accountability Initiative and Centre for Policy Research (2018).

Where there is a lack of clarity or consistency around budget accounting categories, it may distort development spending in favour of capital spending, and may preclude those legitimate recurrent budget expenditures, such as engineering design and supervision services, or non-salary operations and maintenance, which are often an integral part of any "development investment".[35] There is evidence that the conditions attached to the LDF grants in Mongolia have had these undesirable effects where SNGs have been wary of undertaking certain expenditures for fear of audit sanctions for improper use of UCG funds (author, personal field observation).

35 There is widespread tendency to conflate "development" with "capital" expenditures. But most development investments also require various recurrent expenditures (such as engineering services, transport and fuel) if they are to be properly implemented. This banal accounting confusion can seriously undermine the effectiveness of development spending.

Recommendations

There are good reasons for some fiscal transfers to be tied to specific types of expenditures. However, some general recommendations can be made:

- *In regard to UCGs, there is good reason to set administrative and development spending limits, to provide incentives for more efficient administration, and to ensure a minimum level of development spending.*
- *For sectors such as education or health, which are critical for the SDGs, some degree of earmarking should be done through CGs, according to different components of the services, such as staff-related costs, various non-staff operating costs, and investment costs, to ensure the right balance in expenditures.*
- *However, overall, more local discretion is preferable, to ensure that the advantages of decentralizing SDG-related mandates to SNGs are not undermined by putting strict limits on local budget priority-setting. Thus, it is advisable to minimize the proportion of conditional transfers, or at least to ensure that, for example, sectoral CGs allow a degree of discretion in allocating resources between and within sectors critical for the sustainable development agenda.*
- *Where it may be necessary to introduce spending conditions: (a) these should be kept as few and as simple as possible; and (b) there should be a strategy to gradually relax these over time, as SNG capacities and accountabilities are built up, and as central authorities feel reassured that SNGs are able to implement national policy priorities.*
- *Lastly, detailed guidance should be given to SNGs about the conditions of use of transfers provided – both the "positive" and the "negative" menu of legitimate spending options.*[36]

36 Here, a "positive" menu is the list of options for which spending is allowed, while the "negative" menu is the list for which spending is not allowed.

Incentive effects of administration of fiscal transfers

Fiscal transfers can have incentive effects for the local sustainable development agenda not only through their explicit policy design, but also through the procedures and practice of their administration.

Timing of allocation announcements

It matters at what exact point in their budget cycle SNGs are informed of the amount of the fiscal transfer they will receive in the upcoming fiscal year. Where SNGs are not informed until **after** they have finalized their budget and determined their budget priorities then this can lead to serious problems affecting the budget prioritization process:

- Inadequate time, leading to a lack of incentive to seriously review spending options in a long list of budget proposals, and to determine the optimal, affordable priorities in light of the total known budget resource ceiling. As a consequence, when transfer funds are finally announced and arrive, they are spent on priorities which may be formulated at the very last minute and have not been subject to proper review and comparative vetting.

  Before the nationwide PFM reforms in 2015, in Myanmar, similar to other countries with "gap-filling" transfers, SNGs were only informed of their transfers after submitting first draft budget proposals. But even now, with the move to an advance announcement to SNGs of their grant transfer amounts, they still have only some 7 to 10 working days. Similarly, in Mongolia[37] lower-level SNGs (soums) also have only one to two weeks between being informed of the upcoming UCG (LDF) grant size, and having to finalize their own budget. In both cases, this means that the task of appraising and prioritizing some dozens of affordable budget priorities from hundreds or even thousands proposed has to be done in an impossibly short space of time. This restricts the technical analysis and the consultation needed for budget prioritization. As a result, there is every reason to believe that the budget priorities actually selected do not reflect those which are most effective and most efficient in attaining the SDGs.
- There is a further undesirable knock-on incentive effect in such countries. Where SNGs are not informed of the budget ceiling in advance, it is impossible for SNG authorities, in turn, to transmit budget ceilings either to SNG departments or to authorities at lower

37 In general, the budget timetables in socialist transition countries where SNG budgets are approved inside national budgets all appear to provide little time for SNG authorities for key steps in the process.

levels. This means that in the annual bottom-up planning and budgeting process, an excessively large volume of proposals is generated, because originating departments or lower levels of administrations have no incentive[38] to screen and eliminate options from the long lists, and to identify priority proposals **before** they are submitted to SNG authorities. In consequence, SNG authorities receive an overwhelmingly long, unfiltered set of proposals which have to be appraised and prioritized to determine what to include in or exclude from the budget, making it an even harder exercise in the very short time allowed.

- In the specific case of countries where gap-filling transfers are provided, SNGs have clear incentive to generate inflated sets of expenditure proposals, and underestimated revenue projections, in order to present the greatest deficit possible and thereby game the system to attract a greater transfer.

Funds release process

The arrangements for actual release of funds down to SNGs and the associated nature of treasury and reporting requirements for SNGs to access these funds can be problematic and have undesirable results in some countries.

In some cases, the fund flow route is so slow that SNGs only receive transfer funds very late in the fiscal year. Two examples from India illustrate the issue: an extreme case is the Backwards Region Grant Fund, from which grants are reported as arriving sometimes right at the end of the fiscal year or even well into the following fiscal year, in other words, one to two years late. Less extreme but still serious are delays registered in allocation of health and education CGs through the treasury system. Figure 21 shows fund transit delays for health CGs.

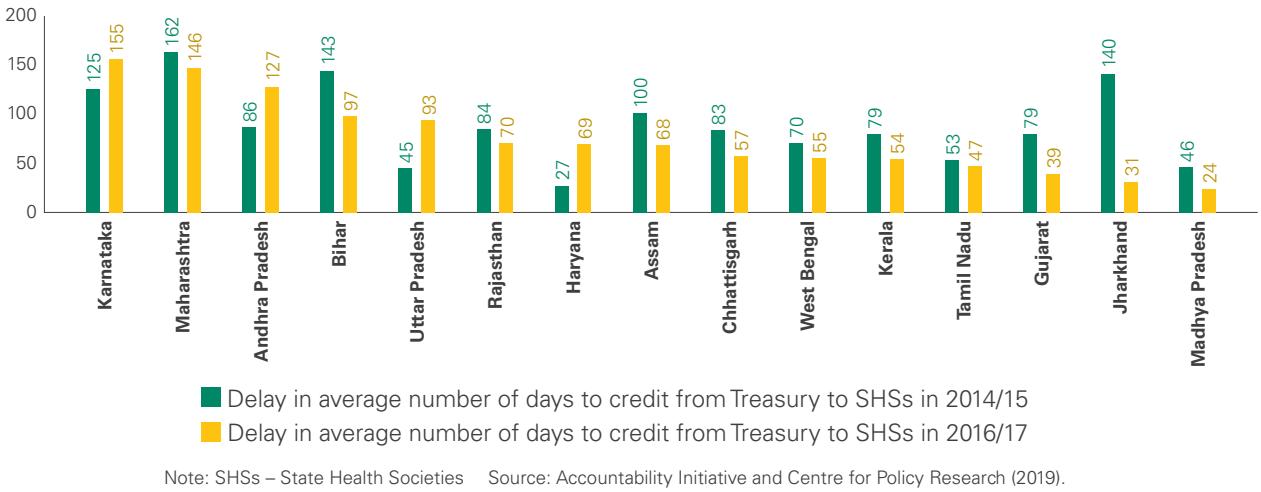
38 It must be understood that there is always an in-built reluctance by communities, local authorities or sector departments to make priorities, unless they are compelled to do so. Making priorities means favouring some proposals but also discarding other proposals – this can be very difficult both technically but also politically, especially where consensual norms prevail.

Recommendations

All transfers should be established according to a timetable whereby the Ministry of Finance gives notice to SNGs of their indicative transfer amounts sufficiently in advance before SNGs finalize their own budget proposals. This will allow SNGs time to review and appraise spending options and determine priorities in knowledge of their total revenue ceiling, and thereby prepare a comprehensive spending plan based on that ceiling, before they finalize their budget proposal.

This makes overall revenue estimates more certain for SNGs and thus constitutes a "hard budget constraint" for them. It constitutes a powerful incentive to (a) make a serious effort to determine real expenditure priorities while (b) making a full effort to mobilize other sources of financing, notably from local revenue collection. It also allows SNGs themselves to move towards allocating budget ceilings to their various departments and to lower administrative levels to constrain and discipline their internal budgeting processes.

Figure 21. India: Delays of National Health Mission CG funds' arrival at the local level, in days, 2017/18



Note: SHSs – State Health Societies Source: Accountability Initiative and Centre for Policy Research (2019).

Similarly, reports on Education CGs[39] suggest that only some 50 percent of grants arrived in the first 6 months of the fiscal year, and that up to 10 percent had not even arrived by the end of the year.

In such cases, when funds do actually arrive in the SNG account, SNGs and school or health officials will be tempted to spend funds hurriedly and thus change the original budget priorities – and resultant expenditures may be very suboptimal. Generally, where SNGs have little faith that such funds will ever arrive on time, the incentive to make a serious effort to plan and budget for their use, and prepare considered implementation and procurement plans, is greatly diminished (Accountability Initiative, 2010; Demmke, Hammerschmid and Meyer, 2006; The World Bank, SIDA and Government of India, 2010).

In countries which operate single treasury systems,[40] two sorts of problem may arise.

Firstly, transferred funds can be stuck in local treasury offices, where problems in reports or other documentation provided by SNGs may hold up their release. This can very often provide a strong incentive for corruption, where SNGs resort to paying off Treasury officials to expedite the release. Both problems are reported to be a common issue in Cambodia where commune and district officials must travel to the (often distant) Provincial Treasury office in the hope of finding an official present that day, and who will approve release of funds (author, personal field observations). This not only wastes time but also encourages rent-seeking by the officials involved.

That aside, where central guidance is unclear as to what are legitimate SNG expenditure responsibilities, local Treasury officials may be fearful of approving even legitimate spending requests. Again, in Cambodia this has been a problem and perhaps one of the factors distorting Commune budgets towards spending on construction works, rather than on recurrent spending for local "soft" services. Spending on construction from the UCG transfer (Commune/Sangkat Fund) is well understood as legitimate by Treasury officials, while recurrent spending from this transfer is often questioned and approval denied, despite being allowed under the more recent policy and regulatory instruments for the transfer (author, personal field observation).

Recommendations

Timely arrival of funds into the SNG account clearly encourages efficient budget execution and provides incentives to SNGs to budget properly, to prepare execution and procurement plans, and to implement these as approved. But this may require reforms elsewhere in national PFM and treasury systems, unrelated to fiscal transfer systems.

One way to improve timeliness is to streamline reporting requirements. Here, reporting after funds are spent should be preferable, rather than control before spending. Care should be taken not to expect an unreasonable degree of detailed and possibly premature reporting on the use of past funds transferred.

Retention and carry-over provisions

Whether SNGs may carry over unspent transfer funds into the next fiscal year has implications on the quality of local spending. The reason why central governments often do not allow carry-over of unspent funds is primarily to pressure SNGs into efficient execution of national budgetary resources. But it is often the reality that SNGs are faced with serious administration constraints through no fault of their own. This is especially the case for the capital or development budget, and in rural, more remote SNGs. The reasons for delays in administration include:

- The funds regularly arrive late in the fiscal year, as illustrated above, leaving little time to spend before year-end.
- There are seasonal weather constraints, such as the long, intense monsoon season in Myanmar, and the long hard winter in Mongolia, which allow only a few months each year to undertake investment activities, especially in rural areas.
- There are problems and inevitable delays in securing supplies, contractors and technical support to implement the development activities.

All of this means that SNGs may be encouraged to prioritize those types of investment which minimize the risk of underspending by year-end: investments in more accessible urban areas, rather than more inaccessible rural areas; a few, more manageable, large investments

39 These are CGs provided under the national flagship "Education for All" programme Sarva Shiksha Abhiyan (SSA).

40 These are systems operated under the central Ministry of Finance, and where SNG authorities must request payments to be made to vendors from their subaccount in the local Treasury office. Such systems are quite common in South-East Asia. They stand in contrast to systems whereby SNGs manage their own bank accounts – which is more common in South Asia.

rather than many, smaller, dispersed investments; investments in facilities for which standard design blueprints are available rather than those which require site-specific design work. The resultant investment pattern may not meet local needs and sustainable development agenda priorities.

Similarly, especially where no carry-over is allowed and when funds only arrive late in the fiscal year, SNGs may be compelled to make rushed spending decisions to use the money in time, but which may not always match the original budget priorities.

That aside, there may also be little incentive for efficient spending if any savings are not retained by SNGs but returned back to the central government. Such foregone opportunities are not always revealed in audit reports, even where SNGs are subject to external audit.

However, in allowing carry-over of unspent funds, caution is also required to avoid misuse. For example, provinces in the Lao People's Democratic Republic are allowed to carry over unspent funds into the next year, but can then spend them in a manner which does not allow any real oversight, and which may all too easily undermine the effectiveness and the transparency of spending.

Recommendations

Where possible, it is helpful to make arrangements to allow SNGs to carry over unspent funds into the next fiscal year, both to create an incentive to search for economies of scale during budget execution and make savings, and to also to discourage SNGs from possible bias to expedite investments which help ensure the full use of funds transferred, but do not necessarily correspond to what the local SDG agenda would require.

At the same time, if such carry-over arrangements are made, then ensure proper accountability in the use of the transferred funds.

Figure 22. Fiscal transfers: Summary of possible incentive effects, lessons and recommendations

Feature of fiscal transfers	Incentive effects on levels and quality of SDG-relevant spending	Lessons and recommendations
Design features of fiscal transfers		
Determination of annual allocable pool	Ad hoc annual determination may cause large yearly variations in allocations to SNGs which may: • Discourage SNGs from serious planning and budgeting for use of these unpredictable funds • Lead In extreme cases to "boom and bust" cycles: wasting resources simply to spend an upsurge or drastic cutbacks, without time for due appraisal of budgeting options. Similarly, where the national pool for a fiscal transfer is determined as a percentage of only one or two volatile streams of revenues – such as revenues from mining, oil and gas – this would also lead to large cyclical variations in the amounts of transfers to SNGs	Where the national pool is determined on a rule basis, this can help ensure stability over the years. This can be achieved through several options: • Setting the national pool size as a given percentage of all or most national revenues. There are examples of good practice in this regard in Asia: in Cambodia: 2.7 percent of national revenues finance the Commune/Sangkhat Fund; and in the Philippines: 40 percent of national revenues finance IRA grants to all SNGs. • Setting the national transfer pool as a fixed total over the medium-term period, as in Myanmar. This, of course, is stable but static. • A better arrangement is if fiscal transfers are formally embedded within medium-term fiscal frameworks, as in Bangladesh, Myanmar and Viet Nam. In consequence, SNGs are faced with a predictable year-to-year revenue stream from the transfer(s), and so are encouraged to undertake medium-term planning and to take the annual budget priority-setting process seriously. • If stability and predictability of fiscal transfers is a preferred objective, avoid (a) setting Revenue-Sharing Transfers as a percentage of a few, highly volatile revenues, and then (b) making Revenue-Sharing Transfers a sizeable proportion within the overall mix of fiscal transfers to SNGs. • The stability and predictability is greater if these arrangements are formally embedded in law, as in Cambodia, India, Indonesia and the Philippines. Leaving the determination of the transfer pool simply to annual legislation should be avoided; it allows parliament to change tax share percentages and other arrangements every year, as in Mongolia.

Figure 22. Fiscal transfers: Summary of possible incentive effects, lessons and recommendations

Feature of fiscal transfers	Incentive effects on levels and quality of SDG-relevant spending	Lessons and recommendations
Design features of fiscal transfers		
Horizontal allocation	• UCG allocation formulas which include a link to local actual revenue collected may in some cases discourage local revenue-raising efforts, but evidence for this is not always strong. • UCG "gap filling" undermines incentives for budget prioritization and for local revenue mobilization. • CG allocation formula based on inputs (existing facilities) rather than service outputs may encourage overinvestment in infrastructure. • Natural resource revenue-sharing allocation by area of derivation, in boom times, may "flood" SNGs with more funds than can be absorbed, encouraging waste.	A move from ad hoc, equal or gap-filling allocations to allocating transfers by clear norms or by a formula is clearly highly desirable. In constructing allocation formulae, it is key to: • Ensure that own- and shared revenues are reflected in a manner which does not undermine incentives for local fiscal-raising. • Avoid allocating UCGs or CGs on the basis of the stock of inputs (e.g. staff and facilities), as it will probably encourage SNGs to overinvest in these facilities or staff. In the case of sector CGs, allocations based on service delivery output (e.g. the number of school-age students to be schooled times the average cost per student) provide more positive incentives for efficient service delivery, as is now practised in Viet Nam. • Since Revenue-Sharing Transfers arrangements are inevitably inequitable, clawback arrangements can be considered, whereby Revenue-Sharing Transfers to SNGs are taken into account before determining the allocation of Unconditional Grants to SNGs.
Matching arrangements	CG transfers that require SNGs to make matching spending for same purposes may: • Encourage greater and closer-to-optimal spending for SDG-related purposes • Encourage more than optimal spending on SDG-related purposes, and undercut spending in other important areas.	• Ensure that the ratio is not an incentive to draw SNG funding away from other equally important spending areas • Ensure that "matching funds" are defined in a way which precludes scope for abuse.
Discretion in the use of funds	Excessive conditions may lead to: • Inadequate local budgeting flexibility and the inability to tailor spending to local needs and priorities, thus undercutting the rationale for decentralization • Too many local plans, undercutting the integrity of planning and budgeting • Too many local reporting requirements • Local uncertainty as to what is permissible, distorting budget priorities.	• There are sound reasons to impose some limits on the use of UCGs, to deal with the inevitable SNG bias towards administrative spending • Similarly, there are reasons for some earmarking for education and health CGs • However, where possible, more – rather than less – local discretion is preferable, to ensure that the advantages of decentralizing SDG-related mandates to SNGs are not undermined by straitjacketing local budget priority-setting. • Where it may be necessary to introduce spending conditions: (a) these should be kept as few and as simple as possible (b) there should be a strategy to gradually relax these over time, as SNG capacities and accountabilities are built up • Detailed guidance should be given to SNGs about the conditions of use of transfers.
Fiscal transfer administration processes		
Timing of allocation announcement	UCG, CG or RS transfers announced after SNG budgets are prepared eliminate incentives for any serious local budget appraisal and prioritization.	• All transfers should be established so as to allow the Ministries of Finance to give notice to SNGs of their (likely) transfer amounts sufficiently in advance before SNGs finalize their own budget proposals. This will allow SNGs to review and appraise spending options and determine priorities in knowledge of their total revenue ceiling, and thereby prepare a comprehensive spending plan based on that ceiling, before they finalize their budget proposal. • At the same time, knowledge of the fiscal transfer amount makes for a revenue certainty and thus constitutes a "hard budget constraint" for the SNG. This constitutes a powerful incentive to (a) make a serious effort to determine real expenditure priorities while (b) making full efforts to mobilize other sources of financing, notably from local revenue collection. • It also allows SNGs themselves to move towards allocating budget ceilings to their various departments to constrain and discipline their internal budgeting process.

Figure 22. Fiscal transfers: Summary of possible incentive effects, lessons and recommendations

Feature of fiscal transfers	Incentive effects on levels and quality of SDG-relevant spending	Lessons and recommendations
Fiscal transfer administration processes		
Treasury and reporting arrangements for funds release	Onerous reporting and/or very slow release of funds may discourage SNGs in serious planning and budgeting for use of these funds. Even if the formal allocation policy might envisage a reasonably fast release of funds, it would discourage SNGs if the process in practice is unreliable and unpredictable, and is seen as such.	• Timely arrival of funds into SNG accounts not only encourages timely and efficient budget execution, but also provides incentives for SNGs to make efforts to determine real budget priorities and implementation and procurement plans. • Efforts should be made to reduce reporting requirements for fund transfers to what is really needed and realistic. Preferably, reporting of the use of funds should be required after spending, rather than controlling them before spending.
Carry-over provisions	Inability to carry over unspent funds to the next year may: • Bias spending to investments more easily implemented or for which contractors are readily available, but not necessarily those most aligned to sustainable development priorities • Discourage cost-efficient budget execution which might generate savings.	• Where SNGs are allowed to retain funds that were not spent and carry them over into the next fiscal year, there is an incentive to both search for economies of scale during budget execution and make savings, where possible. • However, proper accountability in the use of funds should be ensured if such carry-over arrangements are made.

Incentive effects on local public expenditures: A recap

Insofar as SNGs have mandates to deliver public services in SDG-related areas then the various incentive effects reviewed above, deriving from the design and administration of fiscal transfer systems, will impact the quality of public spending needed to attain local SDGs.

As highlighted in Section 1, the SNG budget is the last step in delivering on that part of the sustainable development agenda which has been devolved to SNGs. However good the sustainable development policies and plans are, these will lead to little if they are not reflected in appropriate local budget spending priorities.

Care therefore needs to be taken to avoid the various incentive pitfalls which risk undermining the sustainable development agenda. Specifically:

- The **levels and composition of public spending** (sectoral composition, and capital versus recurrent spending composition) should match the local context and thereby lead to the achievement of the local sustainable development agenda and local SDGs. Levels and compositions of public spending can be distorted through fiscal transfers.
- **Policy and plan priorities should be reflected within SNG budgets and hence public spending** within SNG areas, specifically:
  - **General local budget priority-setting**: SNGs should have incentives to articulate budget spending priorities, to allow the selection of an affordable shortlist from an inevitably very long list of budget proposals, in line with local sustainable development priorities. It is often not well understood just how hard such budget priority-setting can be, both technically and politically.
  - **Budget effectiveness**: SNGs should be allowed to establish budget priorities in a way which matches local context and the local sustainable development agenda. The extent to which SNGs are able to establish budget priorities in reality can be undermined through inadequate fiscal transfer processes.
  - **Budget efficiency**: SNGs should be able to make the best use of scarce resources, and to gain the greatest impact for the sustainable development agenda. Often, the use of public funds is not efficient due to fiscal transfer processes undermining the extent to which budget proposals are properly appraised and prepared, intersectoral linkages are made and overlaps avoided, and budgets executed.
  - **Sustainability**: Investments created through local spending should be sustained. Fiscal transfers that risk encouraging local spending on capital investment without the corresponding recurrent budget commitments should be avoided, to ensure adequate operations and maintenance.
  - **Transparency and accountability**: Local budgets and spending should be known to the public, and citizens should be able to provide input, check and query them. The more complicated that fiscal transfers are – the overall national pool for fiscal transfers and allocations to specific SNGs – the less transparent they will be and the more difficult it will be to ensure accountability. Transparency and accountability are a key element in ensuring generally good-quality public spending for all SDGs, and is also key to achieving SDG 16.

4

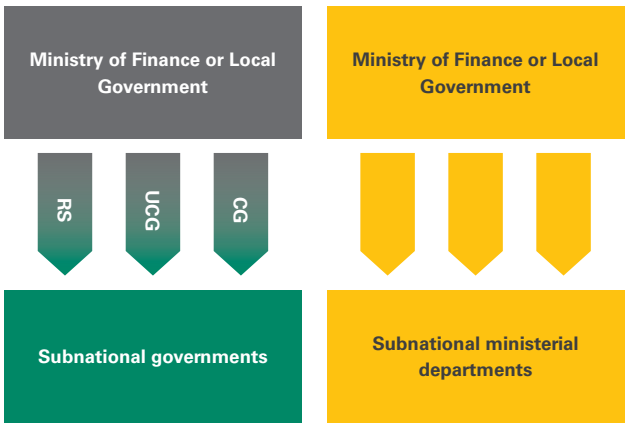
Equity Outcomes

The 2030 Agenda principle of "leaving no one behind" and SDG 10 to reduce inequalities require that public spending in SDG-related areas be **geographically equitable** across the national territory, in a manner reflecting the varying needs of different localities.

Overview of equity effects

As outlined under Section 1, decentralized spending may be devolved or deconcentrated – and is financed accordingly. Consequently, aggregate spending patterns at subnational level will be the sum of several centre-to-local resource flows: the various fiscal transfers to SNGs to finance devolved spending, SNGs' own revenues, and intraministerial flows to subnational line departments to finance deconcentrated spending. There are also other centre-to-local resource flows such as donor and NGO project spending and constituency grants, but these are generally much smaller.

Figure 23. Decentralized and deconcentrated flows to subnational levels



This section focuses on the geographic equity of fiscal transfers to finance devolved spending by SNGs.[41] Some fiscal transfer instruments (mainly UCGs) aim to promote greater horizontal fiscal balance across SNGs. However, when all transfer flows are combined, they can often generate geographic inequity.

For transfers which are not designed with the explicit aim of promoting equity, the resource allocations are almost certainly likely to be inequitable. This is the case with Revenue-Sharing Transfers allocated by derivation, or with "gap-filling" grant mechanisms common in transition countries.

But even for those grant transfers which are created to promote balance and equity, such as many UCG transfers, there are also often problems. First, the transfer pool may not be large enough to compensate for other sources of fiscal inequity and, second, the allocation formula may not properly reflect differing needs and resources between localities.

Clearly, any resulting inequities will undermine not only the achievement of SDG 10 specifically, but also the entire local sustainable development agenda.

In any given country, with its specific devolved spending mandates, the geographic equity of SNG spending will be a function of total budgetary resources derived from own-source revenues and from fiscal transfers.

Own-source revenues

On average, SNG own-source revenues usually provide only modest budget resources. But these may still cause substantial horizontal inequities between SNGs, given the inevitable variations in revenue bases between regions. The differences in own-source revenues are especially

41 It does not consider deconcentrated spending, which in many countries may be larger than devolved spending and the patterns of which may be inequitable. While deconcentrated spending does have implications for the overall horizontal equity, it requires separate analysis of horizontal allocation of sectoral and thematic spending.

large between urban and rural areas, since areas with higher concentrations of economic activity and higher incomes and land or property values will enjoy higher levels of own-source revenues gained by taxing these activities and assets.

Fiscal transfer resource flows

Fiscal transfers constitute the bulk of resources for most SNGs and their allocation has a very direct impact on the equity of public resources and spending across SNG localities, and hence also on the achievement of SDG 10.

As noted, in some countries there is a profusion of transfer flows. The equity of geographic distribution of these resources is the outcome of two factors: the allocation arrangements, and the size of the national pools for each of the various transfers.

Shared revenue flows

Revenue-Sharing fiscal transfers are **not** designed to promote horizontal equity. Instead, they aim to promote other objectives, such as satisfying local political claims or compensating provinces for negative social and environmental externalities. These transfers are therefore almost certain to result in inequities across SNGs, given the usually very uneven distribution of the revenue bases, such as income, profits and sales tax revenues, and especially natural resource-related revenues. Revenue sharing will therefore very likely further compound the disparities already arising from own-revenue assignments.

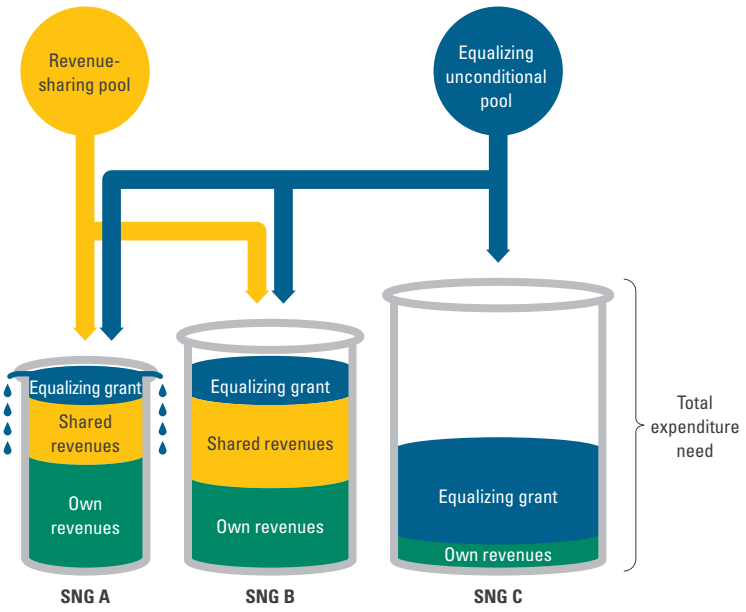
Unconditional Grant transfers

It is therefore the role of UCG transfer instruments to play this equalizing role. UCGs are usually allocated to SNGs by a formula which aims to capture broad, proxy measures of relative need. There are two sides to relative need. On one hand, SNGs will have **different expenditure needs** as a result of different population sizes, levels of development and poverty incidence, and physical conditions of the area, and also due to differing service unit delivery costs arising from differing population densities or degrees of remoteness. On the other hand, SNGs will have **different levels of own-source revenues and of shared revenues** as a result of differing levels of economic development, urbanization, size and the composition of tax bases.

Bringing the factors together

Figure 23 depicts the elements which determine the geographic equity of resources for devolved SNG spending mandates. For any given set of spending mandates, the actual spending needs of each SNG will vary, as illustrated by the different sizes of the buckets illustrated in Figure 24. The levels of own-revenue budgetary resources and revenues shared by derivation will vary (e.g. SNG C receives no shared revenues), according to the revenue bases of the different SNGs.

Figure 24. Factors determining equity between SNGs



The job of equalizing – to compensate for these variations and to ensure horizontal equity – is therefore left to UCG allocations. However, whether UCGs can do so will depend on how big the equalizing UCG pool is relative to other, non-equalizing transfers, and how equalizing are the allocation criteria from the UCG pool to the SNGs.

Identifying the extent of geographic inequities

The clearest measure of equity between SNGs lies in the patterns of **per capita SNG revenues**. Given the varying needs and fiscal capacities of different SNGs, it is **not** expected that fiscal transfers per capita should be **equal** across SNGs and regions. However, any variations around the mean should not be too large, and should reflect different regional needs and capacities, rather than being the product of other more arbitrary factors or even political manipulation.

In the sub-sections below, the combined effects of Revenue-Sharing and Grant Transfers are examined in more detail in three country cases to see how such inequities in SNG resource transfer and spending can be caused unintentionally.

Box 10. Comparison: Per capita public spending variance in two developed countries

In reviewing these three cases below, it is useful to bear in mind the geographic variance of **total public expenditures per capita** (transfers + own revenues) in two developed countries:

United Kingdom (FY 2015/16): The average total per capita spending level was £9,076, with the highest level at £10,093 (N. Ireland) and the lowest level at £7,977 (South East England) – a maximum to minimum (max:min) ratio of **1.27:1**.

United States (FY 2014): The average total per capita spending level was US$8,831 across states. Except Alaska, which enjoys an exceptionally high level of spending (US$19,791 per capita), the highest level was US$13,143 (Wyoming) and the lowest level was US$6,334 per capita (Idaho) – a max:min ratio of **2.1:1**.

Inequities generated by fiscal transfers: Three case studies

Before looking at general issues and lessons, it is instructive to approach the question of equity outcomes through specific examples. There is surprisingly little data available on the geographic equity of overall fiscal transfer systems in Asia, which itself is symptomatic of a problem in coordination and monitoring multiple, disparate centre-to-local fiscal flows.

Three country examples[42] are examined below with the implications of Revenue-Sharing Transfers and "equalizing" UCGs for the equity of devolved funding and general SNG expenditures.

Case I: Myanmar

Revenue-Sharing Transfers

Currently, 15 percent of Commercial and Special Goods Taxes are shared by the Union-level Internal Revenue Department to the state/region of origin. Overall, this constitutes some 7 percent of total SNG revenues and 10 percent of total fiscal transfers. This revenue sharing hugely favours the very urbanized SNGs of Yangon and, to a much lesser extent, the Mandalay Regions, where the bulk of economic activity takes place. The maximum: minimum (max:min) ratio[43] for shared revenues per capita is a very large 97:1 between states/regions in FY 2016/17.

UCGs: Deficit grant transfers

The allocation of the grant transfer UCG pool, accounting for some 90 percent of transfers and hence much greater in size than the shared revenue pool, has been adjusted so as to "claw back" these disparities, so the potential inequity effect of shared revenues has been neutralized.

Since FY 2015/16, these grant transfers have been allocated by a formula which now includes six variables. The problem, however, has been that the formula-based allocation of the UCGs has itself been problematic and has created other sorts of regional inequity.

Firstly, no explicit weights are given to the variables, so by default each has only one-sixth (17%) weighting, which is much too low for the population variable, which is the main driver of expenditure needs.

Box 11. Myanmar: "Deficit grant" transfer formula criteria

Expenditure Needs

- State/Region Population
- State/Region Poverty Index
- State/Region Land Area

Fiscal Constraint

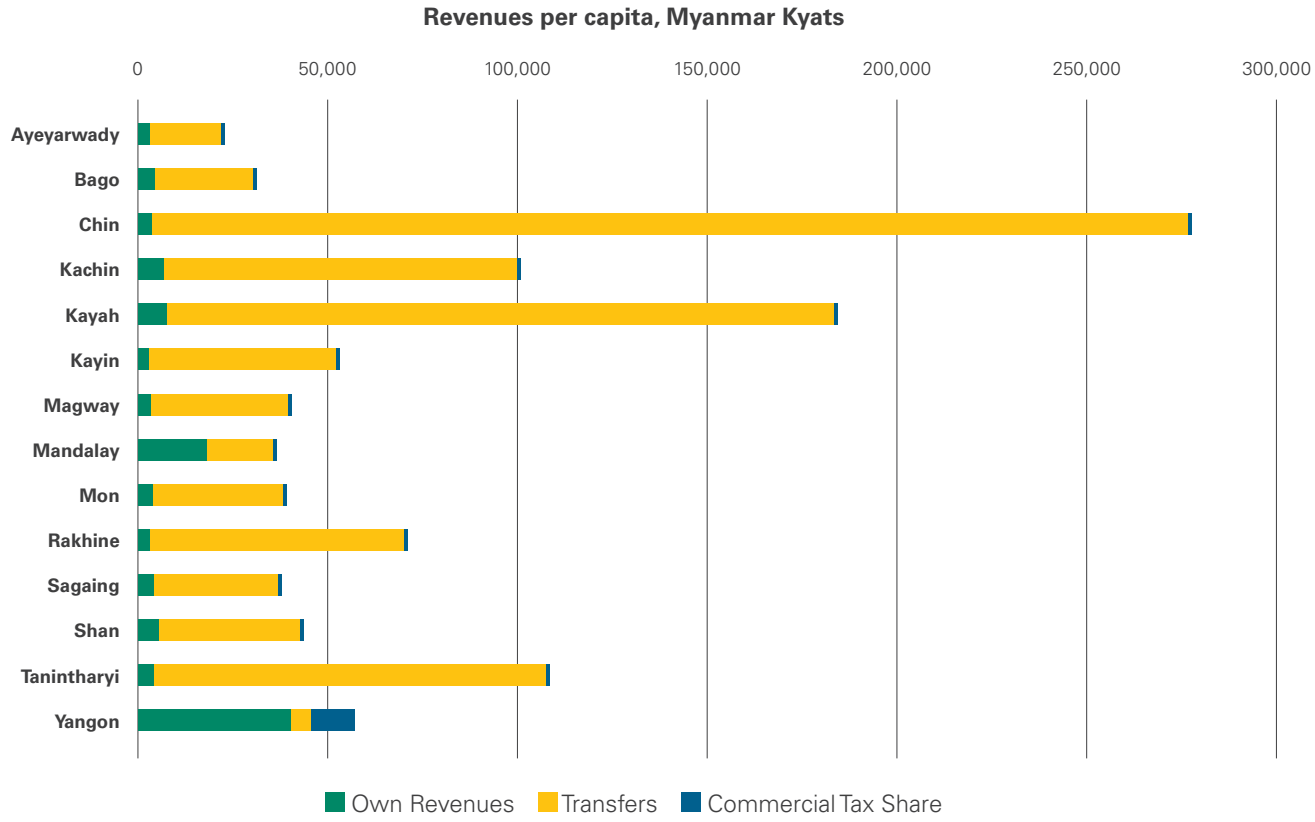
- State/Region per Capita GDP
- State/Region Urban Population as a percentage of the total state population
- Per capita tax collection in the fiscal year N-2 (or the previous fiscal year)[44]

Secondly, the other index variables, such as the poverty index values, are not themselves normalized by relative population. So, two SNGs which may have the same poverty index value but greatly different population sizes will receive the same transfer amount from the one-sixth of the pool demarcated for that variable. This is clearly inequitable.

That aside, the fiscal constraint variables are also problematic. Overall, the three proxy variables combined dictate an allocation of three-sixths (50%) of the pool,

42 The Myanmar and Mongolia cases derive from the author's own recent work in the two countries; the Indonesia case is from research from Fadliya and Mcleod (2010).
43 The ratio between largest versus smallest transfers received by SNGs.
44 See explanation of the generic numbering of fiscal years in the section on Explanatory Notes following the section on Acronyms.

Figure 25. Myanmar: All transfers and own revenues per capita by state/region, FY 2016/17



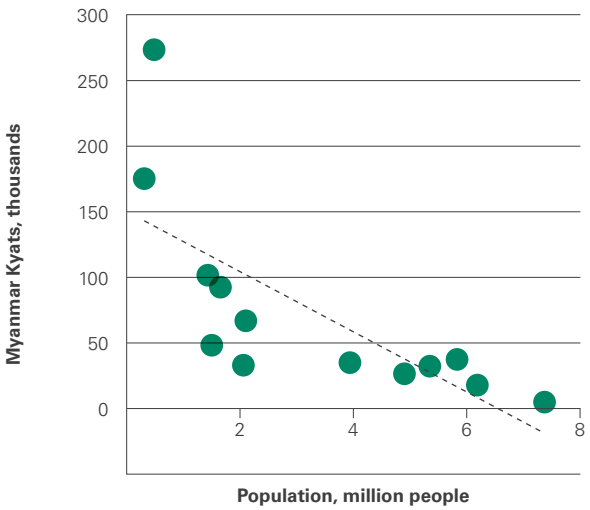
Source: Shotton, Yee, and Oo (2016)

which is a disproportionately high fraction (especially considering how modest SNG revenues are overall). Furthermore, the SNG GDP per capita variable is flawed as a proxy for SNG revenue potential, since almost all the GDP-correlated tax revenues are assigned to the central government, not SNGs.

In consequence, while the grant allocations do somewhat compensate for large disparities between SNGs in own-revenues and shared revenues, they still leave substantial disparities in the overall per capita revenues (and hence public expenditures) of the 14 states and regions, with a high max:min ratio for per capita revenues of 12:1. These disparities are quite arbitrary, and unrelated to any differences in relative need; they also result in a bias in favour of the least-populated SNGs, as depicted in Figure 26.[45]

A key obstacle to reform the grant allocation formula for greater equity is that while some states/regions would gain, others would receive much less than they do now and would likely oppose any change to the status quo.

Figure 26. Myanmar: Transfers per capita against state/region population, FY 2016/17



Source: Shotton, Yee, and Oo (2016).

45 There may be good reasons why less populated SNGs may deserve higher per capita resources because of (a) fixed costs or (b) higher delivery costs for sparsely populated areas or (c) if they also happen to be remote. But the variance seen in the Myanmar case goes far beyond what might be justified by such factors, and in any case should be explicitly reflected in the formula and not be the arbitrary outcome of a failure to properly weight formula variables by relative population size.

Case II: Mongolia

Revenue-Sharing Transfers

During FY 2016, in parallel with the formula-based General Local Development Fund (GLDF) (see below), 30 percent of revenues from mining royalties and 50 percent of mining exploration fees were also shared with the aimags and soums from where mining royalties and fees originated. Since mining operations only occur in certain areas, this caused considerable inequity. Figure 27 illustrates the disparities in per capita allocations across the 21 aimags with the orange line, whose values are indicated on the right-hand column.

One aimag received Mongolian tugrugs 392 per capita from shared mining revenues, while another received Mongolian tugrugs 289,000 per capita – a **massive max:min ratio of 737:1**.

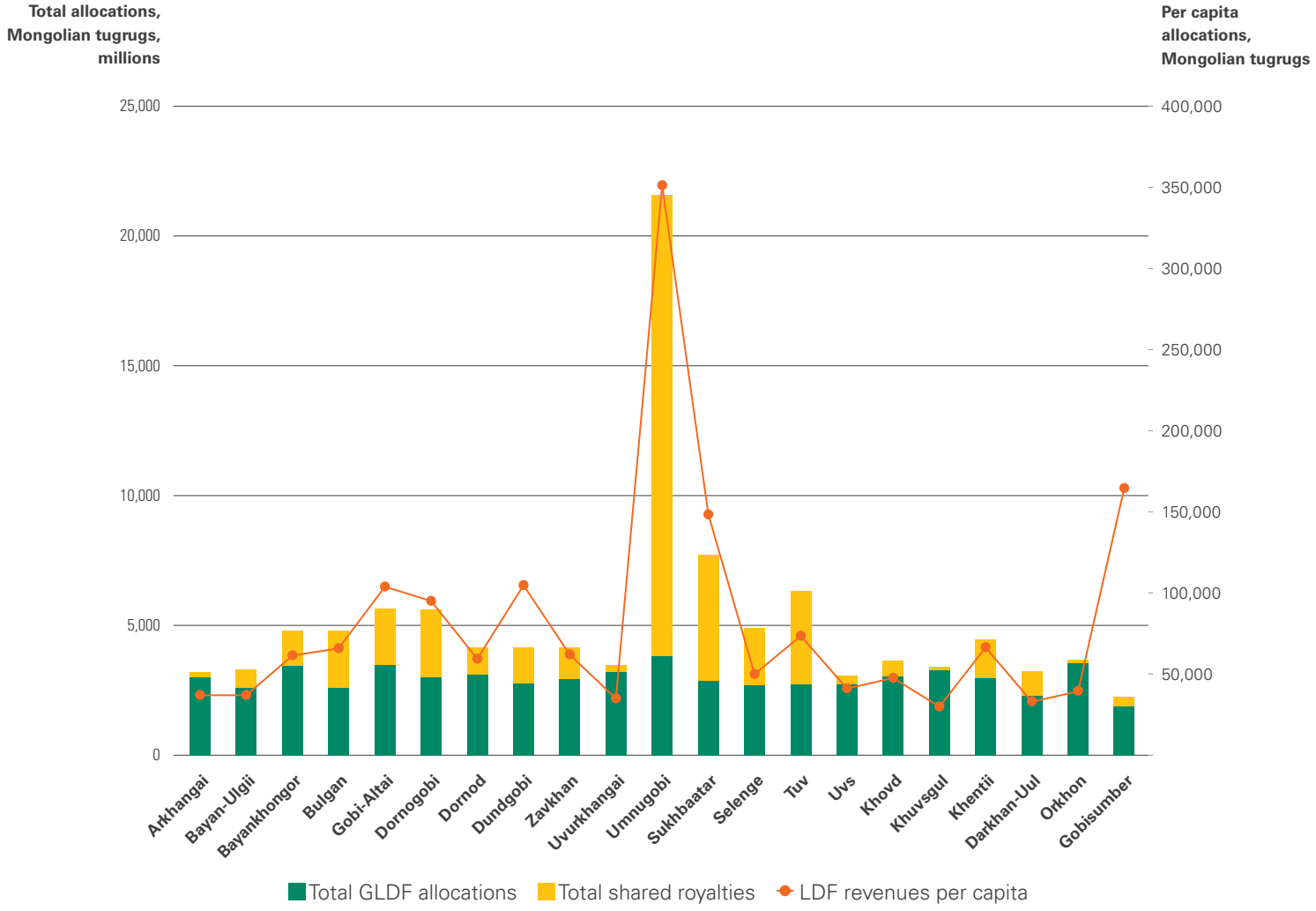
UCGs: General Local Development Fund (GLDF) allocations

The GLDF has been allocated to aimags and soums on the basis of the criteria indicated in the Budget Law: population, development index, remoteness and land area, and fiscal revenue-raising effort. However, this has not led to the equalization of total LDF transfer revenues, for two reasons.[46] Firstly, unlike in Myanmar, the Revenue-Sharing Transfers allocations were not clawed back through the GLDF formula-based grant allocations. Secondly, there were problems in the way the variables were treated in the formula:

- For lack of any explicit weighting of the four variables, each was given by default one-quarter (25%) weighting, which for population, the main driver of need, is too low.

46 Local Development Fund (LDF) consists of GLDF (General LDF) allocations by formula and shared revenues from mining royalties and fees.

Figure 27. Mongolia: Local Development Fund and shared mining revenues by aimag, 2016



Note: LDF – Local Development Fund; GLDF – General Local Development Fund Source: Ministry of Finance (Mongolia), World Bank and SDC (2017).

- When computing the allocations for the development index, the remoteness index and the fiscal effort indices, their respective index values were not normalized by the relative population size of the aimags and soums concerned, as also seen for Myanmar (and for Nepal too until the formula was corrected in 2012).

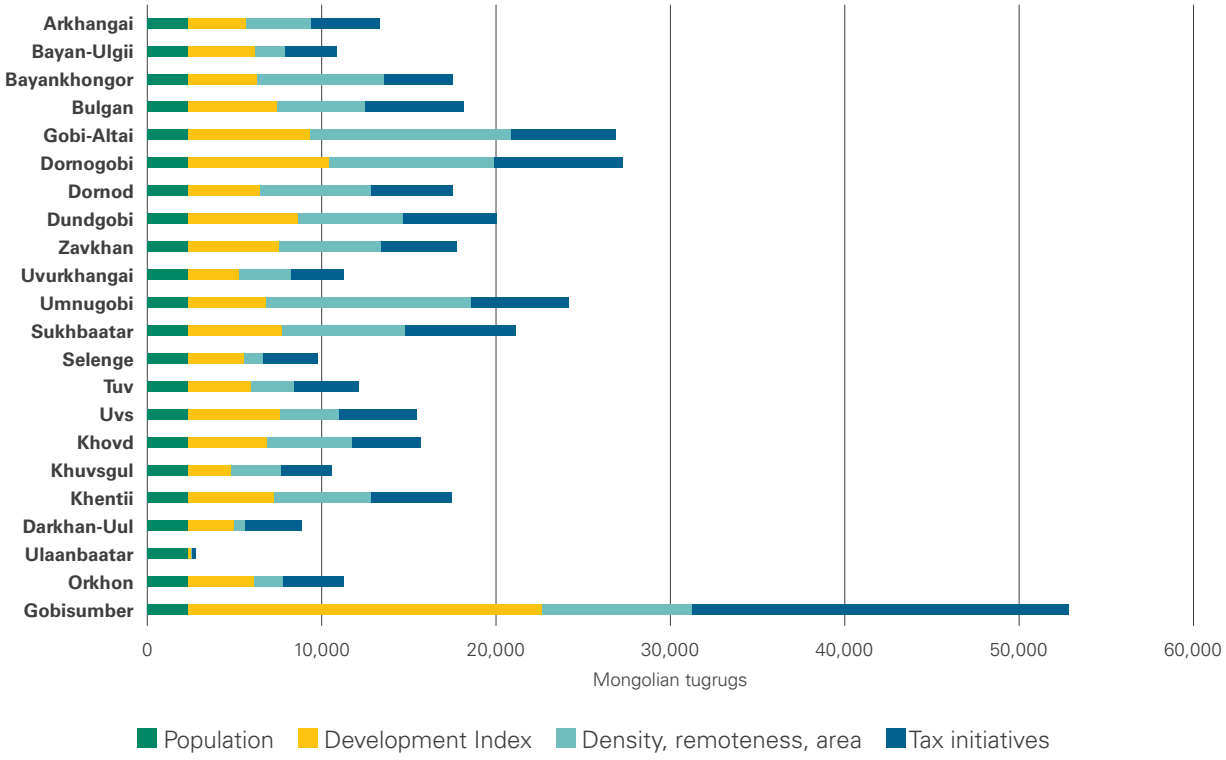
As a result, the outcomes have been very inequitable in per capita terms:

Specifically, as in Myanmar, they have also clearly penalized the more populous aimags, as the negative correlation, depicted in Figure 29, indicates.

Overall, therefore, the total LDF transfer revenues per capita still exhibit very substantial variance, as Figure 29 illustrates.

It should be pointed out that subsequently these problems have been at least partly addressed. The computational method has now been changed to normalize formula variables by relative population size, and the revenue sharing by derivation arrangements has been suspended.

Figure 28. Mongolia: Breakdown of GLDF allocation per capita, by formula variable, 2017



Source: Ministry of Finance (Mongolia), World Bank and SDC (2017).

Figure 29. Mongolia: Disparities in Local Development Fund allocation

Statistics (in Mongolian tugrugs, unless otherwise indicated)	Total LDF per capita	GLDF per capita	Shared mining revenues per capita
Average	82,001	47,722	34,279
Median	62,663	44,803	18,150
Minimum	29,633	24,241	392
Maximum	351,172	142,474	289,049
Max:min ratio	11.9	5.9	737.3

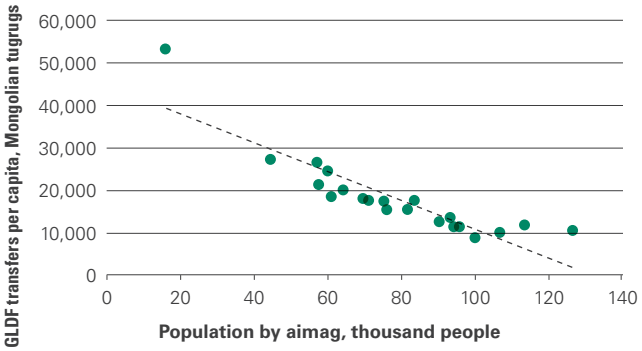
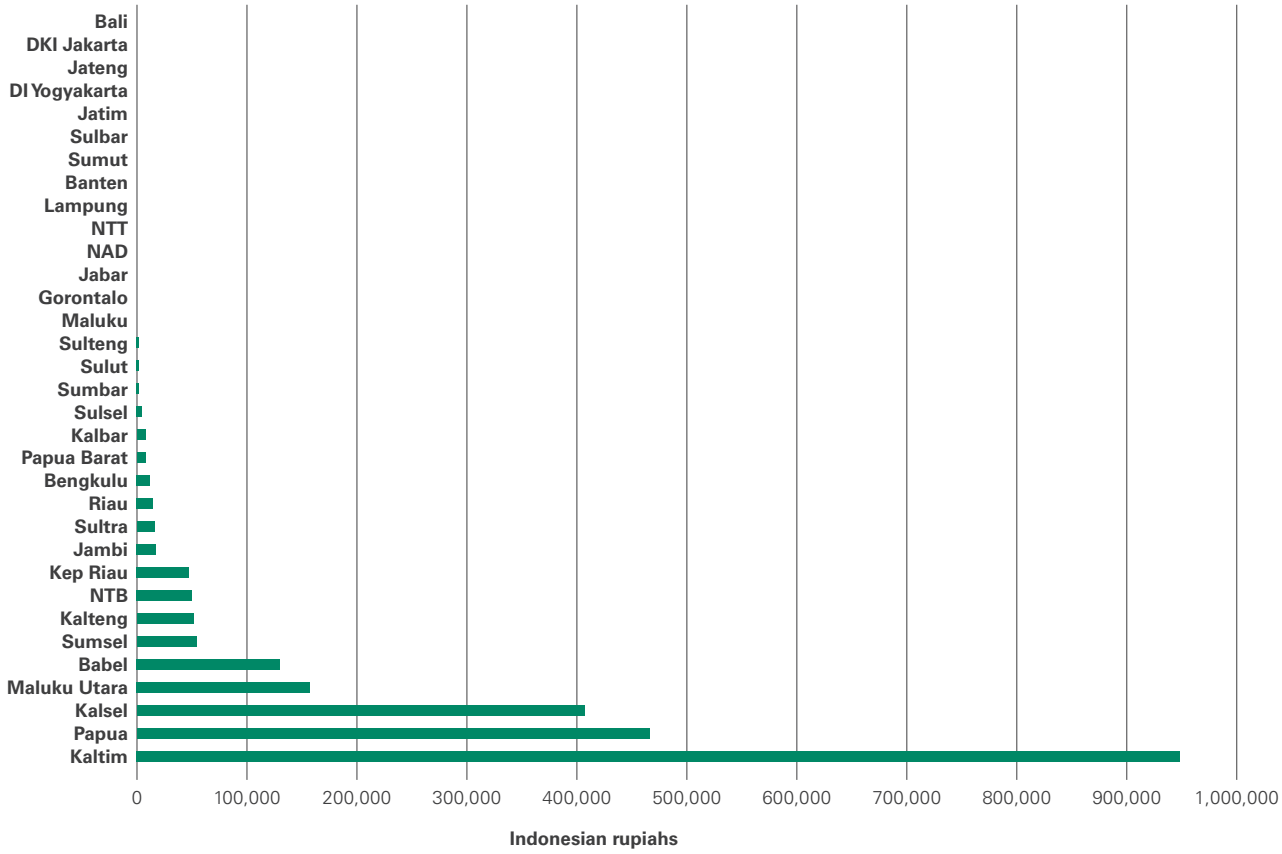


Figure 30. Indonesia: Shared mining revenues per capita by province, 2010



Source: Agustina et al. (2012).

Case III: Indonesia

Revenue-Sharing Transfers

In Indonesia, as described in Section 2, a wide range of central revenues (from income and corporate tax, and from various natural resource extraction activities) are shared by derivation with province, *kabupaten* and municipal SNGs through a complex set of arrangements; overall, these constitute some 20 percent of total fiscal transfers. Unsurprisingly, these generate considerable inequities in SNG per capita revenues across SNGs – for natural resource-related revenues and for the overall revenues. Figure 30 illustrates the massive disparities resulting from shared mining revenues, which accrue primarily to only 9 of the 34 provinces.

UCGs: DAU grant transfers

Here too, the problem is not so much in the equity effects of the shared revenues, but that the allocation of other grant transfers – notably the DAU – has not been enough to compensate for inequities which result from revenue sharing by derivation. Figure 31 clearly illustrates the very wide variance in resulting total SNG revenues.

Figure 31. Indonesia: All fiscal transfers per capita: Variance across SNGs

	Transfers per capita max:min ratios
Districts	
2005	36:1
2006	71:1
2007	71:1
Municipalities	
2005	19:1
2006	26:1
2007	25:1

Source: Fadliya and McLeod (2010).

The core of the problem lies in the DAU. Firstly, it includes a large "basic element" to cover staff costs, and hence only a fraction of the pool is available to "equalize" across SNGs; and, secondly, the formula uses adjusted "per region" rather than "per capita" variables. Once again, this introduces a bias towards inequity, and specifically a

Figure 32. Indonesia: Revenue per capita against district population, by decile

Source: World Bank staff estimates (2017).

bias in favour of SNGs with small populations, penalizing more populated and often areas becoming more urban.

Figure 32, which plots population size and per capita revenue district population decile, clearly illustrates this bias.

These problems have been under discussion now for many years since the fiscal transfer policy (Law 33 of 2004) was introduced. As in Myanmar, one impediment to reform has been the fact that more than 50 percent of districts and municipalities that benefit from current arrangements will lose from a move to more equitable arrangements.[47]

Equity effects: Emerging lessons

Here are some general issues, lessons and recommendations about equity effects.

Own-source revenue assignments

While own-source revenue assignments are not a fiscal transfer policy issue, the tax revenue powers or sharing rights assigned to SNGs will directly impact on horizontal equity. If these powers are such that they generate very substantial disparities in own-source revenues between SNGs, then it may simply prove too difficult to compensate SNGs through the fiscal grant transfer system, if the central government is not able to adequately resource this system.

China was in this situation for a long time, having in the 1960s established a profusion of tax revenue powers and sharing rights for SNGs[48] which then generated major interprovince disparities as economic growth took off in the coastal provinces from the 1980s onwards. Precisely because these revenue sources were under provincial rather than central control, the central government itself did not have the fiscal resources to compensate these disparities through the centrally managed transfer system. Much progress has since been made in recentralizing revenue powers and recrafting a rules-based fiscal transfer system, which has proved a long and difficult political struggle, but the process is far from completed and substantial inequities still persist, as outlined in Section 2 (Wang and Herd, 2013; Wang and Ma, 2014).

A number of other Asian countries also find themselves in similar situations, struggling to recentralize certain revenue powers. In the Lao Democratic People's Republic, the central government has long struggled to recentralize key revenue sources, such as customs duties, against opposition from provincial governors; indeed, even after the reform was approved, provinces defiantly continued

47 The World Bank estimates that some 287 (of a total 508) SNGs would lose from an amendment to the formula and the elimination of the basic allocation.

48 This was in part a result of the Cultural Revolution and the effort to undermine the power of central government bureaucracy by allowing greater local control over public fiscal resources. See Shirk (1993).

to retain these revenues in local Treasury offices for many years (Gomez, Martinez-Vazquez and Sepulveda, 2008). Viet Nam still displays a very high degree of revenue decentralization, with some 33 to 50 percent (depending on interpretation of data) of all government revenues being retained at SNG level, putting it on par with many OECD countries, which greatly limits the central government's ability to finance transfers to offset horizontal imbalances in provincial resources (World Bank, 2015b; Xuan-Binh Vu and Duc-Tho Nguyen, 2015).

Recommendations

As countries embark on major decentralization reforms, or move towards federalism, there is often strong political pressure to decentralize major tax revenue powers to SNGs, especially those deriving from natural resources, over which local political and civil society claims can be very strong and passionate.

While at the time of policy decision-making, these revenues may appear relatively modest and inconsequential, it can be hard to predict how they will grow over time – and hence what future disparities may arise between SNGs. But once such powers are granted, experience suggests that it can be very hard to reverse the arrangements, and great care should be taken.

Revenue-Sharing Transfers

Revenue-sharing transfers – allocated based on area of derivation – entail a major potential bias for inequity, which may not easily be compensated by other UCG "equalization" transfers.

There are two main reasons to share revenues by area of derivation:

- **Economic** – to compensate originating areas for the indirect costs or externalities in hosting the economic activity being taxed. This includes, for example, addressing environmental degradation, pollution or other social costs caused by economic activities in the originating areas, or to finance supporting public infrastructure and services for activities being taxed in areas of economic potential, such as urban development, industries and tourism.
- **Political** – to recognize and reward a political or community "ownership right" over natural resources.

But in many cases it is not made clear what the rationale actually is. For example, there is no clear policy statement given by policymakers for sharing mining royalties by derivation in Mongolia, for sharing commercial taxes by derivation in Myanmar, or for the proposed sharing of VAT revenues in Nepal.[49] Moreover, when Revenue-Sharing Transfers are based on revenues from natural resources, such as mining, oil, gas, hydropower, large-scale agriculture and logging, the SNGs have the incentive to promote economic activities exploiting natural resources, and may be under lobbying pressure from natural resource companies. Excessive exploitation of natural resources, which may result from this incentive, can run counter to the sustainable development agenda.

If there is no clarity of objectives, it can be hard to determine the volume of resources which is appropriate to transfer to SNGs as shared revenues. A political rationale for revenue sharing will always be a matter for bargaining and compromise. But if sharing is for economic reasons, it should be possible to determine approximate orders of magnitude of resources which is appropriate to allocate as shared revenues.

Recommendations

It is important to clarify the aim of a proposed Revenue-Sharing Transfer instrument, and to make approximate forward estimates of the likely SNG revenue per capita disparities which may arise. This will allow some estimate as to how far these may be compensated for by other grant transfers, and hence what the trade-offs are between the political and the geographic equity objectives. Such analysis would also be an important element in a central government negotiating strategy around the sharing arrangements with subnational groups that are lobbying for greater revenue sharing.

Ultimately, if there are no solid reasons to share revenues by derivation then it makes much more sense to direct these resources into a national grant transfer pool, for more equitable allocation by norms or formula. Even if there is a political rationale for revenue sharing (as with natural resource revenues), this may be accommodated more transparently and equitably within a formula-based mechanism, by simply building in a certain percent per capita premium on formula-based allocations to those areas concerned (as is done with one specific fiscal transfer in Mongolia).

49 As foreseen in the Intergovernmental Fiscal Transfer Act (2017) which sets out fiscal transfer policy under the new federal set-up in Nepal.

Equalizing grant transfers

The equity problems illustrated above stem both from the inequities generated by own-source or shared revenues, and from the frequent inadequacy of equalizing grant transfers themselves to play an effective role in compensating for these inequities. The inability of the latter grant transfers to equalize is due to two different problems:

- The **total equalizing UCG pool** itself is not large enough to compensate for other inequities in resources, however appropriate the allocation formula may be.
- The **UCG allocation formula** does not properly reflect the relative need or fiscal capacity factors of different SNGs.

The national UCG transfer pools[50]

While most policy discussions tend to focus on the grant allocation formula, donors and central governments pay surprisingly little attention to the appropriate size of the pool to be allocated.

In many countries, this pool is simply too small to play an equalizing role. An extreme case is Thailand where the equalization UCG pool constitutes only some 2 percent of total fiscal transfers (World Bank, 2012). It is mathematically impossible for such an underresourced instrument to play any equalizing role to compensate for fiscal inequities between SNGs. To a greater or lesser degree, this is also true in many other countries.

That said, in all countries there are inevitable resource constraints on the central government's ability to finance a national equalizing UCG pool, especially if many key revenue powers have been placed under SNG control. This is another reason why care should be taken before setting up revenue assignment or sharing arrangements for which no adequate compensating mechanism may be possible.

UCG allocation formulas

Clearly, the use of a formula to allocate a transfer pool across SNGs is significantly better than alternative methods: either ad hoc, negotiated allocations for deficit transfers, or simply equal allocations.[51]

The rationale for using a formula to allocate a transfer pool across SNGs is that it allows allocation according to the different relative needs of these SNGs. The formula may (a) reflect only the different spending needs of SNGs, or (b) also reflect SNGs' own revenues and shared revenues. The latter is more ambitious, in addition to different spending needs. The algebraic structure of the two approaches is outlined in Box 12.

Several lessons can be learned in regard to the construction of such allocation formulas and related issues in attaining equitable outcomes from the three country case studies outlined earlier in this section, and from more general experience.

50 Whereas Section 3 considered national transfer pools with regard to their determination and incentive effects, this section considers these pools with regard to the equalization – and the overall adequacy of these pools.

51 As practised for some years for VDC grants in Nepal, UP grants in Bangladesh and GP grants in Karnataka State, inevitably leading to very inequitable per capita outcomes given hugely varying populations (for example, Nepali VDC populations varied from only several hundred persons to tens of thousands of persons – automatically creating ranges in the order of 20:1 in VDC per capita allocations).

Box 12. Algebraic structure of allocation formulas for equalization

Type (a): Relative expenditure need only

$$\text{Grant to SNG A} = \frac{\text{Expenditure need of SNG A}}{\text{Expenditure need of all SNGs}} \times \text{Size of the UCG pool}$$

Type (b): Relative expenditure need + relative revenue levels

This may only capture relative own-source revenues:

$$\text{Grant to SNG A} = \left(\frac{\text{Expenditure need of SNG A}}{\text{Expenditure need of all SNGs}} - \frac{\text{Own revenues of SNG A}}{\text{Own revenues of all SNGs}} \right) \times \text{Size of the UCG pool}$$

Or it may also 'claw back' shared revenues:

$$\text{Grant to SNG A} = \left(\frac{\text{Expenditure need of SNG A}}{\text{Expenditure need of all SNGs}} - \frac{\text{Own revenues of SNG A}}{\text{Own revenues of all SNGs}} - \text{Revenue-sharing transfers to SNG A} \right) \times \text{Size of the UCG pool}$$

It should be noted that expenditure need of SNG A and own revenues of SNG A may themselves each comprise several variables, each with their own weightings to denote their relative importance as proxy measures for expenditure need and local revenues.

Variables reflecting relative SNG spending needs. The main proxy variable to reflect relative public spending need is population. In many cases, other variables are also included such as land area, poverty or development indices, population density and remoteness. Of these, population is the main driver of relative spending need and should be given a significantly higher weighting than other variables. But often it is given too low a weighting, as seen in Mongolia and Myanmar. This mathematically results in inequitable allocations per capita and a bias against SNGs with larger population sizes. This statement needs to be qualified by the following considerations:

- Some SNG areas with low population levels may often require higher per capita transfer levels – but this is due to lower population density, or greater remoteness, raising service delivery costs, and should be addressed by reflecting these factors in the formula.
- Conversely, some highly populated urban SNG areas may deserve lower per capita transfer levels because these SNGs often have much higher own-source revenues – but, if so, this fiscal capacity factor should also be included in the allocation formula.

Variables reflecting relative SNG fiscal potential or constraints. Many formulas do not attempt to factor in this element of relative need, although clearly it can be very significant, given the potentially large variations in both own-source revenues and shared revenues between SNGs.

Including own-source revenues is clearly important if these are likely to vary significantly across SNGs. However, to do so requires information on local revenue collection efforts which may not always be readily available in a very timely manner. There are also problems with the possible incentive effects of including measures of local revenue in allocation formulas, as reviewed in Section 3.

Revenue-Sharing Transfers are also reflected in some UCG allocation arrangements, for example, in the DAU allocation formula in Indonesia (although in a manner which is problematic), and in the clawback system in Myanmar, but not in Mongolia. Information on shared revenues is generally more readily available than that on own-source revenues at the central level, and so should be easier to factor in. If these transfers are not factored into the UCG allocations then this greatly increases inequity.

Other pitfalls related to allocation formulas.

A number of other issues should be noted:

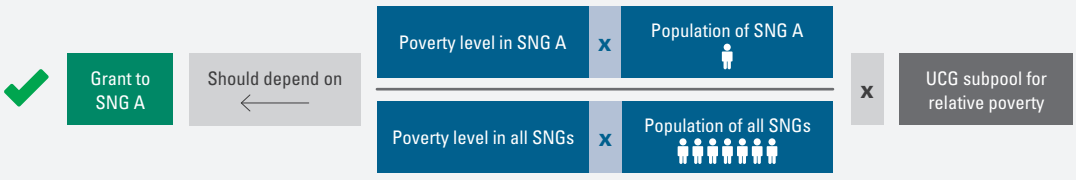
- **Equal fixed allocations**. UCG allocation formulas often contain a fixed element, on the grounds that all SNGs, regardless of population size or context, have a minimum level of expenditure obligations. But if this element is set too high, mathematically, it risks excessive disparity in per capita allocations between SNGs, as seen in Cambodia and Indonesia.
- **Use of index values**. Variables based on an ordinal index such as that for poverty or development must be themselves normalized by the relative population of the

Box 13. Using poverty and other indices in an allocation formula

The generic expenditure needs in Box 12 are comprised of population and often other proxy measures of relative expenditure need – typically including a poverty index of some sort. The formula will assign a percentage weight (z%) to that variable, so that z percent of the total UCG pool is allocated across SNGs based on the relative value for the index value.

But a common mistake is to compute allocations without weighting poverty and similar indices by relative population size, as follows:

Instead, these indices should be weighted by the relative population sizes of the SNG areas concerned, as follows:



The UCG subpool refers to that part of the total UCG pool which is to be allocated for that specific index, based on the weighting given to that variable in the allocation formula.

SNG areas concerned. Yet, often they are simply used as stand-alone absolute values. In this case, they fail to provide a measure of relative need – for example, if two regions have vastly different population sizes, but the same poverty index value, they will be allocated exactly the same amount from the subpool for this variable. This clearly causes a bias against equity and favours SNGs with smaller population sizes.

- **Data and sources**. These variables should be associated with data sources which can reflect as much as possible the current situation, especially the current relative population levels and hence relative needs. Yet data are often very outdated. In Nepal, an effort was made to include a variable to measure relative construction costs in different districts, but it proved too hard to regularly update this. Myanmar exhibits a particularly problematic issue in regard to SNG population sizes – the resident Muslim communities in Rakhine state (numbering up to some 950,000 persons, until 2017), have been excluded from the Rakhine State population in computation of formula-based allocations because they self-identify with an ethnic identity that is not officially recognised by the government of Myanmar.
- **Complexity**. Allocation formulas and variables invariably attract attention of policy makers and analysts. But as more people and agencies are involved, there is a bias for expanding the number of variables and complicating the computations, such that the end result is often non-transparent, and not well understood by the public and even officials themselves,[52] and the results are hard for anyone to justify.

Finally, even though formulas are supposedly in place to allocate to SNGs, there may be occasions when these are simply not used in practice, or are manipulated by politicians or civil servants, such that the actual grant allocations bear no relation to the official "equalization criteria" of the formula.[53]

Figure 33 summarizes the main options in regard to the structure of equalization formulas, and some issues and lessons associated with each.

Obstacles to reform

Two dominant conclusions emerge in regard to equity outcomes of fiscal transfer systems. First, there is often little or no central oversight of the equity consequences of the entire set of all fiscal transfer flows combined. Secondly, where notional "equalization" grants are allocated by formula, these are often inadequate.

Recommendations

Fiscal transfers pool. *Though usually neglected, the adequacy of the size of the national pool of "equalizing" fiscal transfers is a critical issue. Otherwise, even the best-designed formula will not enable these grant transfers to play their role of equalization.*

Allocation formulae. *If the objective is for the grant to play an equalizing role, a few basic lessons emerge. Policymakers must ensure:*

- There is some allowance to compensate for disparities in both shared revenues and own-source revenues. In the latter case, they should take care to avoid embedding disincentives for local fiscal effort.
- The population variable is the main factor in the formula – with weighting at least 50 percent.
- For all variables there are robust, uncontested and regularly updated data available, not based on a one-time survey which will go out of date.
- The computation of poverty and other index-based variables also includes normalizing by relative SNG population sizes (however, absolute values such as land area should not be weighted by population).
- Any equal fixed element is not too large.
- The formula is not too complicated and does not include too many variables.
- A mechanism to monitor and verify those allocations are actually made according to the formula.

Coordination and monitoring

These equity problems are very often hidden, simply because of the lack of readily available comprehensive data on the whole set of centre-to-local fiscal transfers. It is important to establish a central mechanism to consolidate data on and monitor the various centre-to-local fiscal transfer flows, which may be managed by different central government departments and agencies that do not necessarily coordinate with each other, especially in countries without a national local government ministry or finance commission with a mandate to ensure such monitoring.

52 For many decades, local governments in the United Kingdom were funded by a very complex central government grant formula, which was said to be understood by less than a dozen people in the entire country! This has now been simplified.

53 Manipulation by MPs of the former ADP Upazila grant formula in Bangladesh was revealed by a University of Dhaka study in Bangladesh (2002); there are also suggestions that the GLDF allocation formula in Mongolia is sometimes altered by aimags when computing onward allocations to soums. In Myanmar, there is indeed an officially sanctioned adjustment of allocation formula data for Rakhine State, for which the 2012 resident population census number (some 3.15 million) is reduced by the number of non-national residents (some 0.95 million), with a resulting reduction in size of grant allocation.

Figure 33. Unconditional/equalization Grant allocation formula options

Type of allocation formula	Variables	Comments
Type A: Formula with expenditure needs only		
Formula based on equal per capita allocation	Population (may be based on census results, or that which is officially resident).	Population numbers are the single most important driver of relative expenditure needs. They are the simplest, often the easiest starting point, and the only option for low-tier SNGs where no other needs-related data are available. They require fairly recent population data. Census data may be inconsistent with other official resident statistics. This may pose issues in areas of cyclical migration (e.g. of fishermen and herders) where official population residence and related expenditure needs do not always coincide. This also raises issues of residency versus citizenship (as with the Muslim community in Rakhine State, Myanmar).
Formula based on population and other general indicators of expenditure need	Population plus other variables such as: HDI, poverty incidence or proxies such as infant mortality (as proxy for relative per capita expenditure needs); population density (inversely related to service delivery unit costs); land area (proxy for either infrastructure needs and/or service delivery unit costs); and remoteness (proxy for service delivery unit costs). Sometimes a fixed equal amount is also included in the formula to address fixed expenditure needs regardless of other contextual factors.	Should be kept simple – often there is temptation to overcomplicate. Variables need to have reliable,[54] non-contested, recent data sources. Rationale for each needs to be clear, to avoid double-counting of factors. Care needed in calibration: population variable needs major (>50%) weighting, and other index variables (but not land area) should also be weighted by relative population. A too large fixed element will be a driver of inequity – as seen in Cambodia and Indonesia.
Type B: Formulas that consider both expenditure needs and fiscal capacities		
Formulas that aim to reflect both sides of relative need	This includes one or more Type A variables, and also either actual or potential own revenues, and in some cases shared revenues may be clawed back.	Clearly, the preferred approach, if there is agreement and if data are available for the indicators. Increasingly being used in OECD countries (Australia, China, Japan and Rep. of Korea), in Indonesia, and now in Myanmar.
Formulas that aim to reflect both sides of relative need, but also to calibrate allocations based on SNG performance.	Variables to measure performance – typically in regard to revenue-collection efficiencies (not absolute levels of revenue collected), in addition to other variables.	This has a different logic from that of relative need, and care must be taken to ensure that need objectives do not suffer. One option is to establish a separate allocable pool for incentives of performance as a top-up to the basic pool. These options are discussed in Section 5.

Source: Adapted from Boadway and Shah (2001).

54 In this case, the allocations should rely as far as possible on data that are collected by entities other than SNGs themselves, such as National Statistical Offices. Otherwise, SNGs may have incentives to modify the data.

The reform challenge: Winners and losers

However, even where such equity problems are identified, it can be hard to undertake reforms. In any reform to the fiscal transfer system towards greater equity, some SNGs will benefit but others will lose from a change to the status quo. This will be a greater or lesser problem depending on the political power of SNG leaders[55] and their civil society groupings.

The simplest way to address this is for the central government to increase the total volume of national transfer pools to a level where no SNGs will lose with a change in allocation criteria (the "hold harmless" approach). This was the case in Nepal, where a move from equal allocations to formula-based VDC grants meant relatively smaller shares going to the less-populated VDCs; this problem was avoided by a massive increase in the national VDC pool. But not many countries have the resources to make the large budgetary increases to the size of national grant pools that are needed for such allocation reforms.

Elsewhere, the problem has been addressed by phasing in changes over time, to allow SNGs to adjust to the increases or decreases in annual budget resources which are entailed by such reforms. This is currently being considered to ease proposed transfer reforms in Indonesia.

55 Allegedly, one reason why reform of own-revenue powers and revenue-sharing arrangements in the Lao Democratic People's Republic was so difficult is that provincial governors sit on the Party Central Committee and are immensely powerful.

Deconcentrated spending: A postscript

Where there are major disparities in SNG per capita revenues and spending, it may be argued that they may be offset by deconcentrated central government spending patterns, since this covers only part of total government spending in the respective areas. Although deconcentrated central government spending is indeed almost always much greater than devolved spending through SNGs, there is no reason to think this will offset disparities in the latter, for two reasons.

Firstly, SNGs often have exclusive service delivery and expenditure mandates which are not covered by central government expenditures. Therefore, even in principle, the deconcentrated central government spending could not compensate for inequities in the devolved revenues and spending by subnational governments.

Secondly, there is good evidence from several Asian countries that the central government's own deconcentrated spending patterns are themselves often highly inequitable over the national territory. For example, the max:min ratios of central government per capita spending on education in Afghanistan is 7:1 across provinces, and in Myanmar it is 5:1 across states/regions (Boex, Nixon and Lister, 2008; Shotton, Yee and Oo, 2016).

Indeed, evidence from Thailand, where deconcentrated spending on health and education greatly overshadows devolved spending, suggests that inequities in the deconcentrated spending may actually reinforce inequities in the devolved spending, resulting in max:min ratios between provinces of 5:1 for education and 17:1 for total health spending, to the overwhelming benefit of Bangkok (see World Bank, 2012). Service delivery costs per person may be higher in the capital city – for example, if staff salaries are higher, and especially if the costs also include tertiary services. Nevertheless, such massive disparities can hardly be justified.

Figure 34. Thailand: Regional inequities in deconcentrated and devolved funding, 2010

Statistic	Bangkok	Central	North	Northeast	South
Total central spending	**157,104**	**12,488**	**13,467**	**10,192**	**13,666**
• Health	14,722	1,235	1,350	824	1,270
• Education	20,106	3,728	4,745	3,923	4,551
• Other	122,276	7,525	7,372	5,445	7,845
Total local spending	**6,697**	**3,909**	**3,227**	**2,972**	**3,262**
• Health	792	264	162	76	149
• Education	715	552	453	479	420
• Other	5,190	3,093	2,612	2,418	2,694
Total general spending	**163,802**	**16,397**	**16,694**	**13,165**	**16,928**
• Health	15,514	1,397	1,459	919	1,362
• Education	20,821	4,280	5,197	4,402	4,971
• Other	127,466	10,720	10,038	7,843	10,595

Source: World Bank (2012).

Figure 35. Thailand: Health spending per capita, in THB, 2010

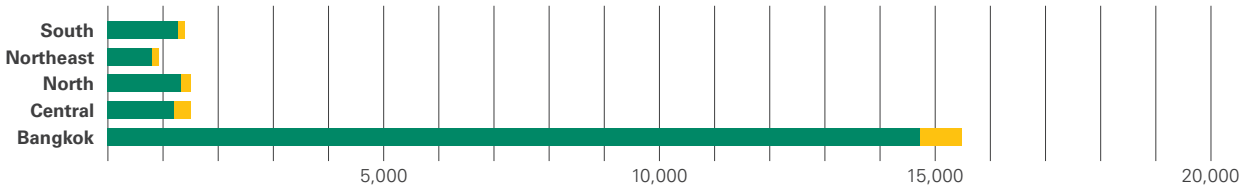
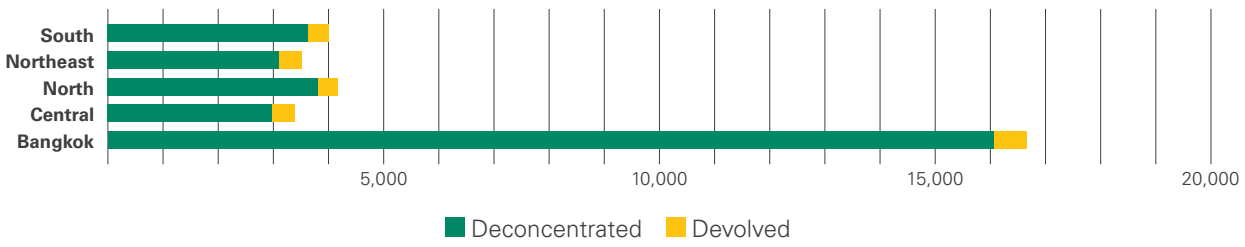


Figure 36. Education spending per capita, in THB, 2010



Source: World Bank (2012).

5

Leveraging Transfers to Promote Better Local Performance

Overview of Performance-Based Grants

While many of the negative incentive effects of fiscal transfers are unintended (Section 4), fiscal transfers can be designed to explicitly embody positive incentives. Historically in some cases, SNG grant transfers have been tied to incentives for local revenue-mobilization efforts, as seen in Mongolia. Usually, this has been done by including a variable in the grant allocation formula which provides additional resources to SNGs that show better performance in collecting own-source tax revenues.[56]

There is now emerging experience worldwide of using fiscal transfers as instruments to promote better local financial management and governance performance more broadly[57] – in addition to purposes such as increasing SNG resources. Box 14 shows a small sample of such schemes, aimed to encourage one or more dimensions of SNG performance. Some of these are then examined in more detail in the following subsections.

56 In the special case of (former) socialist/transition countries, SNGs are encouraged to raise more revenue and move from budget "deficit" to "surplus", through the reward of greater budgeting autonomy and fewer *ex ante* controls and restrictions (however, the perverse nature of these arrangements was also examined above).

57 It is important to distinguish Performance-Based Financing (PBF) from Performance-Based Budgeting (PBB). PBB was developed in an effort to ensure that budgets be aligned to policy priorities, as a departure from the prevalent mode of line-item and incremental budgeting. The record in implementing PBB around the world has been patchy and not always successful. By contrast, PBF mechanisms are an attempt to link central government funding to SNG performance in predetermined areas, as a departure from the usual "entitlement" funding approaches.

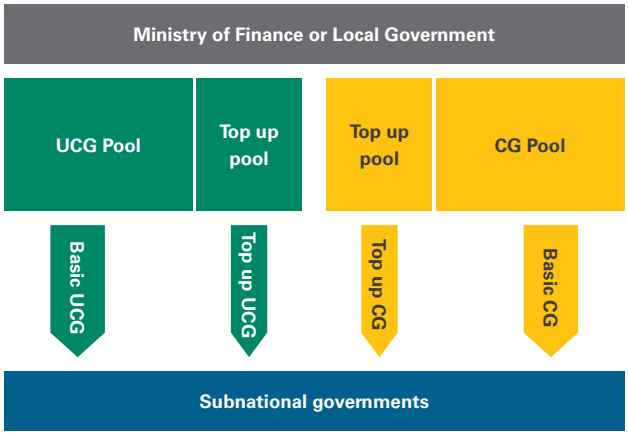
Box 14. Examples of SNG performance incentives

- **United Kingdom**: In 2000–2010, SNGs in England were subject to a "Comprehensive Performance Assessment" which assessed service delivery performance in education, housing, social care, environment, libraries and leisure, and general use of resources. Poorly performing SNGs were then provided with remedial help, while the top-performing SNGs were allowed greater discretion in use of transfers and a three-year exemption from audit inspections, but not an increase in funding. However, this scheme was ended in 2010 on the grounds that it constituted excessive central interference[58] (Lockwood, 2011).
- **Brazil, Portugal and France**: In the early 1990s, Brazil piloted and then scaled up Ecological Fund Grants, as "top-ups" to the basic UCGs, in order to reward good conservation performance in demarcating and managing ecologically fragile areas in SNG jurisdictions, and also to compensate for SNG revenues lost through such conservation measures. A similar incentive mechanism has now been adopted in Portugal and France, and is being studied as an option in Indonesia. SNGs can spend these top-up grants on any sectors under their mandate, not restricted to conservation-related expenditures (Borie et al., 2014; Cassola, 2010; Droste et al., 2015; Loft, Gebara and Wong, 2016; and Santos et al., 2011).
- **Argentina and Brazil**: Plan Nacer is a performance-based funding mechanism begun in Argentina in 2003 to reverse a serious decline in health services in the late 1990s. Funding for health spending is allocated to province and health-service facilities based on several factors, including quality of service delivery and health outcomes. It has been so successful that it has been replicated in Brazil as the Family Health programme (The World Bank, 2015a).
- **The Philippines**: Under the Seal of Good Local Governance initiative, all SNGs are assessed annually against six sets of criteria (disaster preparedness, social protection, business friendliness, peace and order, environmental management, and local revenue-raising efforts) and top-ranked SNGs are awarded a financial prize. A separate Performance Challenge Fund provides matching funds for "high quality and priority" projects submitted by SNGs, to encourage more strategic investments (Department of the Interior and Local Government, 2017).
- **Cambodia**: The recently established Sub-National Investment Fund provides project funding opportunities to districts which rank highest on a prior assessment of their compliance with basic PFM and governance criteria, and which submit strategic investment proposals which meet minimum quality standards.
- **India**: The 14th Central Finance Commission (CFC) has recently recommended that 10 percent of the SNG UCG allocations be performance-based – dependent on audit results, local revenue collection efforts, and service delivery benchmarking. This initiative, partly inspired by the Kerala and West Bengal experiences, will be applied to grants provided to over 250,000 Gram, Block and District Panchayats countrywide. Since the 12th CFC, there have also been performance elements attached to conditional transfers for health (Government of India, 2015; Centre for Global Development, 2015).

58 The termination may also be linked to the start of severe cut backs to transfers to SNGs also starting in 2010, under the national fiscal austerity programme, which arguably rather undercut the legitimacy of this sort of central oversight and reward mechanism.

Some of these schemes simply provide one-off rewards or other forms of recognition to top-performing SNGs. But there is an increasing number of schemes, which aim to **embed positive incentives** for better performance into grant transfer allocations to SNGs. Essentially, "top up" grants are provided, based on assessed performance, to increase the size of UCGs or CGs.

Figure 37. Performance-Based Grants as a top-up to UCGs and CGs



In this section, some of these schemes are reviewed, with general issues and lessons described. More detailed profiles are provided in Annex 1, together with some evidence of their impact.

Multisectoral Performance-Based Grants

One recent approach to performance-based funding of SNGs focuses on the performance of SNGs in complying with processes. These PBGs emerged initially from donor-supported[59] programmes in a number of countries in Asia and Africa. Many of these schemes have since been mainstreamed within national transfer mechanisms, particularly UGCs. This approach is therefore multisectoral, in that it does not focus on performance in any specific sector.

Rationale for Performance-Based Grants

The rationale for the PBG approach is that SNGs may lack adequate incentives to perform adequately or even to simply comply with national policies, laws or procedures in regard to general PFM, local governance, and service delivery arrangements (Steffensen 2010; Stevens 2004).

Normally, it is expected that such compliance is achieved through central government monitoring, inspection and related sanctions (downward accountability and control), as well as the pressure of local civil society and voters (upward accountability and control) (Figure 38).

But both upward and downward incentive and accountability mechanisms are often very weak. SNGs often continue not complying and underperforming without effective sanction and with fiscal transfers still flowing automatically. Citizens are often not aware of the reasons underlying management and performance issues, other than that service delivery may be poor, and have few avenues of redress other than in periodic local elections. PBGs aim to provide a financial incentive to supplement these accountability mechanisms (Steffensen 2010).

Figure 39 illustrates the "chain" of results achieved in the course of SNG planning and management of its resources: from deployment of inputs to process, outputs (actual service delivery), outcomes and impact. Along this chain, from left to right in the chart, these results are progressively subject to more factors outside SNG control.

Box 15. Evolution of Performance-Based Grants

PBGs were initially trialed in Uganda with UNDP and UNCDF support as part of the major devolution reform introduced in the late 1990s, and then scaled up by government with World Bank funding. After this, they were rolled out in several other countries in Africa and Asia.

In Asia, again with UNDP and UNCDF support, they were adapted and piloted in Nepal, Bangladesh, Bhutan and Solomon Islands in 2000–2010, and then mainstreamed by central governments into national UCG transfer mechanisms: the DDC and VDC grants in Nepal, the Union and Upazila Parishad grants in Bangladesh, the Gewog and Thromde grants in Bhutan, and the province grants in Solomon Islands.

Other variants of PBGs in Asia were introduced largely with World Bank support: in Indonesia through the Initiatives for Local Government Reform Project; in West Bengal through the Institutional Strengthening of Gram Panchayats Programme; and in Mongolia, through the Sustainable Livelihoods Project (Phase 3), a performance-based grant is currently being piloted nationally for allocation to eligible soums, alongside the basic LDF grants, with the aim to later mainstream fully within the LDF.

59 These were originally introduced under UNCDF/UNDP projects which in many cases have been replicated in World Bank programmes.

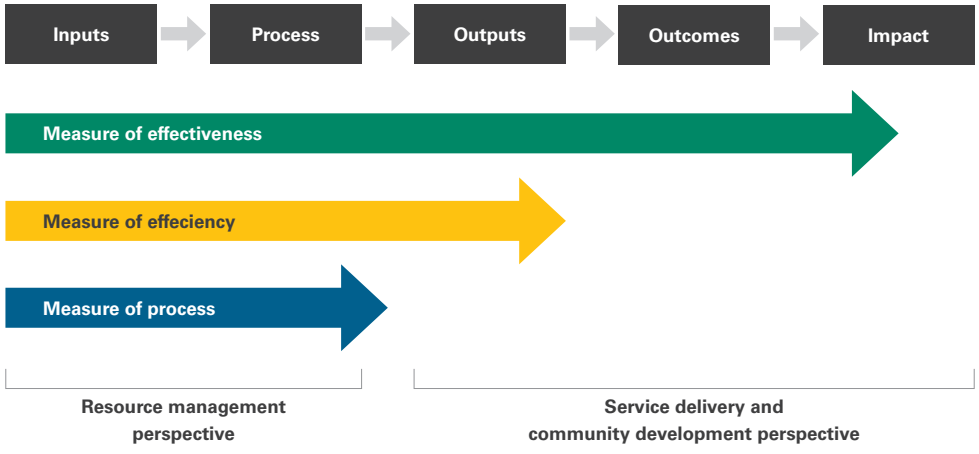
Figure 38. Accountability relationships and incentives to comply and perform

Source: Developed based on Steffensen (2010).

Within this "results chain", the focus of PBGs is deliberately on lower-order performance – "institutional processes", rather than "outputs" or "outcomes". In other words, multisectoral PBGs focus on the compliance with or the quality of processes such as planning, budgeting, procurement and budget execution procedures, human resource management, transparency and disclosure arrangements, and tax revenue collection efforts. There are two reasons for this focus on processes, rather than outputs or outcomes:

- Measuring and comparing SNG performance on the basis of higher-order performance results, such as service quantity and quality or citizen satisfaction, is much harder and also more costly. Comparing fairly across SNGs is problematic, given that many other external factors affect these results which are outside the control of the SNGs.

Figure 39. Levels of SNG performance or results



Source: Adapted from Steffensen (2010).

Box 16. Multisectoral Performance-Based Grants systems: Synthesis

There are important differences between each PBG mechanisms in different countries, given the major variations in national and local contexts. Nevertheless, PBGs also embody a set of common features.

Conditions of access

PBGs (or some part of the PBG pool) are allocated only to SNGs which have shown satisfactory compliance with a set of Minimum Conditions (MCs). These MCs are intended to measure the capacity of SNGs to perform their functions and minimize fiduciary risk. They are usually binary YES/NO criteria related to quality of management, such as basic planning, budgeting, procurement, audit and reporting procedures, asset management, human resource management, disclosure and transparency to the public. SNGs with satisfactory compliance with MCs become eligible to receive the PBG, which provides the incentive for better performance in the areas concerned.

Calibration

Usually PBGs represent a top-up grant (usually 20–25% of the UCGs) in addition to the UCGs. Some PBGs also include an additional incentive, whereby the size of the PBG to eligible SNGs may actually be calibrated (adjusted) up or down depending on the quality of performance measured against the MCs. In this case, at least some of the MCs are not binary, but are scored on a relative scale. This is intended as an added incentive.

PBG use and discretion

Generally, PBGs may be used for the same expenditures allowed for the UCGs which they are topping up – though in cases they are limited only to development investments.

Annual Performance Assessment (APA)

A key feature of a PBG mechanism lies in the Annual Performance Assessment: an annual process whereby independent evaluators usually visit each SNG to verify performance against the specified criteria. The APA is undertaken well ahead of the budget year for which PBGs are to be allocated, to allow time to process results and feed into the national budget process for allocating transfers. In some countries, SNGs are also encouraged to undertake a prior self-assessment as part of this process. The APA process is usually undertaken on behalf of the Ministry of Finance, the Ministry of Local Government or the Finance Commission, which must validate the results prior to approval of PBG allocations.

Publicity

Another key feature is that the results of the APA and of the PBG allocations are made public. Otherwise, the incentive effects will be greatly reduced if people are not aware of the consequences of SNG performance and are not able to bring pressure to bear for improvement.

Link to capacity development targeting

In most countries, the APA results are also used to help target remedial capacity development to bring all SNGs up to standard. Indeed, the prospect of access to PBGs provides an incentive for SNGs to make full use of capacity development support.

Performance against process rather than outcomes

Lastly, common to all PBG systems is the focus on assessment of SNG performance in managing procedures (such as planning, budgeting and procurement) or in delivering basic procedural outputs (such as plans, budgets and other reports), as proxy measures for the quality of public financial management and service delivery. The reason for the focus on processes is that there are huge methodological problems in assessing and fairly comparing SNGs against higher-order results related to the quality and quantity of service delivery.

Some countries where PBG systems are officially adopted:

Asia: Bangladesh, Bhutan, Indonesia, Mongolia, India (Kerala, West Bengal), Nepal (though currently suspended with the move to the federal set-up) and Solomon Islands

Africa: Ethiopia, Ghana, Kenya, Mali, Sierra Leone, Uganda and the United Republic of Tanzania

In Annex 1, some specific examples of the PBG mechanism introduced in Asia are outlined.

- Where PBGs are associated with broad-use UCGs rather than sector- or service-specific CG transfers, it is very hard to compare the performance of different SNGs which may have legitimately opted for very different expenditure and service delivery patterns.

The key features of multisectoral PBGs mechanisms are outlined in Box 16.

Evidence of effectiveness of multisectoral PBGs

Annual Performance Assessment (APA) scores should improve over time if PBGs are effective as incentives to improve SNG performance. Improvements in process performance would be **necessary**, if not sufficient, condition for improvement in service delivery performance. Because of data limitations, it is not possible to construct meaningful cross-country comparisons; instead country results are reviewed separately to provide evidence suggesting the effectiveness of PBGs with a discussion of the issues arising. Details of selected countries' multisectoral PBG systems are in Annex 1, together with some available evidence of impact. However, the evidence is patchy about the effectiveness of many of the instruments.

Most cases do suggest that over time the APA process indicator results tend to improve. While in some cases, this could be partly attributed to capacity support, in other cases, where little or no capacity support was provided, PBG-related incentives indeed seem to have played an important role in improving performance. However, even in these cases, hard evidence is missing that improvements in SNG institutional performance have led to improvements in service delivery. This is an area where more in-depth evaluative research is needed.

Sector and thematic Performance-Based Grants

Another approach to PBGs focuses on specific sectors. Here, performance incentives are built into CG transfer mechanisms to promote performance in specific areas of local service delivery or compliance with specific national policy priorities.

Among these, PBGs are most frequently found in the health sector. Since health services are delivered through discrete, immediate and measurable output transactions, with outcomes directly related to these transactions, the health sector lends itself more readily to such performance measurement than other sectors. Thus, the health sector has the most experience in tying fiscal transfers to output and outcome measures. However, there is also experience in PBGs in other sectors. This section will first review more established PBG experiences, focusing on health and education. Then, it will review more recent PBG experiences related to environment and climate change.

Health and education sector PBGs

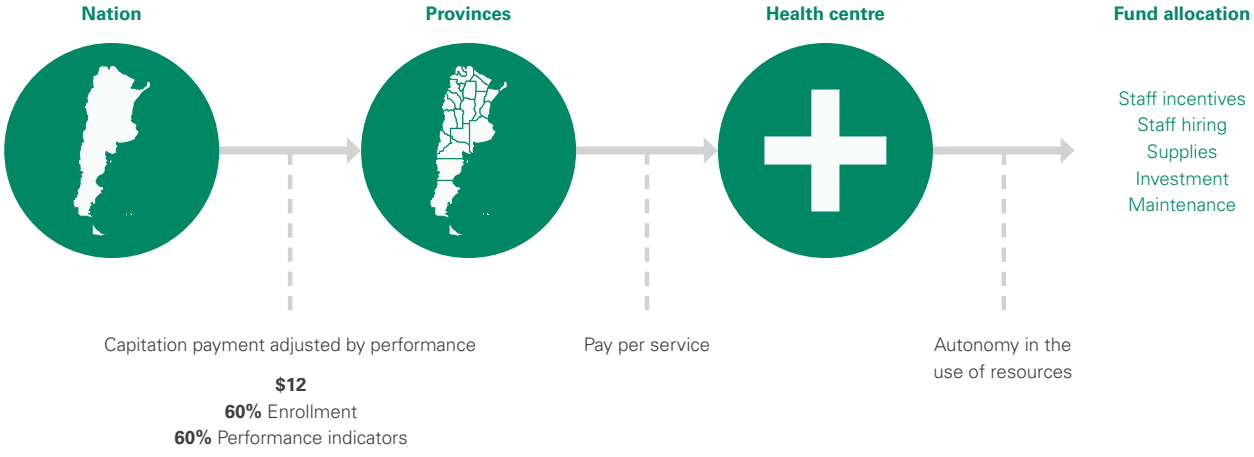
Argentina: Health financing

In Argentina, basic services have long been devolved to SNGs. A Performance-Based Grants scheme was launched in Argentina in 2004 with World Bank support to reverse the severe degradation in local health services following the fiscal crisis of 2001–2002. It was first piloted in a few provinces, then scaled up nationally as *Plan Nacer*, with a focus on maternal and child care. Subsequently, the scheme was renamed *Programa Sumer*, and the range of health services under it was broadened. A similar scheme has since been adopted in Brazil.

This scheme has comprised a broad set of reforms to the health sector. The key element has been a performance-based financing model by which:

- Central government allocates health grant transfers to provinces, based on a per capita formula, but weighted by province performance against a set of 10 "tracer indicators" related to health service outputs and some outcomes, which are audited every year. Performance agreements are established with each of the provinces, specially tailored to ensure consideration of the different local health service contexts.
- The provinces, in turn, allocate part of these funds to front-line health centres, for basic staff and operating and maintenance expenditures. A key aspect is that funds are allocated in a manner which provides flexibility and incentives for better management. Unlike Uganda and the United Republic of Tanzania referred to above, the policy and regulatory framework that allows the necessary degree of flexibility in health centre management has already been established in Argentina and Brazil.

Figure 40. Argentina: Plan Nacer



	Health goals	Description of tracer
I	Early detection of pregnant women	Detection before the 20th week of pregnancy
II	Effectiveness of childbirth and neonatal care	Newborn's physical condition after delivery (APGAR – Appearance, Pulse, Grimace, Activity, Respiration – score >6 at 5 minutes after birth)
III	Effectiveness of prenatal care and prevention of prematurity	Infant birth weight >2500g
IV	Effectiveness of prenatal care and childbirth care	VDRL – Venereal Disease Research Laboratory – test and immunization for mothers against tetanus
V	Audit of mother and child deaths	Audit process in case of mother or child death seeks to evaluate and improve the current level of care
VI	Immunization coverage	Triple viral and measles immunization for children under under 18 months
VII	Sexual and reproductive care	Provision of information on contraceptive and sexual health services during puerperium
VIII	Follow-up healthy children up to one year of age	Provision of health care and checkups for children up to one year of age
IX	Follow-up healthy children from 1 to 6 tears	Provision of health care and checkups for 1- to 6-year-old children
X	Inclusion of indigenous people	Health care provision for indigenous population

Source: The World Bank (2015a).

Punjab, Pakistan: Health financing

In 2010, the government of the province of the Punjab in Pakistan introduced a Performance-Based Equitable Resource Allocation Model which aimed to reward districts in Punjab which achieved improvements in Universal Health Coverage indicators.[60] Performance-based financing was provided on top of regular allocations, and was to be used for both capital and recurrent expenditures. The base component that is based on health service needs accounted for 70 percent of total health allocations to districts, while the performance component accounted for 30 percent (UNICEF, 2013).

The PBG scheme assessed district performance along 10 indicators related to maternal and child health (See Figure 41). It took into account both need and improvement in health outcomes. It guarantees a minimum allocation for districts to meet the needs for health services, and at the same time, provides a top-up for well-performing districts.

Further calibration of the performance allocation component is done to account for the baseline levels of health outcomes in the districts, since making improvements from a low starting point is easier than from an already high starting point.

60 However, this scheme was discontinued in 2014.

Figure 41. Punjab, Pakistan: Key features of performance-based funding of district health services

Component	Weight within each component	Relationship of the indicator vis-à-vis allocation
Base component – Needs Index (70%)	**100%**	
Number of health facilities	40%	Larger number of health facilities – higher allocation
Social deprivation index (literacy, school enrollment, skilled birth attendance, modern contraceptive use, water and sanitation access)	25%	Greater level of social deprivation – higher allocation
Rural population	25%	Larger rural population – higher allocation
Maternal and child mortality index	10%	Higher maternal and child mortality – higher allocation
Performance component (30% from year 2)	**100%**	
% pregnant women registered for antenatal care	Equally weighted – 10% each	Positive change in indicators means higher allocation. Districts are grouped into five categories according to the percentage of performance indicators improved, ranging from very good to poor. Only districts with good and very good performance received allocation from the 30 percent performance component. Among them, districts with very good performance receive an additional bonus.
% pregnant women receiving antenatal visits		
% births delivered by skilled health attendants		
% women who delivered at a health facility		
% fully immunized children 18 to 30 months old		
% Tetanus Toxoid II vaccine coverage of pregnant women		
% Population coverage by community midwives		
% Availability of essential maternal and child health staff		
% Availability of essential drugs at facilities		
% Availability of essential maternal and child health related equipment		

Source: UNICEF (2013).

Preparations were done prior to the full rollout of the reforms. In the first year, all districts received 100 percent of the allocation on the basis of need and the 70 percent base and 30 percent performance allocation was introduced in the second year of the reform. This allowed districts to fill critical gaps. In addition, each district was required to meet Minimum Conditions: sign a Memorandum of Understanding with the provincial government committing to achieve targets, report on delivery and outputs; prepare a three-year rolling plan; and agree to update their plan yearly.

The health PBG scheme was more transparent than traditional ways of allocation, since it involved adoption of a formula so that the districts could verify the accuracy of the allocation.

India: Health financing

India has implemented two important programmes in financing local health care. For a long time, Conditional Grants for health were allocated to states on a formula basis, with a strong equalization objective, such that states with historically lower-than-average per capita health spending would receive additional transfer amounts to compensate.

Under the 13th CFC period (2010–2015), there was a major policy change, and health Conditional Grants were provided based on results, to encourage better performance, and grants were thus allocated based on states' progress in improving Infant Mortality Rate (IMR) outcomes.

Research by the Centre for Global Development has revealed that tying allocations to IMR outcomes led to a highly inequitable allocation of resources, with some states receiving Indian rupees 100–200 per capita, and others less than Indian rupees 1 per capita. These massive disparities arose because there was not adequate recognition of the very different degree to which improvements in IMRs could be made in states at different points on the IMR spectrum – and so states starting at better IMR levels, which were relatively harder to improve, were penalized.

This is not itself evidence against linking allocations to outcomes, but it does underline the importance of careful baseline research to properly calibrate the linkage between allocations and outcome changes, and recognize that different SNGs will be on different health outcome trajectories.

Uganda and the United Republic of Tanzania: Health, education, water and agriculture

The general multisectoral PBG approach outlined in the previous section is being adapted for sector transfers in Uganda, a pioneer in this area; the United Republic of Tanzania is also adopting a similar approach. SNGs in both countries are mandated with a wide range of service responsibilities, and PBGs have been extended to cover health, education and water CGs in Uganda (Government of Uganda 2017) and health, education and agriculture CGs in the United Republic of Tanzania.

As illustrated in Box 17 for Uganda, SNGs must display satisfactory performance against some sector-specific Minimum Conditions (MCs), in addition to a set of general PFM and governance-related Minimum Conditions (MCs).

A key dimension of the strategy for education and health is also to extend the performance-financing chain down through SNGs to front-line facilities such as schools and clinics. However, this will be established on a phased basis, since several preconditions should be established first.

Performance-based funding for health and education: The importance of front-line units

As suggested in the examples above, any performance-based funding mechanism in these sectors critical for the SDGs must ultimately extend down to the front-line units which actually deliver services: health centres, clinics and schools.

As a special category of transfers, grants are sometimes provided directly to front-line service delivery facilities, allowing them some budgetary discretion. There is indeed a body of international evidence that shows that allowing schools and health facilities some operational and budgetary autonomy is a key ingredient for effective and equitable service delivery.

Health facility performance grants

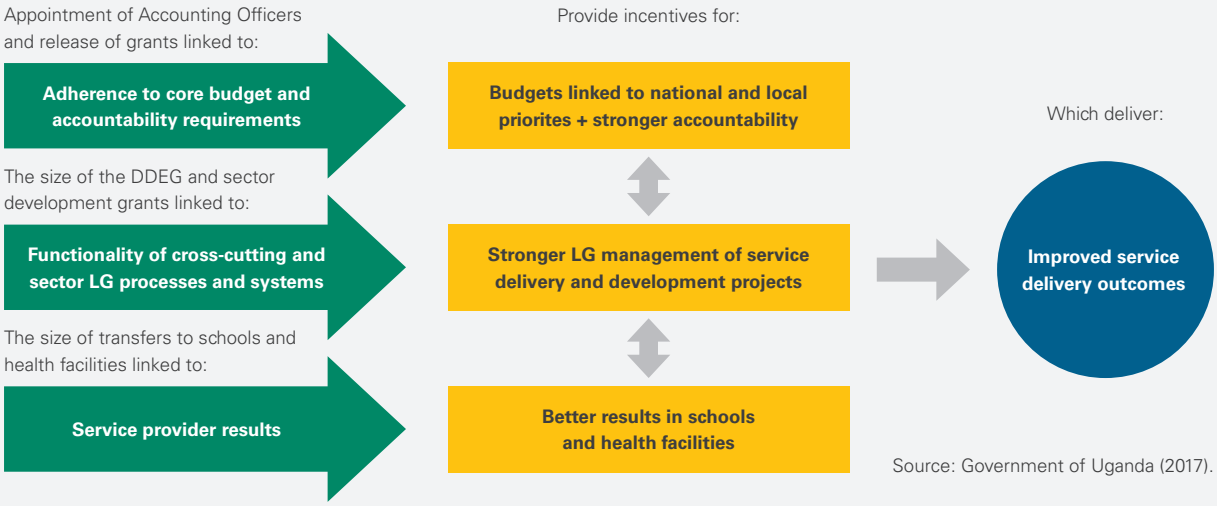
There is a substantial body of experience in performance-based funding of front-line health facilities which reward both service output and process performance, as described in Box 18.

Box 17. Uganda: Expanded performance framework for local service delivery

The expanded PBG mechanism is part of a broader performance framework for SNG service delivery in Uganda, which comprises the following:

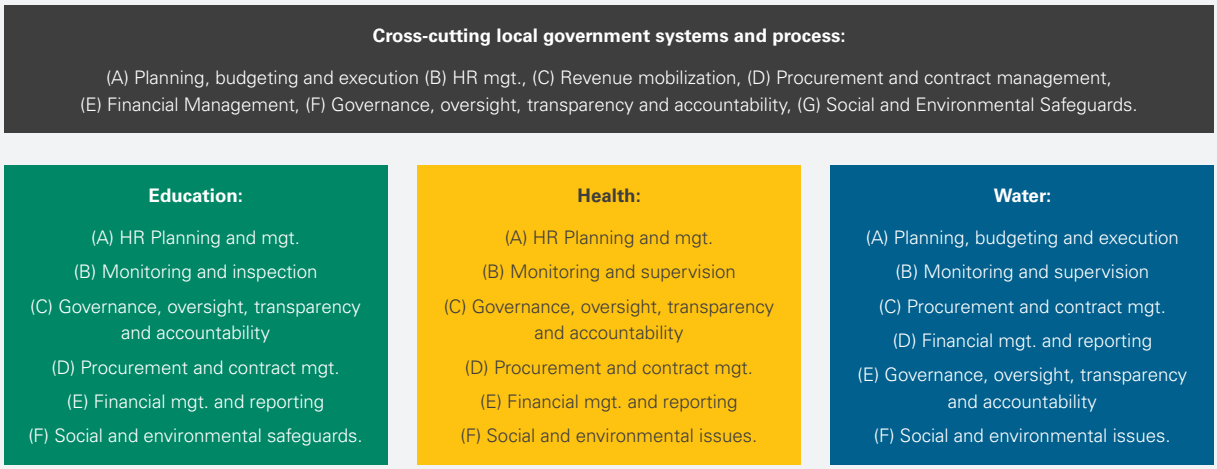
- **Dimension 1**: Strengthening accountability and linkage of SNG expenditure to national and local priorities for service delivery by linking individual SNG staff contracts to their compliance with performance contracts related to budgeting.
- **Dimension 2**: Incentivizing management of local investment and service delivery by allocating a share of both UCG and CG transfer pools to SNGs based on performance assessment results – see Figure 42.
- **Dimension 3**: Incentivizing service delivery processes and results in front-line delivery units (schools, health facilities) by linking operational transfers to their performance.

Figure 42. Uganda: Interlinkages between the three dimensions of the performance framework



Source: Government of Uganda (2017).

Figure 43. Uganda: Dimension 2 of the performance-based framework: General and sector performance criteria



Note: DDEG – Discretionary Development Equalization Grant Source: Government of Uganda (2017).

Box 18. Performance-based transfers to health facilities

Performance funding mechanisms for health service units have grown mainly out of experience since the early 1990s where performance-based contracting schemes were introduced through donor-supported programmes in Cambodia, and then Rwanda, Zambia, and elsewhere in Africa and Asia. There are many variants, but the basic health service performance-based funding model has two key features:

i. Basic grant: Health facilities are provided funding based on the quantity and quality of various health services delivered, as verified independently. These cost norms may need to be calibrated by local context (for example, unit costs may be higher in remote rural areas).
ii. Top-up performance grant: Extra funding may be provided to the health facility based on the performance assessment results of annual service delivery quality or health outcomes. This may also need to be calibrated to reflect the differing baseline health status of different contexts.

Where such grant revenues exceed operating costs, any surplus may be retained and used with some flexibility for agreed types of expenditure, especially expenditures which will improve future performance.

This mechanism potentially provides incentives for more efficient management and service delivery. These schemes have all shown a shift away from financing inputs, such as personnel and medicines, to financing results. In some cases, the measured results were outputs (services delivered), and in other cases, they were higher-order health outcomes.

Sources: Eichler, Levine and the Performance-Based Incentives Working Group (2009); Fritsche, Soeters and Meessen (2014); and Musgrove (2011)

However, establishing a system of performance grants to front-line service delivery units requires a number of preconditions, especially in regard to human resource policy and regulations for health staff. It also requires careful prior research of service delivery costs, staff productivity rates, and the baseline levels in different areas, in order to calibrate fee payments and performance expectations to appropriate levels. Overall, these sector policy preconditions and the upfront baseline study requirements make such mechanisms much more challenging than the design of process-compliance-based PBGs to SNGs, as outlined above.

School performance grants

There is substantial experience worldwide in the management of direct grant transfers to schools and now also a number of school grant transfer mechanisms in Asia.

School grant transfers tend to be restricted to a more narrow subset of non-staff operational expenses and

are often separated into transfers for items such as operational expenses and scholarships. For example, in Indonesia, schools at all levels received grants from the Bantuan Operasional Sekolah (BOS) programme from the Education Ministry and SNGs, with allocations on a per-student basis. The grants cover operational costs. In Sri Lanka, under the Education Quality Initiative (EQI), a percentage of the national education budget is allocated to provincial authorities which, in turn, allocate grants to schools according to a formula based on school size, number of grades taught and technical quality norms.

Some of these are highlighted in Box 19.

Box 19. School grant transfers in Asia

- Indonesia: Schools at all levels received grants from the Bantuan Operasional Sekolah (BOS) programme – grants provided both by the Education Ministry and also by SNGs, with allocations on a per student basis, with the objective of covering school operational costs which otherwise may be borne by families.
- Nepal: Under the Basic Education for All Programme, the Ministry of Education transfers funds directly, through the District Director of Education, to School Management Committees (SMCs).
- Sri Lanka: Under the Education Quality Initiative (EQI), a percentage of the national education budget is allocated to provincial authorities who, in turn, allocate grants to schools according to a formula based on school size, number of grades taught, and technical quality norms.

There are some examples where school grant mechanisms are also designed to encourage better performance, as in the case of the pilot project in the Lao People's Democratic Republic below.

Box 20. Lao People's Democratic Republic: School performance grants

Since 2012, the non-staff operational costs of schools in the Lao People's Democratic Republic have been funded by formula-based grants based on the number of enrolled students, with differing per student rates in pre-primary, primary and secondary schools. These PBGs allowed school management the autonomy needed to ensure expenditures match greatly differing needs of different locations. Under a World Bank-managed Global Partnership Education project, a performance element is now being piloted in 88 districts, whereby a top-up grant, in addition to the basic grant, will be provided to schools which meet certain Minimum Conditions:

- A school education development plan has been prepared
- A school budget has been prepared
- A financial report has been prepared for the previous year
- The principal and school committee members have completed training on the "school self-assessment" methodology.

This pilot has started only recently so it is too early to assess the impact or effectiveness.

Unlike grants to health facilities, it is more difficult to link school grants to educational outputs or outcomes, and so most schemes basically link extra funding to aspects of process compliance. However, some school grant programmes in OECD countries illustrate a scope to link funding with areas of national policy importance, such as enrolling students from minority backgrounds, or girl students, or introducing local languages into the curriculum (See Figure 44). Similarly to PBGs to health facilities, the challenge is to calibrate the rewards in ways which take due account of differing contexts and baselines.

Environmental performance-based grants

Brazil: Ecological fiscal transfers

In Brazil, a federal country, states are empowered to impose a tax on the circulation of goods and services of interstate and intermunicipal transportation and communication (ICMS). At least 25 percent of revenues from this tax are allocated by states to municipalities. The Constitution states that at least three-quarters of these revenues should be allocated on the basis of the value added on goods and services by municipalities, but up to a quarter of these revenues can be allocated based on the discretion of the states. Since 1991, the states started introducing ecological fiscal transfers, whereby this share of ICMS allocable to municipalities (25 percent

Figure 44. School grants in selected OECD countries

Country	Coverage of school grant/funding	Basic of basic funding allocation to schools	Factors that increase/decrease basic funding allocation
England	All personnel and operating costs	Student numbers	1. Social deprivation (e.g. students eligible for free school meals) 2. Students with special educational needs 3. Students with English as an additional language 4. Site and school factors (e.g. size of school, business rates etc.)
Korea	Non-salary recurrent	1. Teacher numbers 2. Classroom numbers 3. Student numbers	None
Malaysia	Non-salary recurrent	Student numbers are main determinant but there are many other smaller grants	1. Language groups in schools 2. Subjects based adjustments 3. Students with low language proficiency 4. Additional per-student grants for poor children (e.g. milk, supplementary food and uniforms) 5. School size 6. Resource center, guidance and counselling provision 7. Special programs
Australia	All personnel and operating costs	Standard for primary and secondary school per student	1. Students with non-English language 2. Students from minority groups 3. Students with special educational needs 4. School size 5. School location (e.g. remoteness) 6. Students from two lowest socio-economic quartiles)
Poland (Kwidzyn)	All personnel and operating costs	Student numbers with a per-student allocation for teachers, non-teaching staff and non-staff operating expenses	None

Note: This is a summary table and is designed to give a broad outline of the major components of the elements that determine the allocation to schools. Frequently, there are funding formulas used by central governments to allocate resources to local government or administrative units which these units then use to allocate to schools. These formulas are excluded from the table. Information in the table does no include capital allocations. Refer to original sources for more detailed information.

Source: NFER and LGA (2005). School funding: a review of existing models in European and OECD countries.

of 25 percent of ICMS) is allocated on the basis of environmental conservation criteria.

By 2016, 16 out of 26 Brazilian states have instituted such transfers, which are allocated on the basis not only of more "traditional" criteria, such as population and land area, but also additional criteria related to coverage and quality of environmental protected areas (PAs). Indicators of quality include, for example, the types of PAs and land uses allowed, as well as procedural indicators of protected area management, such as quality of planning, implementation and maintenance of PAs. Some states also use criteria such as investments in primary sanitation, and protection of water resources.

Ecological fiscal transfers in Brazil represent an adjustment in redistribution of fiscal revenues from ICMS, which account for a significant share of municipal revenues (28 to 82 percent). Impact evaluations find that ecological fiscal transfers based on protected area indicators have a positive impact on increasing the size of protected areas (Loft, Gebara and Wong, 2016).

Portugal: Ecological fiscal transfers

In Portugal, intergovernmental fiscal transfers from central government to 308 municipalities are an important source of municipal revenues. On average, these transfers

account for 60 percent of revenues, but for some municipalities, as much as 97 percent of revenues.

The government of Portugal introduced environmental criteria within intergovernmental fiscal transfers in its new Local Finances Law 2007 to give financial incentives to local governments to maintain protected areas. The key rationale was that municipalities with protected areas incur the costs of their preservation, as well as opportunity costs, but for which the benefits extend beyond municipal boundaries.

Allocation of the Municipal General Fund is based on several criteria, among which the indicator of protected areas and presence of Natura 2000 sites[61] is given 5 to 10 percent weight. The rest of the weight is given to population (65 percent) and total area (20 to 25 percent), as well as an equal share to all municipalities (5 percent) (Santos et al. 2011).

A subsequent assessment found that the ecological component of the Municipal General Fund benefits municipalities with a large share of protected areas and Natura 2000 areas disproportionately, but might not constitute a strong enough incentive to induce the optimal level of environmental protection (Santos et al. 2011).

61 Natura 2000 sites are protected areas, part of an extensive protected area network in the European Union.

Climate change-related PBGs

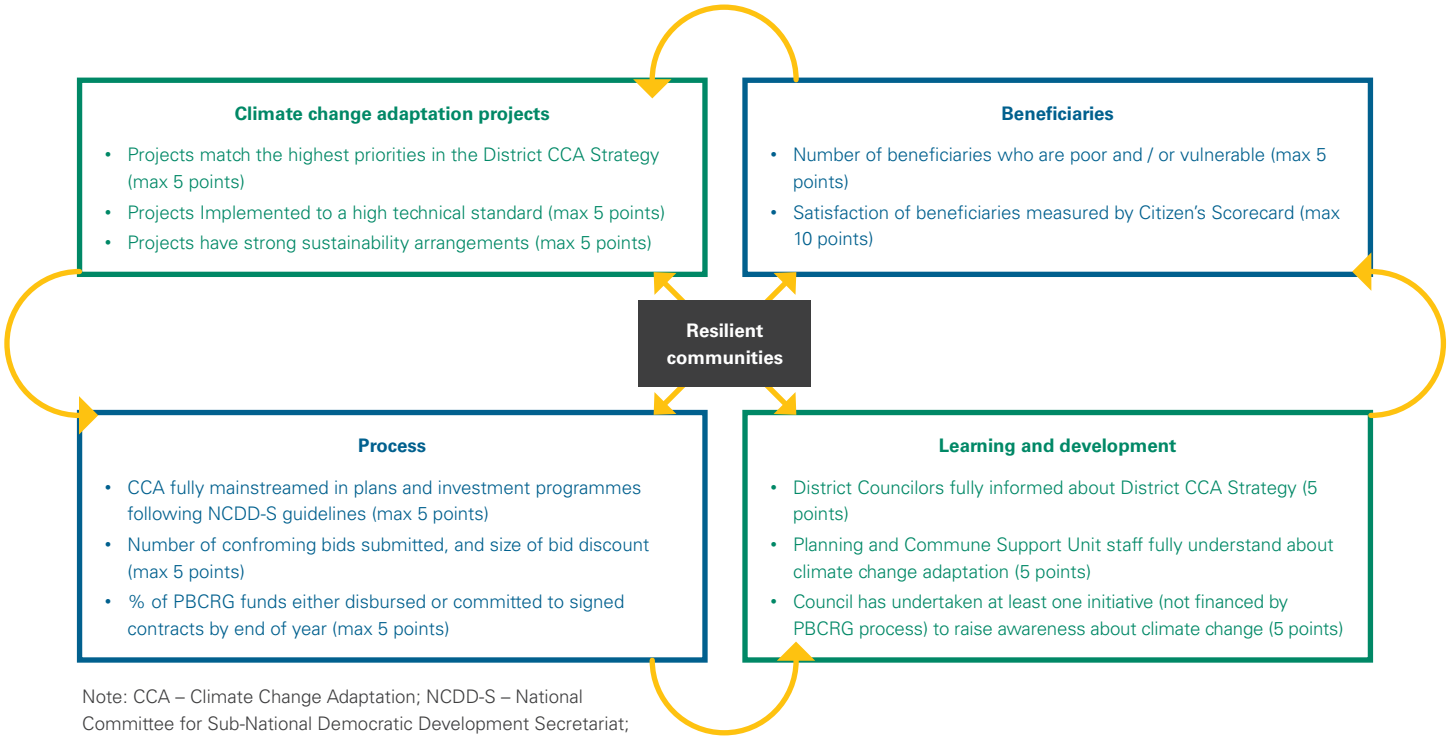
PBGs to encourage performance in planning and implementing climate-change mitigation or adaptation investments are also being piloted for selected SNGs in Bangladesh, Cambodia, Bhutan, and Vanuatu under the UNCDF/UNDP LoCAL programme.

Box 21. Cambodia: Performance-based funding for climate change resilience

Performance-Based Climate Resilience Grants (PBCRGs) are allocated to selected SNGs (districts) in Cambodia, additional to the basic UCGs. The key features are:

- Compliance with Minimum Conditions: SNGs must be in satisfactory compliance with a set of criteria related to basic PFM and local governance to be eligible.
- Scoring against balanced scorecard criteria related to SNG planning and management of climate change-related measures. Eligible SNGs are then allocated PBCRGs based on their scores, and also in proportion to their basic UCG allocations.

Figure 45. Cambodia's performance-based funding for climate change resilience



Note: CCA – Climate Change Adaptation; NCDD-S – National Committee for Sub-National Democratic Development Secretariat; PBCRG – Performance-Based Climate-Resilient Grants

Sources: NCDD, UNCDF and SIDA (2013).

Performance-Based Grants: Emerging lessons

Variety of performance-based mechanisms

In the examples above, a wide variety in focus, strategy and incentives of the PBG mechanisms can be seen:

- Whether they focus on broad multisectoral service delivery across the broad SNG mandate, or whether they focus on specific sectors or services.
- Whether they assess basic institutional performance and compliance, or whether they also assess measures of service delivery quantity and quality.
- The variations in types of incentive offered: additional funds for general use, or for earmarked use in the area of performance in question; additional funds to match those allocated by the SNGs already; relaxation of constraints on existing funds; and dispensation of audit inspections on use of funds.

Performance-based funding mechanisms can therefore be classified along two dimensions: firstly, whether they aim to promote the performance of (i) a broad multisectoral range of SNG services through UCGs, or of (ii) more specific sectors or services through CGs; and secondly, whether they assess performance on the basis of (i) compliance with procedures and provision of inputs, or (ii) the level or quality of service outputs, or even service outcomes. This allows a simple typology – but noting that differences are usually not very clear-cut.

Overall, mechanisms focusing on specific sectors or services can be more easily geared towards improvement in service outputs, whereas for those focusing on broad multisectoral delivery it can be much harder. This is due to the variety in different SNG service patterns, which makes it hard to compare outputs across SNGs.

Lessons for wider adoption of performance-based transfers

General

Performance-based transfers can **potentially** play an important role in encouraging better SNG performance in service delivery, and hence in promoting the sustainable development agenda.

There are several lessons learned from countries' experiences in designing and implementing performance-based grant mechanisms. PBGs are not easy to implement and several caveats must be considered and certain preconditions should be met before implementing PBGs. This section reviews general lessons and subsequently discusses them in detail.

- **Political buy-in**: Any PBG mechanism will only work if politicians, central government policymakers and officials back it up on a sustained basis, and are willing to resist the inevitable pressure from SNGs which may feel unfairly penalized under any performance assessment.
- **Results assessed**:
  - PBGs may be allocated based on: 1) institutional process results; 2) output-related results or 3) outcome-related results. In general, it is easier to tie multisectoral PBGs with institutional process results, while sectoral PBGs lend themselves more readily to output and (in some cases) outcome-related results.

Figure 46. Typology of SNG Performance-Based Grants with examples

	SNG service delivery focus	
Main focus of performance to be assessed	**Broad multisectoral mandate**	**Specific sector or service mandate**
Institutional results: PFM and governance arrangements and procedures	• PBGs (Nepal, Bangladesh, Bhutan, Solomon Islands, Indonesia, West Bengal, Mongolia)	• Health, Education, Water (Uganda, Tanzania) – Phase 1 • LoCAL (Cambodia, Bhutan, Bangladesh, Vanuatu) • Performance-based top-up school grants (Lao PDR)
Service delivery: quantity and quality of outputs	• Comprehensive Performance Assessment 2002–2010 (UK-England)	• Ecological Fiscal Transfers (Brazil, Portugal, France) – top-up funds; however, can be used as multisectoral UCGs at the discretion of SNGs
Both institutional and service delivery results	• Proposed 10 percent top-up performance funding pool for all panchayats across India (14th CFC) which will be linked to service delivery baseline standards	• Health Sector Grants (Punjab (Pakistan), Argentina, Brazil) • Health, Education, Water, Agriculture (Uganda, Tanzania) – Phase 2 • School Grants (Indonesia, Nepal, Sri Lanka, Lao PDR)

Source: Adapted from Steffensen (2010).

  - In sectoral PBGs, not only SNG performance, but also performance of front line service facilities (schools and clinics) needs to be measured.
  - An important precondition for PBGs is that the processes against which performance is assessed, such as laws, regulations and procedures, must be appropriate, clear and consistent, and generally be such that compliance with them is likely to lead to better service delivery.
- **Size and selectivity of the incentive**: The size of PBGs is another important precondition. PBGs are usually given as top-up funding, attached to UCGs or CGs. In addition, the fraction of SNGs that receive PBGs also matters for their incentive effect.
- **Performance criteria and APA methodology**: The criteria for performance assessment for PBGs should be robust, simple enough, capable of being verified objectively, not subject to discretion or manipulation, allow fair comparison, and be rooted in "reasonable standards". They should measure activities or decisions which SNGs are in control of, rather than being dependent on external factors outside their control.
- **APAs**: First, APAs of SNGs should be done annually, to link to the national budget timetable for fiscal transfers. Second, extensive fieldwork needs to be done for APAs, which is usually beyond the capacity of government staff. Thus, those who do APAs need to maintain independence. However, in outsourcing APAs to contractors, there are major logistical challenges in procuring and managing contractors, and ensuring consistency in the quality of APAs, all while adhering to a tight timetable. Outsourcing also poses long-term sustainability issues.
- **Capacity development**: Performance-based transfers alone are not sufficient to promote better performance. They need to be complemented with systematic capacity support for SNGs.
- **Transparency**: Information about APA methodology, results and PBG allocations should be made public, so that poorly performing SNGs receive pressure to improve.

The rest of this section will review in detail the above lessons for design and administration of PBGs.

Results assessed

Which results?

Results assessed and incentivized through PBGs can be laid out on the "results chain" which displays the hierarchy of results of public or development actions (Figure 47).

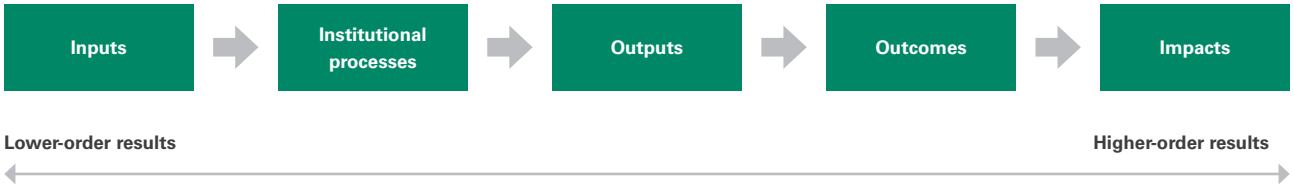
Performance-Based Grants commonly incentivize improved performance related to: 1) institutional process results, such as transparency or quality of planning; 2) output-related results, such as the number of prenatal consultations with expecting mothers; or, in a few cases, 3) outcome results, such as the child mortality rate.

An important precondition for PBGs is that the processes against which performance is assessed, such as laws, regulations and procedures, must be appropriate, clear and consistent, and generally be such that compliance with them is likely to lead to better service delivery. This is the case regardless of whether PBGs are tied to processes, outputs or outcomes.

In general, it is much easier to focus performance assessment on lower-order results, such as institutional processes, rather than on higher-order results, such as outputs or even less so on outcomes. This is especially the case for multisectoral PBGs that are usually tied with UCGs. This is because multisectoral PBGs may be used by different subnational governments for different mixes of sector expenditure purposes. For example, one subnational government might use such multisectoral PBGs for health services and another for rural road investments. In this situation, comparing health outputs or outcomes with rural transport access outputs or outcomes would be like comparing apples and oranges. In contrast, sectoral PBGs lend themselves more readily to output and outcome-related results.

Using institutional performance criteria can positively shape service delivery, but only if the institutional arrangements and procedures themselves are sound and provide the framework for good annual planning,

Figure 47. Results chain of public service delivery



budgeting and delivery. If they are problematic, then there is little point in constructing a PBG mechanism around compliance with them (Figure 48). For example, in a country such as Myanmar, where there are serious problems in the existing human resources, legal and regulatory framework for SNGs generally, and for PFM in particular, a strategy based on compliance with processes would not necessarily lead to better development outcomes.

More generally, it is necessary to understand how these institutional processes translate into better service delivery. The point is not to question the linkage between institutional performance and service delivery, but simply to point out that this linkage needs to be better researched, to better understand which are really the key elements in process which determine desired outputs and outcomes to render future assessments more relevant and effective.

Whose results?

To use Performance-Based Grants in the key social service areas – education and health – requires a multilevel approach, whereby performance of both SNG and also front-line facilities are measured to determine transfers to each level.

However, to be able to encompass school or clinic management performance, and to allow these entities the degree of flexibility in resource management needed for incentives to be effective, requires a considerable amount of preliminary reform groundwork with the sector ministries, in order to allow front-line units the necessary flexibility in human and financial resource management.

Size and selectivity of the incentive

If PBGs are to constitute an incentive for better SNG performance, they should be a significant and attractive increment to SNG resources. If the size of transfers received by SNGs is too small, it is not attractive enough for SNGs and this dilutes the incentive effect of PBGs.

Generally, the PBG top-up (or "cut-back") is set at about 15 to 25 percent of the UCG size. This size seems generally to be adequate, but it may need to be rethought where SNGs receive a relatively large volume of other resources, which overshadow UCGs and the PBG top-ups to UCGs.

SNGs also receive, alongside UCGs and CGs, shared revenues and own-source revenues. Therefore, it is important to consider the relative size of the UCGs or CGs to which PBGs are attached. If, for example, UCGs to which PBGs are attached are only a small element in the overall stream of revenues received by SNGs, and if PBGs are only a small top-up to UCGs, the size of PBGs would be insignificant. In this case, PBGs would exert little incentive effect, since they may seem not worth the effort by SNG personnel. This is likely to be an issue for any large urban SNG, often with substantial own-source revenues.

One common concern with introducing performance-based transfer systems is that this will penalize poorer areas, where SNG performance is believed to be weaker. However, this is not bourne out by the evidence. In Nepal, for example, poorer, more rural districts and the smaller municipalities had significantly higher scores than Kathmandu, the capital. The more real concern is that SNGs in richer and more urbanized areas will usually enjoy much greater own revenues, such that the incentive effects of relatively modest PBGs may simply be too weak to encourage better performance.

Another issue concerns the selectivity of PBGs – how large or small should be the fraction of SNGs to receive PBGs. If too many SNGs receive PBGs, the receipt of funds may be seen as almost automatic; if too few receive PBGs, this may be seen as unattainable. In either case, the incentive effect may be lost. Targeting a range of 30 to 70 percent of SNGs to receive PBGs is reasonable.

Performance criteria and APA methodology

One early lesson from PBG programmes is the need to ensure that the criteria used to measure SNG performance is suitably robust, simple enough, tied as far as possible to binary indicators whose verification can be objective, not subject to discretion or manipulation,

Figure 48. A possible breakdown in the results chain of public service delivery

allows fair cross-SNG comparison, and be rooted in "reasonable expected standards". These basic lessons, or emerging principles, apply to all areas of performance to be assessed, and are reviewed in more detail below:

- **Relevance**. If performance criteria cannot be related directly to mandated local service delivery, they should at least be directly relevant to the quality of SNG planning, budgeting, budget execution, asset management, oversight and accountability, as these activities relate to the service delivery mandates.
- **Simplicity**. The list of criteria should not be excessive or take too long to verify, so that field assessments can be managed within a short time-frame. It may be tempting to calibrate the PBG reward by other factors, such as the poverty levels in the provinces concerned, but this risks both complicating the performance-reward link and also to assign too many objectives to one modest policy instrument. Where the methodology is very complex, it may be very hard for SNGs to see the connection between their performance and the resulting top-up PBG. Likewise, it will be hard for the central government to explain or defend the results. It is important to remember that no single policy instrument can properly satisfy multiple objectives. For example, the complexity of performance criteria, or APA methodology, may be an issue in West Bengal, where the methodology is especially complex and the results hard to interpret.
- **Objectivity and verifiability**. They must as far as possible allow a simple yes/no or 1 to 5 scoring, with no or minimal discretion for the assessor, and be linked to ready documentary evidence.
- **SNG responsibility**. They should be activities or decisions which SNGs are responsible for and in control of. The SNGs should be able to comply with these processes on their own initiative, rather than being dependent on technical staffing or other resources outside SNG control, provided by central government, donors or other entities.
- **Reasonable and accepted standards**. They should relate to standards which SNGs can understand they are expected to meet and hence have roots in the national policy, legal and regulatory framework, rather than reflect some sort of ideal norms of particular donor agencies.
- **Reasonable time frame**. They should relate to SNG activity in the recent past, such as the last two budget years; undertaken by SNG personnel in place; and if problematic, should be areas where improvements in the near future are feasible. For instance, it would be unreasonable and pointless to assess the quality of a 10-year development plan prepared 7 years ago as a meaningful performance issue.

All these considerations mean that institutional processes, including compliance with national policy, law and regulations, are easier to operationalize into performance criteria compared with higher-order results concerning service delivery. Thus, most PBGs focus on process performance.

Annual Performance Assessments

Management arrangements should be put in place for conducting Annual Performance Assessments every year, within the target time-frame, even when the donor support has been withdrawn.

Outsourcing

In nearly all cases (with the exception of earlier VDC assessments in Nepal), APAs are carried out by contractors and consultants in order to ensure independence, and also because of the personnel needed to conduct these exercises in a short time-frame. There are strong reasons for these to be undertaken on an outsourced basis rather than by government staff, for reasons of both independence and feasibility (given the intense human resource deployment needed for the field visits in a tight time-frame each year). But, even outsourced, this is a challenging exercise to manage in terms of both time and cost.

Arrangements and time should be made for quality control of the assessment reports – since even the most robust set of criteria can be interpreted differently by different assessors.

These arrangements need to be developed with an eye to longer-term sustainability. Where possible, the option of folding the APA within the external audits of SNGs, in countries where these take place, should be explored early on. For example, in Bangladesh this occurs under the national local governance support programme and Union Parishads (Local governments) are actually paid for the cost of the expanded audits.

Delays

There have been frequent **delays and overrun of budget cycle deadlines** due to the procurement demands and sheer logistic complexity involved in managing APA processes and ensuring support and quality control. This is the case especially in large countries (typically in South Asia) with thousands of SNG units needing annual assessment. Such delays occurred at the time when these programmes were still receiving donor support and technical assistance, before being taken over by governments, which have far fewer resources to manage

such arrangements. Where the essential APA processes are not completed – analysed and the resultant PBGs computed – in time for SNGs to prepare their budgets with these additional resources factored in, then the utility of the PBGs is greatly undermined. There are cases with chronic delays and serious overshooting of budget calendar deadlines.

The timing of the APA should be planned very carefully, so that results are available in good time to feed results before the annual SNG budgeting process, given the extreme difficulty seen in managing such exercises within the inevitably tight timetable. Also, space and time should be ensured for query and appeals by SNGs.

Costs

There is also a concern over the **long-term costs** of the APA, which governments may be reluctant to carry once donor support has ended, however strong the case may be that the benefits of improved service delivery performance potentially greatly outweigh the cost. Generating more robust evidence on impact will be key to resolving this.

Capacity development

Performance-based transfer incentives alone are not sufficient to promote the better performance of SNGs, to the extent needed to improve local service delivery. SNGs will also need remedial support to address performance shortfalls.

This may not be critical when the performance assessed is to comply with well-established statutory norms on basic PFM and governance. However, capacity development is especially needed when the incentive aims to encourage SNGs to adopt **innovative, new** systems and procedures.

Conversely, SNG capacity-support programmes should make good use of PBG assessment results and target remedial action accordingly. One advantage of APA measures is that they clearly reveal points of functional weakness in SNG systems and procedures, and provide a very practical basis for targeting local capacity support.

Transparency. Key to an effective incentive mechanism is that the information about APA criteria, methodology, results and PBG allocations is made public, so that pressure can be brought to bear on poorly performing SNGs by citizens and civil society. This is a further reason to ensure that PBG allocation and assessment criteria are as simple as possible.

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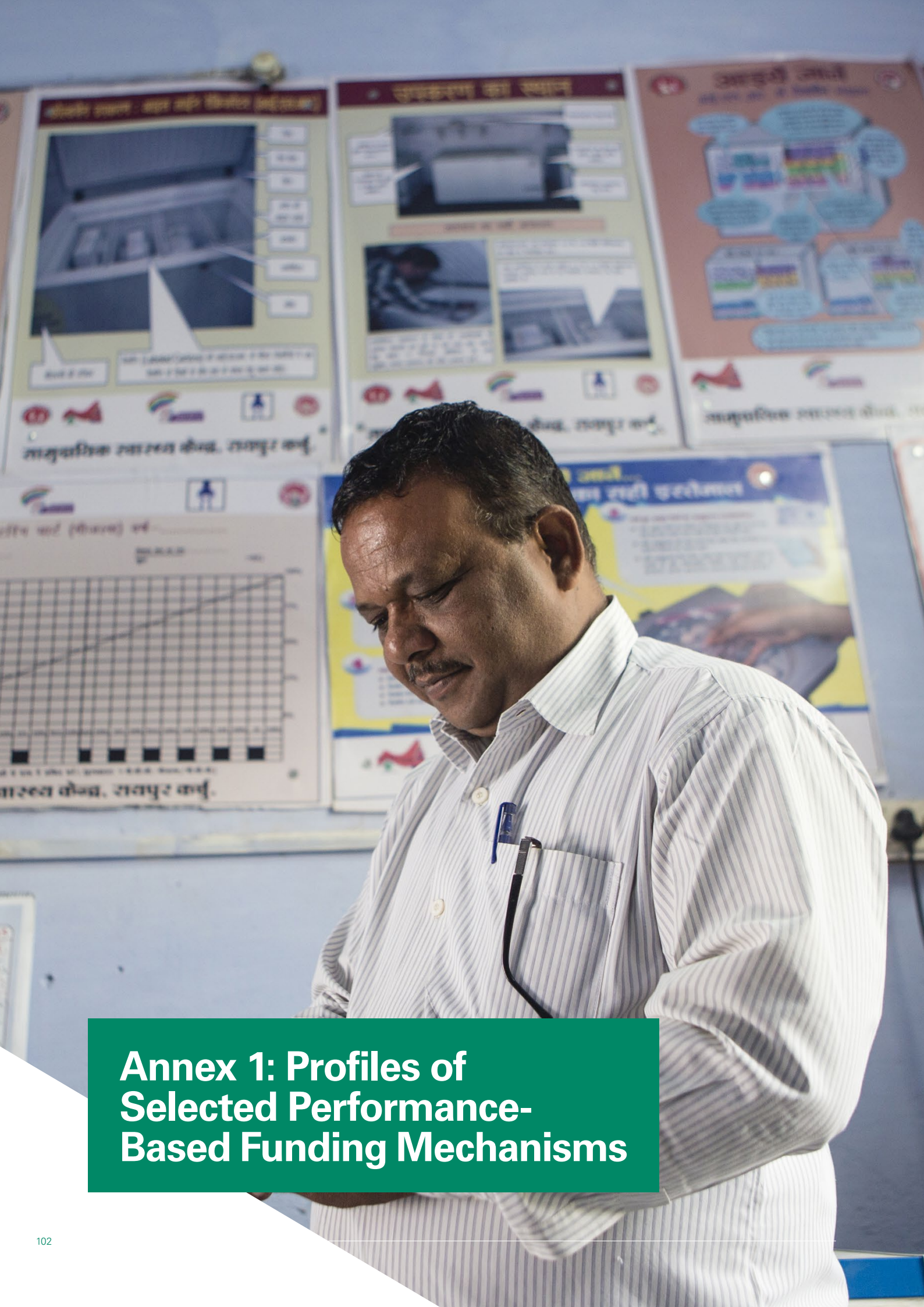


Annex 1: Profiles of Selected Performance-Based Funding Mechanisms

PBGs in Nepal

Background

Up until 2015, all SNGs received a standard formula-based UCG allocation, based on the criteria shown in Figure 49.[62]

A PBG mechanism was piloted for 20 district SNGs from FY 2004/05, then rolled out to all district SNGs in FY 2007/08, and then also extended to the Village and Municipal SNGs. The PBG mechanism was associated with the UCGs. However, in view of the move to a federal structure, the mechanism has been temporarily suspended from FY 2017/18, until new federal SNG arrangements have been established.

Figure 49. Nepal: Block grant allocation criteria and weightings

Indicators	VDCs	Municipalities	DDCs
Population	60	50	40
Weighted poverty	–	25	25
Area	10	10	10
Weighted cost	30	-	25
Weighted tax effort	–	15	–
Total	**100**	**100**	**100**

Source: Nepal, Ministry of Federal Affairs and Local Development (2016).

Performance criteria: Minimum conditions and performance measures[63]

In Nepal, the PBG is widely known as the MCPM (Minimum Conditions and Performance Measures) mechanism. Under the MCPM mechanism, SNGs at each tier may receive a top-up PBG if they meet Minimum Conditions (MCs). In addition, district and municipal SNGs may get a further graduated increase (ranging from 10 to 20 percent of the PBG), depending on how well they score on an additional set of Performance Measures (PMs). Conversely, they may face a similar decrease (from 10 to 20 percent) if they score badly on the performance measures. For example, the failure to score at least 40 percent on the performance measures leads to a 20 percent deduction in the PBG.

Minimum Conditions: The Minimum Conditions for access to PBGs include criteria such as (a) the timely approval of the annual programme and budget for the current fiscal year, (b) whether the annual progress review has been undertaken, and (c) completion of the final financial audit of incomes and expenditures (See Figure 50):

62 With the move to a federal constitution, financing arrangements for SNGs have since been revised.

63 Local Body Fiscal Commission (2008 and 2009); District Development Committee's Minimum Condition and Performance Measure Procedure (2008); and Municipalities' and VDCs' Minimum Condition and Performance Measure Procedure (2009).

Figure 50. Nepal: Minimum Conditions of access for PBGs

District Development Committees Indicators	Village Development Committees Indicators	Municipalities Indicators
Annual Budget and Program Approval	Plan and Program Approval	Annual Program and Budget Approval
Annual Progress Appraisal	Annual Progress Appraisal	Annual Progress Appraisal
Annual and Quarterly Progress Report	Grant Utilization and Accounting	Quarterly and Annual Progress Report
Internal Audit and VDCs' Final Audit	Final Audit	Account Operation of Municipality Funds
Account Operation of District Development Fund	Inventory Management	Tax and Record of Internal Revenue Source
Information and Record Management	Social Security Program	Audit and Irregularity Rectification
Final Audit and Record of Irregularities	Personnel Management	Assets Management
Inventory Management		Building Construction and Design Approval
Personnel Management		Publication of Revenue and Expenditure Details and Tax Rate
		Personnel Management

Source: Local Bodies Fiscal Commission (2015).

Performance Measures (PMs): PMs provide a relative performance scoring which is used to adjust the size of the PBG for those SNGs which satisfy the MCs. There are 13 PM indicators for VDCs, 40 for Municipalities and 46 for DDCs. The Performance Measures for district SNGs fall under five categories, as indicated in Figure 51.

Figure 51. Nepal: Performance Measures to adjust PBGs to district level

No.	Thematic areas	Number of indicators	Maximum marks	Minimum marks
1	Planning and budget management	8	16	7
2	Resource mobilization and financial management	11	25	10
3	Budget release and programme implementation.	6	16	6
4	Monitoring, assessment, communication and transparency	12	26	10
5	Organization management and work responsibility	9	17	7
Total		46	100	40

Source: Local Bodies Fiscal Commission (2015).

Different sets of PMs apply to the other SNG tiers, in line with their differing responsibilities. For example, PMs for VDCs cover performance in areas such as:

- Allocation of budgets to *dalits* and other targeted groups
- Maintenance of birth, death, marriage, migration and other vital registration documents
- Display of citizen charters in VDC premises.

APA process

Each year the Local Bodies Fiscal Commission (LBFC), whose functions are to be assumed under the newly established National Natural Resource and Fiscal Commission, hired contractors who undertook the annual performance assessment for district and municipal SNGs.

The APA for Village SNGs in the former subnational governance set-up was undertaken by district SNGs – by locally selected evaluators who reported to the District Minimum Condition and Performance Measure Committee.

The APA process usually ran between November and February in FY N-1 (In Nepal, the fiscal year runs from 16 July to 15 July).

The LBFC reviews APA results and makes recommendations to MoF for PBG allocations in the upcoming fiscal year.

Results

The PBG mechanism was first introduced in Nepal in FY 2004/05, on a project basis in a limited number of DDCs, and then expanded nationally in 2007/08, to cover all SNG tiers. However, even after this, there were important changes in the performance criteria and scoring, and especially in the assessment process and quality control arrangements.

Therefore, the time series data for Nepal are especially hard to interpret.

Here is a summary of the most consistent comparison possible: the percentage of SNGs at each tier (DDCs, Municipalities and VDCs) which complied with the subset of criteria which were Minimum Conditions (MCs) for access to top-up grants, from FY 2007/08 when the mechanism was applied nationwide[66] (Local Bodies Fiscal Commission 2015).

Figure 52. Nepal: Percentages of SNGs meeting Minimum Conditions each year

FY	DDCs	Municipalities	VDCs
2007/08	89	97	89
2008/09	84	91	93
2009/10	81	88	90
2010/11	85	93	87
2011/12	92	91	79
2012/13	89	98	79
2013/14	93	100	70

There is no clearly discernible trend for DDCs and Municipalities, while the performance of the VDCs seems to have declined over the period – contrary to what would be expected, if top-up grants are an incentive to score better. This may be in part due to the fact that – because of the rapid expansion of UCGs transfers to VDCs over this period – the top-up grants to VDCs are now only a relatively small proportion (15%) of these UCGs, and this is not an adequate incentive to perform better. That aside, there have also been questions about the quality and consistency of the VDC APAs, which are now undertaken by staff from their "parent" DDCs, and about the ability of VDCs to address their shortcomings due both to chronic understaffing and to the demise of the remedial capacity support programme (Land et al., 2016).

PBGs in Bangladesh

Background

Union Parishads (UPs) – in place since the 1880s – comprise the lowest rural SNG tier. However, it was only in 2004 that the central government started to make direct UCG transfers to Union Parishads, largely triggered by a successful previous UNCDF/UNDP pilot programme, which had piloted PBGs in Sirajganj district.[67] From 2006, to support this policy initiative, a national local governance support programme was rolled out with World Bank, UNDP and UNCDF support to support all 4,550 UPs.

The national programme provides top-up PBGs to Union Parishads nationwide, based on their performance against 12 governance and PFM indicators. Within this programme, under a UNDP/UNCDF component, a more articulated PBG mechanism has been tested for some 350 UPs in 7 districts,

Figure 53. Nepal: PBGs in total UCG transfers for each tier of SNGs, FY 2014/15

Types of Grants	DDCs	VDCs	Municipalities	Total
Total grants to local bodies	3,347,000	7,360,000	4,148,000	14,855,300
Total Unconditional Grants to DDCs	1,272,925	5,794,000	1,150,000	8,216,925
% Unconditional to total local bodies Grants	38	79	28	55
Minimum Unconditional Grants to local bodies	4,000	1,500	3,000	
Number of local bodies	75	3,276	191	3,542
Total minimum Unconditional Grants to local bodies	300,000	4,914,000	573,000	5,787,000
Performance-based Unconditional Grants	972,925	880,000	577,000	2,429,925
PBGs as % of total Unconditional Grants	76%	15%	50%	30%

Note: Figures in thousands of Nepal rupees, unless otherwise indicated Source: MoFALD (2016)

66 Although it was not possible to assess all VDCs nationwide until some years later, due to persistent conflict in some areas.
67 Sirajganj Local Development and Governance Project.

Figure 54. PBGs in Bangladesh: Performance indicators

Themes	1. Planning and budgeting			2. Fiduciary aspects (expenditure, financial management, procurement and reporting)			3. Own source revenue mobilization			4. Monitoring, oversight, transparency and accountability			5. Implementation performance/expenditure targeting (for MDGs)			6. Democratic governance systems			Total maximum scores
	No.	Indicators	Max. score	No.	Indicators	Max. score	No.	Indicators	Max. score	No.	Indicators	Max. score	No.	Indicators	Max. score	No.	Indicators	Max. score	
Nationwide set of indicators	1.	Five year development plan (or three years rolling Capital Investment Plan) available	4	1.	Asset registry created / each asset clearly marked	2	1.	Year-on-year improvement in own revenue collection	4	1.	Public disclosure of AFS, audit opinion annual budget	4				1.	Village Courts operational	1	
	2.	Finalized Plan and budget submitted to UNO by 31 May	2	2.	Annual Financial Statement available by 31 July	2	2.	Actual own revenue for past year in relation to the budgeted own revenue	2										
	3.	End of year actual development expenditure to development budget for the year (level or realization)	3	3.	Monthly bank reconciliations made (with in a month)	2													
				4.	Procurement plans in place by 31st July and compliance with procurement rules	2													
				5.	Audit queries resolved	2													
Total max scores			**9**			**10**			**6**			**4**						**1**	**30**
UPGP pilot-specific set of indicators	4.	Women involvement in the planning process	3	6.	Mail registry and filing system in place and up to date	1	3.	Tax assessment conducted	2	2.	Information about BG, revenue/ expenditure overviews, UP plans on UP Notice Boards	2	1.	Number of projects implemented last year as compared to plan	2	1.	UP Council functional	3	
	5.	Poverty targeting in the planning process	5	7.	Tax collection register up to date	2	4.	Tax assessment eligible households done at rate of 7%	2	3.	Right to Information Act 2009 operationalized	2	2.	Share of actual development expenditure in social sectors (MDG areas)	2	2.	Active women participation in UP meetings	3	
	6.	Fiver year development plan (or three-year rolling CIP) has clear linkages with MDG sectors	3	8.	Income and expenditure vouchers property numbered, posted and filed	2	5.	Tax defaulter system and "good tax payer reward" system in place	2	4.	Publication/ dissemination (public disclosure) of results previous assessment	2	3.	Evidence of budgeting for maintenance	2	3.	Establishment and actual functioning of eight core Standing committees	3	
	7.	Quality of the Development Plan	4				6.	Evidence of innovative measures to improve local revenue collection	2	5.	UP Information Centre established and operational	2	4.	UP Household register updated and accessible to the public	2	4.	Input from Standing Committees in the Annual UP Plans	3	
							7.	Share of own-source revenue used for development expenditure	2	6.	At least two public UP information sharing meeting held in the previous FY	3	5.	% of BBG (E) PBG used for projects benefiting more than one ward	2	5.	Functionality of Ward Shavas	2	
							8.	Share of development/ service delivery expenditure funded by own revenues	2	7.	Peoples' involvement in projects supervision	3							
Total max scores			**15**			**5**			**12**			**14**			**10**			**14**	**70**
Grand total max scores			**24**			**15**			**18**			**18**			**10**			**15**	**100**

Notes: UPGP – Union Parishad Governance Project BBG – Basic Block Grant AFS – Annual Financial Statement
(E)PBG – Expanded/Performance Based Grant UNO – Upazila Nirbahi Officer (Sub-District Commissioner)
Source: Balakrishnan, S. for Local Government Division, Government of Bangladesh (2013).

whereby further PBGs are provided against performance on a wider, more demanding range of indicators.

Performance criteria

Figure 55 details the performance criteria under the national programme and the UNDP/UNCD component, in each of the six areas:

- Planning and budgeting
- Financial management, procurement and reporting
- Own-source revenue mobilization
- Monitoring, oversight and transparency
- Targeting of MDGs
- Democratic governance

APA process

The annual performance assessment entails engagement of a batch of private accounting firms which send out teams to the UPs, after initial indication training, to verify their performance and prepare their assessment reports for the Local Government Division.

Results

The first PBG funding scheme was implemented in Sirajganj district in 2000. Over 2000–2004, there was substantial improvement in UP performance – in local revenue-raising efforts, local participatory planning, budgeting, procurement and implementation – which can probably be almost wholly ascribed to PBG incentives, because the capacity-support activities were delayed until the end of the project.

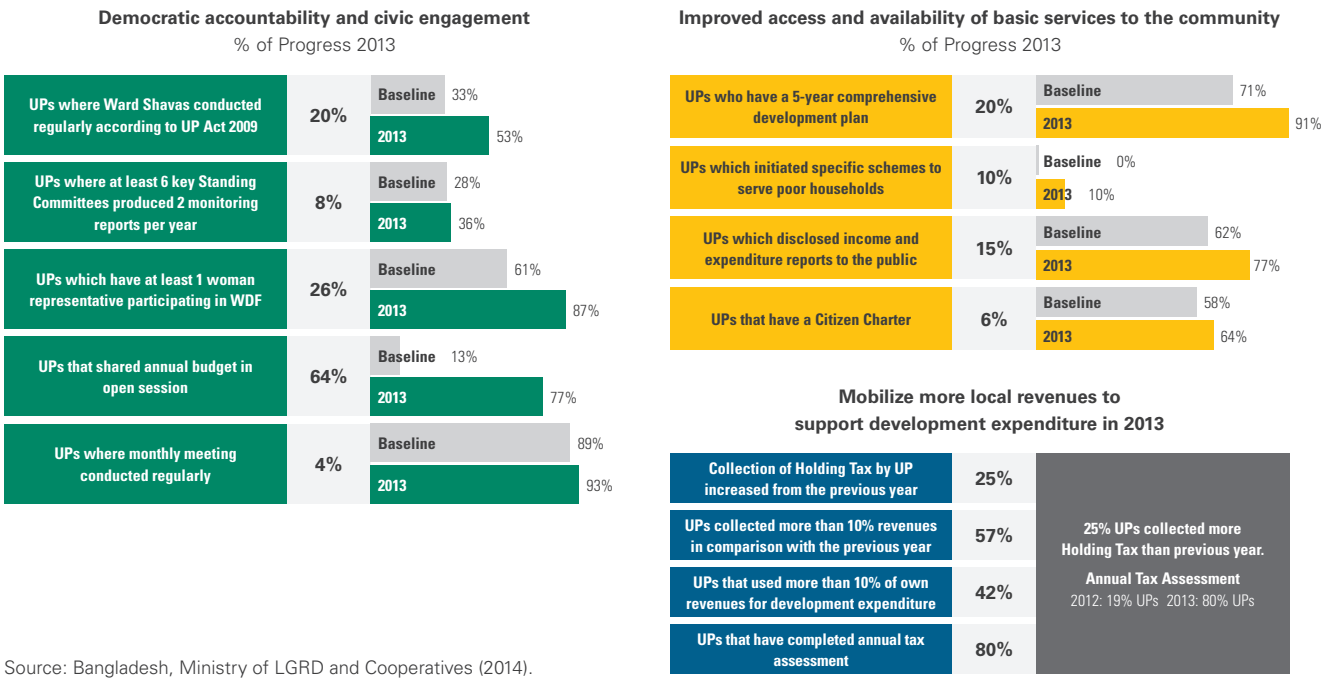
There is no ready trend data for the results of PBGs in the subsequent national Local Governance Support Project (LGSP), but there are data for the UNDP/UNCDF project nested within LGSP, which allocates "extended PBGs" to 564 UPs (out of some 4,550 in total), on the basis of an additional set of performance criteria (Balakrishnan for Local Government Division, 2013).

Over the three years in 2011–14, there were clear trend improvements in UP scores for 37 of the 41 indicators, with especially marked improvements in average scores for those related to the quality of MDG-focused strategic planning (+62%), the quality and timeliness of the annual plan and budget (+17%), approval of strategic projects (+24%), establishment of monitoring committees (+19%), and local tax assessment and revenue collection (+27%). The performance of these UPs was also clearly better than that of other "control" UPs in the wider national LGSP.

Despite such clear improvements, it can be asked how much they were due simply to incentives inherent in the PBGs, or instead to the broader capacity-development activities underway in the project.

One key issue emerging is the difficulty in managing the APA process – the basis for PBG allocation – in a timely manner. For each of the three years reviewed, this was delayed by between one and two years (due to procurement and other delays), so that PBGs were then only announced and released right at the very **end of the fiscal year** for which they were supposedly

Figure 55. Bangladesh: Union Parishads' performance improvements, 2011–14



Source: Bangladesh, Ministry of LGRD and Cooperatives (2014).

allocated. UPs were therefore not able to plan and budget properly for these additional resources, and the link to past performance was greatly weakened. Such serious delays (also seen in some other PBG programmes) risk completely undermining the effectiveness of the PBG mechanism.

PBGs in Mongolia

Background

SNGs in Mongolia comprise 21 rural *aimags* (provinces), 333 *soums* (districts), under which there are 1,559 *baghs*; Ulaanbaatar, the capital, also has aimag status and includes 6 urban districts. Each SNG level receives an annual UCG, which is the Local Development Fund (LDF) grant. This is generally formula-based (although in FY 2016, there was an additional stream of LDF grant financing from mining royalty revenues allocated by derivation).

The World Bank and SDC are supporting the Ministry of Finance in establishing a PBG mechanism associated with the Local Development Fund allocations to soum governments. The aim is to annually reward those soums which perform best, starting with the 45 percent best soums, and gradually increasing this share over time (see the performance criteria in Figure 56). Each eligible soum will be awarded a PBG equivalent to 25 percent of its LDF grant in the previous fiscal year. A PBG pool based on these factors is established annually.

Performance criteria

The initial set of performance criteria were all derived from legal and regulatory provisions regarding the roles of soum and bagh authorities: the bagh governor, the soum governor and the elected soum Khural. The criteria are grouped under six areas of functional performance:

- Bagh/citizen participation in determining priorities
- Budget preparation process
- Transparency and disclosure
- Budget execution and procurement
- Monitoring and inspection
- Asset ownership and maintenance

The initial set of 33 criteria and their scoring ranges are listed in Figure 56. These criteria and the scoring and documentary requirements are revised each year to reflect the experience regarding the appropriate calibration of the scoring, the continued relevance of indicators, the feasibility of gathering verifiable evidence for them, and – overall – the effectiveness of criteria in measuring and incentivizing subnational government performance.

Figure 56. Mongolia: Performance criteria, 2017

No.	Performance Area and Indicator	Score Range
Citizen Participation		
1	Proposal forms issued to households	1-10
2	*Soum* guidance to households on plan priorities	1-8
3	*Bagh* meeting held with quorum	0/5
4	Priorities voted by citizens	0/5
5	Proposals duly submitted to soum governor	1-5
Soum Planning and Budget Preparation		
6	Investment planning working group established	0/5
7	Working group functional	1-5
8	Proposals developed are complete	1-10
9	Proposals also consistent with soum plan	1-5
10	Proposals also consistent with bagh priorities	0/5
11	Elected *Khural* meeting duly held	0/5
12	Elected *Khural* meeting meets quorum	1-10
13	Elected *Khural* debates proposals submitted	0/8
14	Adopted *soum* budget duly reflects details of approved projects	0/8
15	Adopted *soum* budget attaches implementation and procurement plan	1-10
Transparency and Disclosure		
16	Public attendance at budget meetings	1-8
17	Budget reports made public	1-10
18	Budgets uploaded to Glass Account website	0/8
Procurement and Budget Execution		
19	Budget expenditures consistent with eligible list	0/5
20	Procurement tender committees duly established	0/5
21	Members sign no conflict of interest forms	0/5
22	Tenders are public	1-10
23	Selected contractors duly meet requirements	1-10
24	Six–monthly implementation reports issued	1-10
25	Payments duly certified	1-10
26	Overrun projects given priority	1-5
27	Budget carry–over approvals gained where needed	0/5
Monitoring and Evaluation of Implementation		
28	Information uploaded to MoF MIS by due date	0/5
29	Information is complete and accurate	1-5
30	*Khural* monitoring committee has undertaken inspection of projects	1-10
31	Results and impact of projects have been assessed and reported	1-8
Asset Transfer, Ownership and Maintenance		
32	Asset acceptance committee established	1-8
33	Completed projects registered as *soum* assets	0/5

Note: Khurals – citizens' assemblies

APA process

The annual performance assessment is conducted by two or three independent contractors hired, trained by and operating under the supervision of MoF. The fieldwork in the soums takes place over about six weeks, mid-year (June and July) of the fiscal year preceding (FY N-1) the year of PBG allocation (FY N), to allow time for the APA results to be approved and PBG allocations inserted into the state budget approved by the national parliament in November (FY N-1). Assessment of each soum by a team of three assessors, with standard assessment format and scoring guidelines, takes one day. Assessment is made based on documented performance for each of the criteria in one or other years preceding FY N (e.g. budget preparation for FY N-1, procurement for FY N-2, etc.).

APA results are then reviewed and approved by MoF, and then proposed PBG allocations are submitted within the overall budget submission to the national parliament.

PBG allocation and use by soums

After PBGs are approved by the national parliament, eligible soums are informed of this along with their basic LDF grant allocations. They are then able to finalize their budgets accordingly, to reflect the increased resources. PBG funds are effectively merged with basic LDF funds and budget execution is undertaken according to MoF regulations.

Results

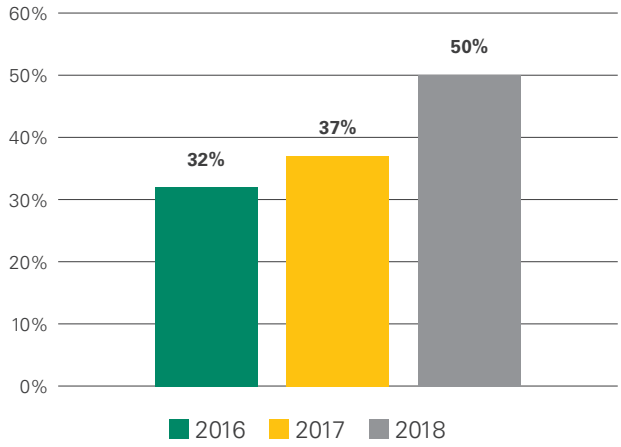
In Mongolia, over the 2016–17 period, the scores for the 6 performance areas for 330 soums are as indicated in Figure 58 – with some degree of improvement in all areas, mainly in citizen participation in the planning process (for which the average score increased by a factor of 2.5). There was also a significant decline in the number of soums scoring 0 against 5 of the 9 key performance indicators but with small increases on the other 4 (author's own analysis).

In this case, since capacity-development activities were so delayed that soums did not benefit from them between the two assessments, it is reasonable to infer that these improvements were primarily due to the incentive effects of the PBG. Conversely, without a remedial capacity-support mechanism, it may be hard to significantly reduce the substantial performance shortcomings in the future.

In the first year, the APA process was delayed due to late project start-up, and so the PBGs had to be reflected in mid-year amendments to the national and soum budgets.

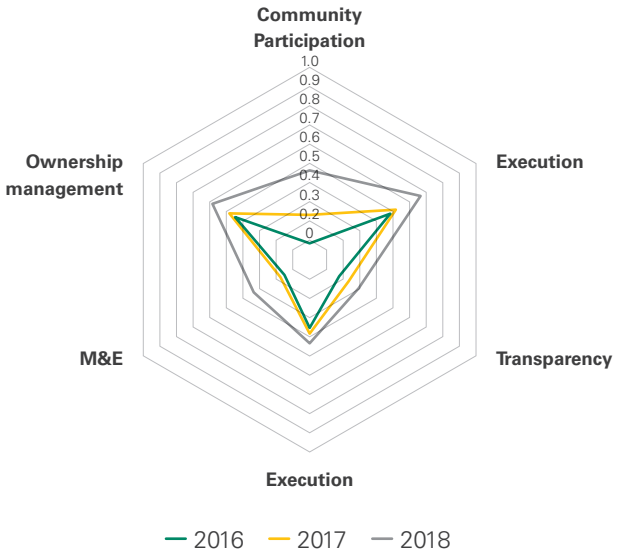
In the second year, it was possible to complete the process in time to approve PBGs in time for soums to include them in their regular budgets. Managing the APA process in Mongolia – and ensuring quality control of the results – was much simpler than in other larger South Asian countries, given the relatively small number SNGs to be assessed.

Figure 57. Mongolia PBGs: Average performance rate of all soums



Source: Mongolia, Sustainable Livelihoods Project-3 (2018).

Figure 58. Average scores by performance area



Source: Mongolia, Sustainable Livelihoods Project-3 (2018).

PBGs in West Bengal, India

Background

The 3,342 Gram Panchayats (GPs) in West Bengal receive an array of UCG and CG transfers (see Figure 59).

The West Bengal State Government, with support from the World Bank under the Institutional Strengthening of Gram Panchayat Project (ISGP) – Phases I and II – has been testing a PBG mechanism to encourage better performance by the GPs. This approach has recently received endorsement by the 14th Central Finance Commission, one of whose recommendations was the nationwide adoption of a similar PBG mechanism for all SNGs (Panchayati Raj Institutions), whereby 10 percent of the UCG pool for rural SNGs and 20 percent of the pool for urban SNGs is to be allocated on the basis of performance.

Performance criteria

The mechanism is designed to measure and reward three levels of performance:

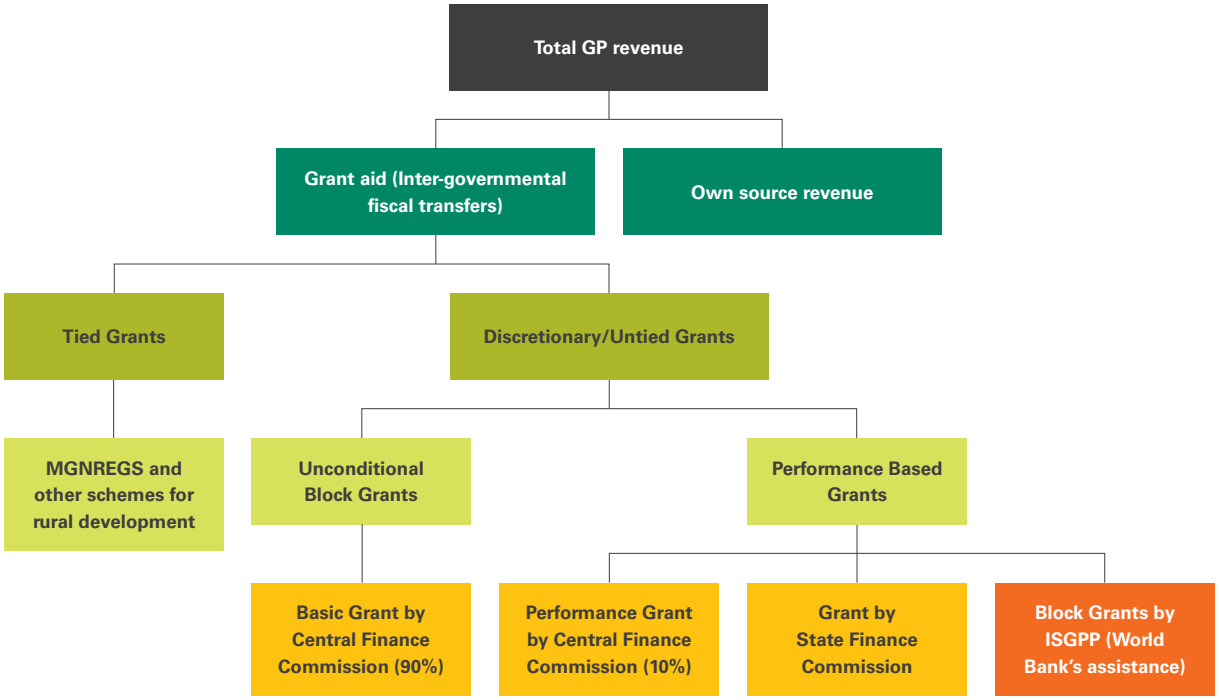
1. Basic Minimum Conditions (BMCs) of access:
   a. Own-source revenue "in a steady manner".
   b. No adverse or disclaimed audit opinion.
   c. The integrated GP Plan and Budget – derived from the Upa-Samiti Plan – approved by 31 January of the relevant year.
2. Expanded Minimum Conditions (MCs)
   a. GPs to have achieved a minimum 60 percent expenditure of untied grants (up to and including the third quarter) within the fourth quarter.
   b. GPs shall maintain a computerized accounting system as per the national government norms.
3. Performance benchmarks for 30 Performance Measures (PMs).

PBG sizing

The PBG pool is comprised of 10 percent of CFC UCG allocations, together with funds from the SFC and the World Bank. This pool is divided into three subpools, corresponding to the three levels of performance. Initially the Basic Minimum Conditions pool is to account for 50 percent of the overall PBG pool, with 25 percent each for the other two criteria (See Figure 60). Then, in later years, this is to be reversed, with performance benchmarking to account for 50 percent, and subpools 1 and 2 to account for 25 percent.

PBG allocations are then made to GPs as top-ups to the basic UCGs, according to the basic grant formula, with performance measure scores included.

Figure 59. West Bengal, India: Fiscal transfers to Gram Panchayats



Note: MGNREGS – Mahatma Gandhi National Rural Employment Guarantee Scheme; ISGPP – Institutional Strengthening of Gram Panchayats Project, World Bank

Figure 60. Key elements of PBGs in West Bengal, India

Elements	Basis for PBG allocation
Element 1: Assessment against Basic Minimum Conditions (BMC)	All qualified GPs eligible to receive a minimum fixed fraction of PBG if Basic Minimum Conditions are complied with
Element 2: Assessment against Expanded Minimum Conditions (EMC)	All qualified GPs eligible for the PBG as per their performance scores
Element 3: Assessment against Performance Measures	All EMC-qualified GPs receive a PBG on assessment against performance measures. PBG allocation for all GPs is based on a weighted formula comprising the GP's population and the GP's geographical area and performance scores.

APA process

The annual performance assessment process is undertaken by about 170 teams of 2 persons, each hired by the State Ministry of Panchayati Raj. They first receive four days of training in three batches and then conduct field assessments over the period from September to November in FY N-1.

Results

PBGs were first introduced in 2010 on a phased basis. During Phase 1 (2010–2015), 998 GPs were subject to an APA as basis for allocation of PBGs. Over this five-year period, the number of GPs that met minimum threshold scores doubled from 483 to 987 GPs in 2015 – and of these 987 GPs, 982 achieved over 90 percent of their maximum potential scores (Sutra Consulting 2016).

There is some evidence to suggest that not only did Phase 1 GPs perform better against "process" indicators in the six performance areas than other control GPs outside the project, but that the quality of basic infrastructure delivery (all key for the sustainable development agenda) was also better. Figure 61 indicates community perceptions of infrastructure and service quality as delivered by GPs under Phase 1 and other control GPs in West Bengal – there is a consistently higher rating for Phase 1 GP output quality.

However, such evidence is suggestive of but not conclusive as to the incentive effects of PBGs – and may also be attributed in part to the more intensive capacity development enjoyed by those GPs under Phase 1.

It should be noted that these APA and PBG mechanisms have been fully adopted by West Bengal State, and have also inspired the 14th CFC recommendations to establish PBGs across India. Phase 2 is now underway, after a very positive rating of Phase 1 by the World Bank Independent Evaluation Group, which covered all 3,230 GPs in the state.

One problem which has emerged here, as in Bangladesh, was the difficulty of conducting such a large-scale APA exercise within the budget timetable deadlines, so that scores can be fed into PBG allocations following the budget calendar.

Figure 61. West Bengal, India: Infrastructure output quality, Phase 1 Gram Panchayats versus control group of Gram Panchayats

Local infrastructure and services	Percentages as rated by communities							
	Good		Average		Poor		Don't Know	
	Phase 1	Control	Phase 1	Control	Phase 1	Control	Phase 1	Control
Roads	79.2	61.0	11.2	34.2	8.9	3.6	0.7	1.2
Water Service	64.3	48.2	15.2	30.0	18.4	17.7	2.1	4.1
Irrigation	46.3	36.7	26.3	34.4	22.4	22.2	5.0	6.7
Drainage	50.3	40.6	21.4	23.7	23.8	27.1	4.5	8.5

Sources: ICRA Management Consulting (2017) and Sutra Consulting (2016).

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