INTERGOVERNMENTAL FISCAL SYSTEMS AND DEVELOPMENT AID
COMPARISONS AND LESSONS OF EXPERIENCE

Abebe Adugna and J. Fitz Ford
May 2010
Intergovernmental Fiscal Systems and Development Aid: Some Comparisons and Lessons of Experience

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Abstract:

This paper reviews the experiences of intergovernmental fiscal systems (IGFS) to look for possible lessons for how Official Development Assistance (ODA) is delivered. Specifically, it compares IGFS and ODA in two specific respects. The first is the proportion of public resources that central governments make available to sub-national governments on a conditional basis, and how that compares with the proportion of non-earmarked ODA given to low income countries. The second is the role of performance in resource allocation to sub-national governments and how that compares with the role of performance in ODA, particularly multilateral ODA allocation. The comparisons show that (i) the share of earmarked ODA is more than three times higher than that of conditional grants in intergovernmental systems, suggesting that donors in ODA rely more on earmarking to influence the spending decisions of the recipient countries than their federal governments do on conditional grants to induce policy changes in their own sub-national governments; (ii) none of the OECD countries currently use outcome measures in determining resource allocation to their sub-national governments for a variety of good reasons, and the recent debate as to whether multilateral ODA allocation should be based on development outcomes seems to ignore this experience.

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Abebe Adugna and J. Fitz Ford

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# Abbreviations and Acronyms

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AAA</td>
<td>Accra Agenda for Action</td>
</tr>
<tr>
<td>AIDS</td>
<td>Acquired Immune-Deficiency Syndrome</td>
</tr>
<tr>
<td>AfDB</td>
<td>African Development Bank</td>
</tr>
<tr>
<td>AsDB</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>CDB</td>
<td>Caribbean Development Bank</td>
</tr>
<tr>
<td>CPIA</td>
<td>Country Policy and Institutional Assessment</td>
</tr>
<tr>
<td>DAC</td>
<td>Development Assistance Committee</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EFA-FTI</td>
<td>Education for All - Fast Track Initiative</td>
</tr>
<tr>
<td>FTC</td>
<td>Free-standing Technical Cooperation</td>
</tr>
<tr>
<td>GAVI</td>
<td>Global Alliance for Vaccines and Immunizations</td>
</tr>
<tr>
<td>GEF</td>
<td>Global Environment Facility</td>
</tr>
<tr>
<td>GFATM</td>
<td>Global Fund to Fight AIDS, Tuberculosis and Malaria</td>
</tr>
<tr>
<td>GNI</td>
<td>Gross National Income</td>
</tr>
<tr>
<td>HIV</td>
<td>Human Immunodeficiency Virus</td>
</tr>
<tr>
<td>IDA</td>
<td>International Development Association</td>
</tr>
<tr>
<td>IFAD</td>
<td>International Fund for Agricultural Development</td>
</tr>
<tr>
<td>MDB</td>
<td>Multilateral Development Bank</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>NGO</td>
<td>Non-Governmental Organization</td>
</tr>
<tr>
<td>ODA</td>
<td>Official Development Assistance</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
</tr>
<tr>
<td>PBA</td>
<td>Performance-based Allocation</td>
</tr>
<tr>
<td>PEPFAR</td>
<td>US President’s Emergency Program for AIDS Relief</td>
</tr>
<tr>
<td>PI</td>
<td>Performance Information</td>
</tr>
<tr>
<td>SWAp</td>
<td>Sector-Wide Approach</td>
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ACKNOWLEDGEMENTS

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EXECUTIVE SUMMARY

i. This paper compares intergovernmental fiscal systems with Official Development Assistance (ODA) in two respects. The first is the balance between discretionary and non-discretionary transfers in total subnational government resources, and how that compares with that in global development aid. The second is whether outcome performance measures are used in intergovernmental fiscal systems, and how that experience compares with that of ODA. The key findings can be summarized as follows.

ii. On the balance between discretionary and non-discretionary resources of subnational governments, the review shows that:

- In OECD countries, most governments make more than 50 percent of their national revenues available to subnational governments (the average share of discretionary resources is about 53 percent) as discretionary resources, while non-discretionary resources in the form of conditional transfers have been much more limited in their use to an average of around 8 percent;

- In developing countries, most national governments make over one-third of national revenues available to subnational governments as discretionary resources, while conditional transfers have averaged around 6 percent (with a range of between 0-17 percent); and,

- In transition countries, discretionary resources of subnational governments average about 20 percent, while conditional transfers have averaged around 3 percent (with a range between 0-9 percent). Furthermore, in recent years, the share of discretionary resources to subnational governments has been increasing, both in OECD and developing countries, and much of this discretion has been provided through greater taxing authority for subnational governments in exchange for smaller unconditional grants.

iii. This is in sharp contrast to ODA, where discretionary resources (i.e. unearmarked ODA) have remained much lower at only 25 percent of total ODA and where earmarked or “conditional” ODA is much higher—at more than three times that of conditional grants in intergovernmental systems. Overall, the evidence suggests that donors in ODA rely more on earmarking to influence the spending decisions of the recipient countries than the federal governments of both OECD and developing countries rely on conditional grants to induce policy changes in their own subnational and local governments.

iv. On the use of outcome measures in resource allocation, the experience of OECD countries shows that:

- Outcome measures are not used to determine resource allocation in intergovernmental systems. The reasons for this include technical reasons such as what to measure –outputs or outcomes--and the inherent problems of accurate measurement; the comprehensiveness or lack thereof of indicators; and the fact that outcomes may be open to interpretation and thus open to misuse given the difficulty of pinpointing accountability for outcomes.
• However, portfolio performance, as measured by the disbursement rate (or “burn” rate) is used in resource allocation decisions of OECD countries. Portfolio performance itself is a key input in project and program success. Program disbursements are replenished on a quarterly basis and, if undisbursed, the balances cancelled at the end of the fiscal year. In addition, subnational governments whose disbursements perform well in a current year may receive additional funds that will be distributed as part of their future years’ allocation. In contrast, subnational governments with poor disbursement rate may actually lose the unused funds at the end of the year.

v. On the ODA side, the experience seems to be broadly similar with the exception of the recent debate on outcome-based aid allocation. In particular,

• Most multilateral development banks allocate resources in accordance with a recipient country’s performance, as measured by Country Policy and Institutional Assessment (CPIA) and portfolio performance rating. The CPIA captures the quality of the policy and institutional framework -- intermediate measure that are critical to achieving development results.

• Portfolio performance is used as an indicator for aid allocation decisions. Most multilateral aid agencies use portfolio performance rating, as measured by the proportion of projects facing implementation difficulties, as a proxy for the absorption capacity of the recipient countries and how well they’re using the money. The focus of the rating in development aid is therefore on the proportion of projects facing implementation difficulties in total project portfolio instead of rate of disbursement of funds in intergovernmental finance. While this is obviously different from the disbursement rate used in intergovernmental finance systems, the essence of both systems remains similar, i.e. both systems seem to rely on portfolio performance as a factor influencing how much additional resources are allocated.

vi. Finally, none of the OECD countries use development outcomes as an indicator in their intergovernmental resource allocation decisions, and the recent debate on whether to move toward outcome-based ODA allocation (in particular for multilateral ODA) seems to be in stark contrast to this experience. The practical reasons for not using outcome measures in the context of intergovernmental systems include technical, managerial, and political considerations. When performance information is used by a Ministry of Finance in budgetary decision making, it is one factor in the decision making process used along with other information to inform rather than determine budget allocations. The insight to be drawn from this for aid allocation is that multilateral aid agencies including IDA face a similar—and in some cases even more complex--set of challenges that would make it impractical for aid allocations to be based on development outcomes.
I. INTRODUCTION

1. This paper reviews selected aspects of the intergovernmental fiscal systems in a diverse set of countries to look for possible lessons and implications for how global development aid is delivered. Despite some clear differences between the global aid system and intergovernmental fiscal systems, most notably the direct authority and associated instruments that central governments have with regard to subnational governments, there are sufficient similarities to warrant such an examination. The most obvious is with regard to the transfer of resources between donors and aid recipients for the purposes of carrying out vital public services on the one hand, and similar resource transfers from central to subnational governments for related services on the other.

2. The review focuses on two main areas. The first is the proportion of public resources that central governments make available to subnational governments for them to apply to areas of expenditure of their choosing within their remit, and how that compares with the proportion of discretionary (unemarked) aid that is given to low income countries in the global aid system. The second is the role of performance measurement in resource allocation/transfer to sub-national governments (in OECD countries) and how that compares with the role of performance in aid allocation in the global aid system. While the relevance of performance measurement in both systems may be obvious, the issues and options associated with its utilization may be very different and worthy of a closer examination. Within performance measurement, the review will focus on a set of comparisons in three sub-areas: the extent to which central governments use performance measurement to allocate resources across services and/or regions; the incentives that central governments provide to encourage specific performance (in raising revenues or improving service delivery); and, incentives to improve portfolio performance. On the aid side, we will review how performance is used in aid allocation, particularly among multilateral aid agencies including IDA.

3. This review does not attempt to be universal. Instead it draws upon relatively recent studies of countries from OECD, Transition, and Developing countries that appear to illustrate the range that exists. To the degree possible, factors that influence the observed choices will be elucidated. On the aid side, we will draw on recent studies and reports that have examined both the evolution in the global aid architecture as well as the debate around performance-based aid allocation systems.

4. The rest of the paper is organized as follows. Section II provides a brief comparison and parallels between the intergovernmental systems and the global aid system. It highlights key dimensions along which a review of the intergovernmental fiscal systems may impart useful lessons for the global development aid system. Section III reviews the proportion of discretionary public resources in total subnational resources, and how that compares with the level of discretionary resource in global aid. Section IV reviews to what extent performance measurements are used in allocating resources across services and subnational governments within the framework of intergovernmental fiscal transfer systems, and how such uses may compare with that in the aid system. Section V offers conclusions.
II. INTERGOVERNMENTAL FISCAL SYSTEMS AND DEVELOPMENT AID: SIMILARITIES AND DIFFERENCES

5. Five major sets of arguments are usually promulgated for intergovernmental transfers in the public finance. The traditional arguments are: addressing fiscal imbalances – vertical and horizontal; and dealing with inter-jurisdictional spillover effects. More recently, two other considerations have gained credence. One is that government that is closer to the people is better able to identify and respond effectively to the particular demands, needs and priorities of its constituents than a more distant government, a crucial aspect underlying the establishment of subnational governments. The political impetus towards decentralization within many countries suggests the validity of this premise. Another is that the willingness of local communities to pay for particular services is the most efficient indicator of demand for public services. These last two arguments are sometimes referred to as the Subsidiarity Principle. These perspectives are not exclusive, but different systems may reflect particular emphases in the design of a complete package. In practice, the systems that have emerged have reflected practical political, technical, institutional and historical realities. Thus, all of these approaches in practice have a strong overlay of pragmatism in design and implementation and accordingly reflect a diversity of design solutions.

6. Development aid1 is aid given by governments and other agencies to support the economic, social and political development of developing countries. The bulk of development aid comes from government sources and involves resource transfers from developed to developing nations. Aid can also be either bilateral (given from one country directly to another) or multilateral (given by the donor country to an international organization such as IDA to then distribute it among the developing countries). The share of bilateral official development assistance (excluding debt relief) has remained relatively stable at about 70 percent of total aid flows since the mid 1970s, while multilateral aid has constituted around 30 percent.2

7. Decision-makers and managers of development aid confront issues and options in resource allocation strategy that share a set of characteristics similar to those faced by federal governments with intergovernmental fiscal systems. To be sure, there are important differences between the two systems.

- First, the political relationships and accountabilities between aid-giving agencies and aid recipient countries do not parallel those of federal and sub-national governments within the same country. In federal governments with parliamentary democracies, elections provide a mechanism through which people entrusted with power at the federal and local levels are held accountable for their decisions.3

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1 It is sometimes alternatively referred to also as “development assistance”, “international aid”, or “foreign aid”.
3 This should not be construed however to mean that political objectives are always shared between federal and sub-national governments.
Elections thus constitute an important mechanism not only for the obligation of power-holders to justify their decisions and actions (answerability) but also for the existence of mechanisms for punishing poor performance or abuse of power (enforceability). While the concept of mutual accountability has gained momentum in the global aid system in recent years, direct political accountability, however, is generally absent.

- Second, aid agencies and donors do not have the type of more direct, ongoing interactive authority that many federal governments may have over their subnational governments in the context of intergovernmental fiscal systems. While aid policy makers and managers do not have the same sovereign oversight and enforcement mechanisms available to the federal governments, they also do not have the same extent of direct responsibility for results and service delivery, in part because of the difficulty of attribution.

- Finally, donor agencies are primarily accountable to their domestic constituencies, while the consequences of their actions are felt by recipient governments and their populations. This implies that donors have to factor in the demands of their domestic constituency in their aid allocation and delivery decisions, and often that there is very little direct ‘feedback loop’ mechanism that allows aid recipients to influence policy-making in donor countries.

8. Nevertheless, there are some similarities between the two that warrant an examination. Three parallels are especially worth emphasizing:

- First, the modes of transfer are strikingly similar: global development aid comprises of multilateral flows and vertical or special-purpose funds, which are largely akin to intergovernmental financial transfers of discretionary/block grants and specific-purpose/conditional grants.4 Given their non-earmarked nature, multilateral aid flows, for example, can be seen as analogous to block grants and vertical global funds as conditional or targeted grants in the context of intergovernmental fiscal systems. Whereas there are often sound reasons to target a particular sector or subsector, the application of too many of these targeted operations may in both systems distort the overall priorities of development programs, reduce the autonomy and ability of the recipients to respond to their constituencies, and severely clog the institutional capacity of the recipients.

- Second, the concept of mutual accountability is gaining momentum in global development aid, slowly strengthening the accountability system for aid. The Paris Declaration on Aid Effectiveness represents the most advanced and credible international attempt at promoting mutual accountability in aid through a series of reciprocal and agreed commitments and targets. Similarly, the Accra Agenda for Action (AAA), drawn up in 2008 and building on the commitments agreed in the

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4 Exceptions are specific-purpose multilateral global funds (e.g., the Global Fund for AIDS, TB and Malaria) which may also be considered earmarked.
Paris Declaration, calls for\textsuperscript{5}: (i) making aid more transparent, where donors will publicly disclose regular, detailed and timely information on volume, allocation and, when available, results, while developing countries will facilitate parliamentary oversight by implementing greater transparency in public financial management, including public disclosure of revenues, budgets, expenditures, procurement and audits; (ii) ensuring that mutual assessment reviews are in place by 2010 in all countries that have endorsed the Declaration; and (iii) jointly reviewing and strengthening existing international accountability mechanisms, including peer review with participation of developing countries. As a result, the accountability relationships in global development aid have been strengthened, bringing the global aid system a step closer to the intergovernmental fiscal systems.

- Finally, other similarities between global aid and intergovernmental systems include the use of performance measurement in resource allocation and/or program evaluations.

9. **These similarities suggest that the experiences from inter-governmental finance can be usefully brought to bear on the discussion of the global aid architecture,\textsuperscript{6} including its balance and effectiveness.** As noted in a recent paper on aid architecture,\textsuperscript{7} the global development aid is characterized by a high degree of proliferation and fragmentation. Over the last four decades, the average number of sovereign donors per recipient country has increased significantly; and the number of special purpose funds and programs has grown rapidly, with more than 100 major international organizations operating in the health sector alone today. This proliferation has in turn translated into an increasing fragmentation of aid—of reduced financial size of aid projects—thereby putting an onerous burden on recipient countries, particularly those with low policy and institutional capacity. Furthermore, aid earmarking—defined as the practice of dedicating aid to spending on specific sectors, public services, or activities—has increased over time.\textsuperscript{8} Given these trends in the global aid system, it becomes all the more important to examine, whenever possible, the long-running lessons of experiences in intergovernmental finance systems in order to draw lessons for the global development aid and its effectiveness.

10. **In the next two sections, this paper will review country experiences with regard to their intergovernmental fiscal transfer systems in two specific areas that have implications for the global aid system.** *First*, it reviews the relative share of

\begin{itemize}
\item \textsuperscript{5} See Accra High Level Forum 3 at: http://www.accrahlf.net/WBSITE/EXTERNAL/ACCRAEXT/0,,contentMDK:21690826~menuPK:64861649~pagePK:64861884~piPK:64860737~theSitePK:4700791,00.html
\item \textsuperscript{6} Aid architecture can be defined as the set of rules and institutions governing aid flows to developing countries. \textit{Ibid.}
\item \textsuperscript{7} IDA 2007, “Aid Architecture: An Overview of the Main Trends in Official Development Assistance Flows”, Washington DC.
\end{itemize}
discretionary and non-discretionary transfers in total subnational government resources and whether there has been a shift over time towards discretionary transfers, and what may be some of the considerations underlying such shifts. **Second**, it reviews whether and in what way performance measurements are used in intergovernmental fiscal systems, including whether they directly matter in resource allocation decisions. It compares this experience with that in the global aid system, in particular the use of performance based aid allocation system in multilateral aid.

### III. COMPARISON I: TRENDS IN PROPORTION OF DISCRETIONARY RESOURCES

#### A. What is the Proportion of Discretionary Public Resources in Total Resources of Subnational Governments?

11. **In comparing the global development aid to intergovernmental fiscal systems, one important metric to examine is the proportion of discretionary resources** that national governments transfer to their subnational governments. A key question is whether the experiences of these countries provide any guidance on the appropriate level of discretionary allocation to be made available to recipient countries in the context of global development aid. It is important to note, however, that transfers are not the only means by which federal governments make resources available to subnational governments. National governments can also explicitly or implicitly grant the subnational authorities the right to particular sources of income through taxation or by agreeing to share with, or transfer a centrally collected tax to, subnational governments.9

12. Broadly, intergovernmental fiscal systems appear to fall into three historic categories: those that developed essentially in accommodation to the growth of countries from small communities into nations; those that appear to have been designed under the substantial influence of economic thinking in large and somewhat diverse countries to satisfy political objectives of national equity in critical service delivery; and others of the most recent vintage that have been designed as a response to strong regional political pressures that if not adequately and expeditiously addressed could result in national fragmentation. These three categories appear to match broadly the geographical regions of Europe; North America, Japan and Australia; and the developing countries in LAC, Africa, East and South Asia. For coherence of analysis, the review of countries is grouped under the OECD, Transition Countries, and Developing Countries. Transition countries include a number of countries, essentially previously under the former Soviet Union influence, which have been reforming their intergovernmental fiscal systems in order to fit within the European Union (EU).

13. The key questions explored in this section are: what are the ranges of discretionary public resources (as measured by tax revenues and unconditional grants) that central governments allow their subnational governments to share as a percentage of

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total national revenues; and how do these ranges differ by groups of countries in different stages of development and what lessons may these results have for the balance of financing in the global development aid.

**OECD Countries**

14. During the decades of the 1970s to 2000s, the role of subnational governments in taxing authority and expenditure responsibilities appear to have been relatively stable in proportional terms (Table 1).\(^\text{10}\) In OECD countries, the share of subnational taxes as a share of total government taxes rose from 17.91 percent in 1970s to 18.18 percent in 1980s to 18.39 percent in 1990s-2000s. With grants – conditional and unconditional – included, the proportion of subnational governments’ expenditures as a share of total government expenditures hovered around one-third of total government expenditures in the 1970s, with a slight fall in the 1980s and almost a full rebound in the 1990s.


<table>
<thead>
<tr>
<th>1970s</th>
<th>1980s</th>
<th>1990s-2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD COUNTRIES</td>
<td>Subnational Government Tax as a Share of Total Government Tax</td>
<td>17.91 (33)</td>
</tr>
<tr>
<td>Subnational Expenditure as a Share of Total Government Expenditure</td>
<td>33.68 (23)</td>
<td>31.97 (24)</td>
</tr>
</tbody>
</table>

| DEVELOPING COUNTRIES | Subnational Government Tax as a Share of Total Government Tax | 10.68 (43) | 8.87 (33) | 10.61 (28) |
| Subnational Expenditure as a Share of Total Government Expenditure | 33.68 (45) | 31.97 (41) | 32.68 (54) |

| TRANSITION COUNTRIES | Subnational Government Tax as a Share of Total Government Tax | 22.41 (23) |
| Subnational Expenditure as a Share of Total Government Expenditure | 30.32 (24) |

**Table 1: OECD, Developing, and Transition Countries: Percent Share of Subnational Government in Total Government Revenue and Expenditure**

Note: Sample sizes are in parenthesis.


15. A closer look suggests that significant changes appear to be underway in recent years (Table 2 and 3). National governments appear to have determined, perhaps under pressure from their subnational components, that not only should subnational governments have greater discretion over their expenditures, but that much of this discretion should be provided through greater sharing of the tax base and taxing authority in the countries. These changes are evident in data from seven OECD countries (Table 2) and seven large countries outside of the OECD (Table 3).

Table 2. OECD Countries: Subnational Governments’ Discretionary Resources (% in total government resources)

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Total Gov’t</th>
<th>Nat’l Gov’t</th>
<th>Subnational government</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Initial (Post Distrib)</td>
<td>Tax</td>
<td>Unconditional Transfers</td>
</tr>
<tr>
<td>Australia</td>
<td>2006/7</td>
<td>100</td>
<td>76 (55)</td>
<td>24</td>
</tr>
<tr>
<td>Canada</td>
<td>2005</td>
<td>100</td>
<td>46(36)</td>
<td>54</td>
</tr>
<tr>
<td>Germany</td>
<td>2002</td>
<td>100</td>
<td>34(22)</td>
<td>66</td>
</tr>
<tr>
<td>Spain</td>
<td>2005</td>
<td>100</td>
<td>68(51)</td>
<td>33</td>
</tr>
<tr>
<td>Swiss Con</td>
<td>2003</td>
<td>100</td>
<td>37(30)</td>
<td>62</td>
</tr>
<tr>
<td>U. S. A.</td>
<td>2003/4</td>
<td>100</td>
<td>55(46)</td>
<td>45</td>
</tr>
<tr>
<td>Japan</td>
<td>1989</td>
<td>100</td>
<td>60(35)</td>
<td>40</td>
</tr>
</tbody>
</table>

*Negligible  
**Estimated  

16. Several points are worth noting from Table 2:

- All national governments make much greater than one-third of their national revenues available to subnational governments as discretionary resources, and almost half of these national governments provide over 50 percent in discretionary resources;

- The share of subnational taxes in total government resources has ranged between about a quarter (24 percent) in Australia and about two-thirds (66 percent) in Germany;

- Unconditional federal transfers have ranged between zero/ negligible in Canada, Germany and the USA and about 13 percent and 16 percent of national resources in Australia and Spain, respectively;

- Conditional transfers range between negligible in Switzerland and Spain to 10-14 percent of subnational resources in Canada, Germany, and Japan.

17. Overall, recent data show that discretionary resources have increased. With the exception of Australia, where the overall resources available to subnational governments have slightly declined from almost half in 1997 to 45 percent in 2006/7, discretionary resources have increased in all other countries. Most of these subnational governments have received more taxing authority in exchange for smaller unconditional grants. In the case of Canada, for example, additional taxing room to subnational governments had almost completely replaced unconditional grants. This trend towards replacing unconditional grants with greater taxing authority brings these countries closer
to the practice in the United States where discretionary resources at the subnational level had been entirely in the form of taxing authority.

**Box 1. Intergovernmental Fiscal System of the European Union**

The European Union (EU), a supra-government authority with quite prescribed limits to its powers but clear responsibilities for the equitable and orderly development of its members, is a unique arrangement that deserves a brief review. It operates without a ratified constitution (so far) but on the basis of a significant set of agreements that determine powers and responsibilities as assigned by its members. Among its assigned responsibilities is the strengthening of the collective economy of its members while also strengthening social cohesion across its membership by reducing developmental disparities between its regions.

**The key features of the EU’s intergovernmental fiscal transfer systems are that:**

(i) it explicitly applies the Subsidiarity Principle in its own budgeting;\(^{11}\) (ii) its second largest budgetary allocation (35.6%) is to its program for: “Cohesion for growth and employment, designed to enhance convergence of the least developed Member States and regions, to complement the EU strategy for sustainable development outside the less prosperous regions and to support interregional cooperation.”\(^ {12}\) (iii) European financing supplements national aid to the regions; and, the least developed Member States—defined as those where GDP per capita is below 75% of the EU average—select the specific projects and are responsible for their implementation.

**Because the decisions on the use of funds rest with the recipient states, EU’s funds bear a family resemblance to unconditional grants.** Because of these characteristics, the EU’s system may even provide a good model for the aid community of donors and recipients in terms of resource transfers.


**Developing Countries**

18. **In developing countries subnational taxes as a share of total government taxes were 10.68 percent during the 1970s, 8.87 percent during the 1980s, and 10.61 percent during the 1990s** (Table 1). However, when grants – both conditional and unconditional – were added, the proportion of subnational governments’ expenditures as a share of total government expenditures rose to 33.68 percent in the 1970s, 31.97 percent in the 1980s (apparently due to the fall in tax revenues) and 32.68 percent in the 1990s.

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11 “The ‘subsidiarity principle’ ensures that activities best managed at national, regional or local level are funded at the most appropriate level and that the Union does not intervene.” See “EU Budget at a glance”, EU website: [http://ec.europa.eu/budget/budget_glance/what_for_en.htm](http://ec.europa.eu/budget/budget_glance/what_for_en.htm).

### Table 3. Developing Countries: Subnational Governments’ Discretionary Resources (% in total government resources)

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Total Gov’t</th>
<th>Nat’l Gov’t</th>
<th>Subnational government</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Initial (Post Distrib)</td>
<td>Tax</td>
<td>Unconditional Transfers</td>
</tr>
<tr>
<td>Brazil</td>
<td>2003</td>
<td>100 68(55)</td>
<td>32</td>
<td>7</td>
</tr>
<tr>
<td>India</td>
<td>2005</td>
<td>100 63(46)</td>
<td>37</td>
<td>0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2002</td>
<td>100 97(NA)</td>
<td>3</td>
<td>40</td>
</tr>
<tr>
<td>Nigeria</td>
<td>2001/4</td>
<td>100 92(41)</td>
<td>8</td>
<td>51</td>
</tr>
<tr>
<td>Philippines</td>
<td>2003</td>
<td>100 92(70.5)</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>South Africa</td>
<td>2005</td>
<td>100 82(35)</td>
<td>18</td>
<td>47</td>
</tr>
</tbody>
</table>

*Negligible ***Derivation unclear
NA=Not Available.


19. **Just as in OECD countries, significant changes have taken place recently.**

Table 3 presents some recent data on the proportion of total discretionary resources in large developing countries. Several points could be noted from this table:

- As in OECD countries, most national governments make over one-third of national revenues available to subnational governments as discretionary resources. Only the Philippines among these countries provided less than a third – 29 percent - of total revenues for untied resources.\(^\text{13}\)

- Some developing countries such as Indonesia, Nigeria, the Philippines, and South Africa have highly centralized tax resources (oil revenues in the cases of Indonesia and Nigeria). Other countries such as India and Brazil seem closer to the median in terms of subnational government tax resources.

- Countries with large centralized tax resources share these resources through relatively high unconditional grants, which results in a much higher total discretionary resources for subnational governments than is suggested by their tax collection alone. On the other hand, in countries where subnational governments raise significant resources through taxing authority, unconditional transfers from the federal government seem to be relatively small.

- Conditional transfers range between zero or negligible in South Africa and Nigeria, and 10 to17 percent of national resources in Brazil and India.

\(^{13}\) 2009 Proposed Budget raises the unconditional grant to 31% of total government expenditure. With Local revenues of 8% this would result in a total of 39% - more in line with Brazil, and India.
Transitional Countries

20. Data for transitional countries are available only from the last decade of the 20th century (Table 1). Subnational taxes as a share of total government taxes in these countries averaged 22.41 percent in the 1990s. Their average expenditures, at 30.32 percent, were close to but less than the level in the OECD countries, reflecting an almost 6 percent lower level of grants transferred to subnational governments compared to the OECD countries. Given that the 1990s was a prelude to full membership in the EU for many of the countries, changes have taken place since then.14

Table 4: Transition Countries: Sub-national Taxes and Grants as Percent of National Revenues, 1999

<table>
<thead>
<tr>
<th></th>
<th>Taxes</th>
<th>Unconditional Grants</th>
<th>Total Discretionary</th>
<th>Conditional</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech</td>
<td>9.8</td>
<td>9.7</td>
<td>19.5</td>
<td>3.7</td>
<td>23.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>8.8</td>
<td>0.9</td>
<td>9.7</td>
<td>9.3</td>
<td>19.0</td>
</tr>
<tr>
<td>Poland</td>
<td>6.7</td>
<td>7.3</td>
<td>14.0</td>
<td>2.5</td>
<td>16.5</td>
</tr>
<tr>
<td>Estonia</td>
<td>15.1</td>
<td>13.2</td>
<td>28.3</td>
<td>1.0</td>
<td>14.2</td>
</tr>
<tr>
<td>Latvia</td>
<td>14.6</td>
<td>2.6</td>
<td>17.2</td>
<td>2.9</td>
<td>20.1</td>
</tr>
<tr>
<td>Lithuania</td>
<td>20.8</td>
<td>12.4</td>
<td>33.2</td>
<td>0.2</td>
<td>33.4</td>
</tr>
</tbody>
</table>

Source: OECD (2002)

21. Most recent data15 suggest wide variations among transition countries in terms of discretionary resources made available to subnational governments (Table 4). Several points are worth noting from Table 4:

- Total discretionary resources ranged between around 10 percent of government revenues and one-third of government revenues;
- The share of taxes in national revenues ranged between around 7 percent in Poland and around 21 percent in Lithuania, a much lower share overall compared to the OECD countries. These countries assigned modest spending authority to their subnational governments.
- Unconditional federal transfers ranged between 1 percent of national resources in Hungary and about 12 percent in Lithuania;
- Conditional transfers ranged between negligible in Lithuania and 9 percent of national revenue in Hungary, the country with largest share of conditional grants among transition countries.

22. Among key factors explaining the wide divergence in discretionary resources in these countries were incomplete assignment of functions and mismatch of allocation of resources. As noted in the OECD study: “the combination of a fragmented structure and incomplete expenditure assignments raises a number of problems and

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14 See Dillinger, William, “Intergovernmental Fiscal Relations in the New EU Member States, 2007”.
constraints on the overall possibilities of ensuring an efficient local government system with extensive subnational political accountability.”\textsuperscript{16} In short, the systems of subnational financing in these countries seemed to be fraught with design issues.

Summary

23. **The review shows that, for OECD countries, the proportion of total discretionary resources in total governments’ expenditures ranges between 49 percent and 70 percent.** Many OECD national governments make more than 50 percent of their national revenues available to subnational governments as discretionary resources, with the average share of discretionary resources standing at about 53 percent (Figure 1).

24. **The average share of conditional transfers has been around 8 percent** (Figure 2), but ranging between negligible in Switzerland and Spain to between 10-14 percent of subnational resources in Canada, Germany, and Japan.

![Figure 1: Average percent share of total discretionary resources of subnational governments in national revenues, 2000s](image)

25. **In developing and transition countries, the experience has remained broadly similar.** As in OECD countries, most national governments (with the exception of the Philippines) make over one-third of national revenues available to subnational governments as discretionary resources. While some big developing countries such as Indonesia, Nigeria, the Philippines, and South Africa have highly centralized tax resources (oil revenues in the cases of Indonesia and Nigeria), others such as India and Brazil seem to have a much higher decentralized tax system, with more taxes collected by subnational governments. However, offsetting these disparities, countries with large centralized tax resources provide high unconditional grants, whereas unconditional resources...
transfers in countries with high decentralized taxing authority are relatively much smaller.

26. **Conditional transfers in developing and transition countries are smaller compared to OECD countries** (figure 2). In developing countries, they average around 6 percent, but with a range between negligible in South Africa and Nigeria to 10-17 percent in Brazil and India. In transition countries, the average is around 3 percent, with a range between negligible in Lithuania to 9 percent of national revenue in Hungary, the highest within transition countries.

![Figure 2: Average percent share of discretionary and conditional transfers of subnational governments in national revenues, 2000s](chart.png)

*Source: Tables 1-3 above*

27. **Finally, in recent years, the share of discretionary resources to subnational governments has been increasing, both in OECD and developing countries (Figures 1 and 2).** In OECD countries, much of this discretion has been provided through greater taxing authority for subnational governments in exchange for smaller unconditional grants. In the case of Canada, for example, additional taxing room to subnational governments has almost completely replaced unconditional grants. This trend towards replacing unconditional grants with greater taxing authority brings these countries closer to the practice in the United States where discretionary resources at the subnational level have been entirely in the form of taxing authority. The trend in global development aid seems to be the opposite, where earmarking has been on the rise (see comparison section below).
B. Comparison with Discretionary Resources in Global Development Aid

28. As pointed out earlier, the bulk of official development assistance (ODA) is delivered as bilateral aid. The share of bilateral ODA has remained relatively stable at about 70 percent of total aid flows (excluding debt relief) since the mid 1970s. The rest (30 percent) is multilateral aid, delivered through multilateral organizations, such as the European Commission, the United Nations, and the World Bank’s concessional window, the International Development Association (IDA). Whereas bilateral aid may be driven by strategic ties, economic interests, or potential markets, it is generally the case that multilateral aid is less tied to such considerations. In that sense, multilateral aid may be more discretionary.

29. To facilitate a comparison between the levels of discretionary resources in intergovernmental finance and ODA, a standardized definition may be warranted as to what may constitute discretionary and non-discretionary resources in the context of ODA. One concept, developed in a recent paper, is the concept of non-earmarked and earmarked ODA that may approximately correspond, respectively, to the concept of discretionary and conditional transfers in the context of intergovernmental fiscal systems. In the same way that conditional grants are key levers for federal policymakers seeking to affect a broad range of state and local policies, so too earmarked ODA are often used by donors to drive spending into particular sectors or services in the recipient countries.

30. Earmarked ODA can be viewed as analogous to conditional grants in the context of intergovernmental fiscal systems. Such appropriations often specify, and require, that aid money be devoted to the financing of specific themes, sectors, or services in recipient countries. Three key elements of earmarked ODA are:

- **Free-standing technical cooperation (FTC)**, where the funding is largely donor-driven and tied. While directed thematically at capacity building, FTC is often donor-driven and tied to the purchase of goods and services in the donor country. It is also exempt from untying, as mandated by the 2001 OECD/DAC agreement.

- **Global program funds** and other multilateral-bilateral trust funds set up to fund specific issues or sectors such as health, education, and the environment (e.g., GFATM, GAVI, GEF, EFA-FTI); and

- **Emergency assistance**, including emergency reconstruction and food aid, administrative costs on bilateral aid, and support to NGOs and refugees in donor

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18 These are defined as “international initiatives outside the UN system which deliver significant funding at country level in support of focused thematic objectives” and includes the Global Fund for Aids, Tuberculosis and Malaria (GFATM), the Global Environment Facility (GEF), the US President’s Emergency Program for Aids Relief (PEPFAR), the Global Alliance for Vaccines and Immunization (GAVI), and the Education For All—Fast Track Initiative (EFA-FTI).
countries—and where aid funds are earmarked for those purposes by donors and which are sometimes even delivered in kind.

Figure 3: Earmarked ODA as a percent of total ODA

Source: Adugna (2009)

31. **A recent study estimates that earmarked ODA, analogous to conditional transfers, averaged about 38 percent of total ODA during 2001-2006, up from about 29 percent during 1995-2000** (Figure 3). Most of this increase in earmarking reflects the growth in stand-alone technical cooperation, and, to a lesser extent, the rising importance of special purpose trust funds and global programs in health, education and the environment (from about 1 percent during 1995-2000 to about 3 percent of ODA during 2003-06). Emergency aid held steady at about 9 percent of ODA.

32. **A striking result of this comparison is that while the magnitude of conditional grants in total government resources remains fairly low at 0-12 percent, the magnitude of earmarked ODA is much higher at 38 percent--more than three times as much as that of conditional grants. While they may be sound reasons to target a particular sector or subsector in both systems, and not all conditional grants or earmarked aid can be considered bad, the application of too many of these targeted operations may in both instances distort the overall priorities of development programs, reduce the autonomy and ability of the recipients to respond to their constituencies, and severely clog the institutional capacity of the recipient countries.**

33. **Non-earmarked ODA, on the other hand, can be viewed as analogous to discretionary resources in the context of intergovernmental fiscal systems.** The former consists of general budget support, sector program support, and debt relief.

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19 There is a strong prospect that the proportion will rise further with the likely setting up of additional global initiatives in areas such as food security and climate change.
General budget support typically includes non-earmarked support to the government budget; support for the implementation of macroeconomic reforms (structural adjustment programs, poverty reduction strategies), and non-sector allocable general program assistance. Similarly, sector program includes sector program assistance, including budget support in the form of sector-wide approaches (SWAp), and sector program in combination with other types of assistance such as technical cooperation. Debt relief given on liabilities that are being serviced is equivalent to a flow of new resources for development and as such akin to budget support.

34. A recent estimate again shows that “discretionary” ODA too has increased to 25 percent of ODA in 2001-06, up from 14 percent of ODA in 1995-2000 mainly because of debt relief (Figure 4). When debt relief is excluded, the increase in non-earmarked ODA is much more modest (from 7 percent to 11 percent of ODA).

![Figure 4: Non-earmarked ODA as a percent of total ODA](image)

Source: Adugna (2009)

35. Overall, the comparison demonstrates two key points: (i) non-earmarked ODA, which is akin to discretionary spending in the context of intergovernmental fiscal systems, stands at around 25 percent—slightly lower than the discretionary resources of subnational governments in intergovernmental finance—but it has increased in recent years just as discretionary resources have increased; (ii) the share of earmarked or “conditional” ODA is much higher—at more than three times that of conditional grants in intergovernmental systems. It appears therefore that donors in international aid rely more on earmarking to influence the spending decisions of the recipient countries than the federal governments of both OECD and developing countries rely on conditional grants to induce policy changes in their own subnational and local governments.

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20 Adugna (2009), op cit.
21 One rationale for excluding debt relief is that there is uncertainty about whether the debt relief data in OECD/DAC Aid Activity Database are accurately captured. In some cases, it appears that DAC donors record upfront the entire debt relief that is supposed to accrue to countries over many decades, thereby inflating the actual amount of debt relief given.
III. COMPARISON II: THE USE OF PERFORMANCE MEASUREMENT IN RESOURCE ALLOCATION

36. This section turns to a comparison of the use of performance measurements in the resource allocations decisions of intergovernmental systems versus their use in the allocation decision of global development aid (especially allocation of multilateral aid).

37. As global aid commitments have increased and the spectrum of instruments widened, there has been a concomitant increase in donors’ interest in trying to improve the effectiveness of aid. This interest has been motivated by two important concerns. The first has been to ensure that aid is providing the maximum benefits to the people, especially the poor, to whom the resources are targeted. The second is to demonstrate to key decision-makers in donor countries that scarce resources are efficiently applied so they may assure their constituencies that their contributions are not wasted. A consequence of these concerns has been a growing interest in being able to measure not only results, but also the efficiency with which they are achieved. It is in this context that performance measurement has become a growing preoccupation of decision makers and agencies in the aid system.

38. The review of how performance measurements are used in the context of intergovernmental systems could have useful lessons and insights for the extent to which they could be used in the allocation of global (multilateral) aid. Following the review of experience in the context of intergovernmental fiscal systems (Section A), we compare that experience with the practice in the global development aid (Section B).

A. How Is Performance Measurement Used in Intergovernmental Fiscal Systems?

39. We examine two specific questions in the context of intergovernmental finance: (i) to what extent resources are allocated across services or regions on the basis of performance as measured by outputs/outcomes; (ii) how intermediate measures of performance, such as portfolio performance, are used as an incentive for results. The review focuses mainly on the experiences of OECD countries (where there is the longest and most extensive engagement on these issues), and to a lesser extent, on developing countries.22

(i) Use of Outcome Measures of Performance in Resource Allocation across Services and Regions

40. Across Services. Off-the-record conversations with Ministries of Finance or Planning officials with responsibility for resource allocation may sometimes reveal that, at the margin, and under specific opportunities, preference may be given to a particular

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sector because they are better able to utilize resources. However, there have not been formal mechanisms indicating that decisions about resource allocation across sectors and Ministries have been made on the basis of performance indicators.

41. While this is readily understandable among developing countries where the technical infrastructure and accumulated data may not be available, it may seem surprising that no OECD country uses performance indicators as the basis for resource allocation across ministries or sectors. This is the case despite the fact that among the OECD countries:

- 72 percent of the countries include non-financial performance data in their budget documentation.
- In 44 percent of the countries, these data are available for more than three-quarters of the programs.
- In 71 percent of the countries, performance data include performance targets although there is a wide variation in terms of program coverage.
- In 65 percent of the countries, these results are included in the main budget documents and/or the annual financial document.23

42. “Performance budgeting”—defined as the practice of linking expenditure to output/outcome targets, and using the results to make future resource allocations—is very rare.24 Only 18 percent of countries reported that they specifically link expenditures to all or most of their output or outcome targets. This form of budgeting has been applied only in a few countries and in a limited number of functional areas, most commonly in health and education, and especially higher education.25 Even where it has been introduced, the countries have opted for an incremental approach to implementation.26

43. There are good reasons for the reluctance to extend the use of outcome performance data into resource allocation decisions. These reasons include technical, managerial and political considerations.

- Technical considerations include the difficulty of deciding what to measure – outputs or outcomes - and the inherent problems of accurate measurement. In addition, pinpointing accountability especially for outcomes is an ongoing problem and source of debate. Further, the comprehensiveness or lack thereof with regard to indicators and the implication for accurate interpretation are also ongoing sources of controversy.
- Managerial considerations include the cost of establishing and maintaining a credible and useful system that provides timely and actionable results. Efforts to

25 Ibid.
be adequately comprehensive can lead to information overload, and focusing on performance measurement may divert managerial attention from other important realities. Knowing that a target was or was not achieved may not necessarily explain the how or why of the results, and what is needed to replicate or improve those results.

- **Political considerations** include the fact that performance results are usually open to interpretation and thus to misuse, misunderstanding or mistrust. While almost 60 percent Ministers with portfolio responsibilities in the areas being measured use these measures in decision-making, only about 10 percent of the Cabinets and the members of the legislative committees overseeing the particular ministry do so, and even smaller percentage of politicians in the budget committee in legislatures and Heads of Government use the available performance measures in their decision making.\(^{27}\) There is a differential appreciation of performance measurement the further a political actor is from direct responsibility for the performance that is being measured.

44. **Perhaps the most important, if not explicitly acknowledged rationale for caution in the application of performance results strictly in resource allocation is that it may be inherently counterproductive to the underlying objective of a program.** Mechanistically applying the results of performance measurement may result in punishing deserving constituents for bureaucratic failures. The conclusion from experience therefore is that while performance results are not directly used in determining inter-sectoral resource allocation, they are used, often extensively, as a management tool by managers with portfolio responsibilities to engage with the relevant stakeholders—whether those are local citizens, the parliament, or designated officers and program managers with direct responsibility for delivery of public services.

45. **Across Regions.** Overall, there appears to be little competition for resources across geographic regions or subnational governments based on performance. Most cross-regional or subnational allocations have been motivated by need and (primarily tax) effort. The overarching principle in intergovernmental resource allocation is to equalize as far as possible the capacity of subnational governments to be able to provide an equivalent level of social services. The incentive that receives some attention is to discourage subnational governments from reducing their tax efforts as a result of transfers. In developing countries, the experience with regard to this issue has tended to tilt in the opposite direction in some cases (Indonesia, among the countries reviewed\(^ {28}\)) where subnational governments are discouraged from introducing excessive, and often counterproductive, tax measures in order to boost revenues.

46. **Most transfer to subnational governments or regions are formula-based.** The five OECD countries discussed earlier—Canada, Australia, Germany, the UK, and Japan...

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\(^{27}\) Ibid.

\(^{28}\) Decentralizing Indonesia, p. 38-40.
–have elaborate and detailed formulae for their core transfers. Roughly speaking, there are four types of formula for equalization transfers. 29

• **Formula A.** Formulas that consider not only the equalization of fiscal capacities, but also adjust for the expenditure needs of different regions. Applications of these formulas can be found in Australia, Germany, Japan, Korea, and the United Kingdom.

• **Formula B.** A formula that considers only the equalization of fiscal capacities. An example is the formula used in Canada.

• **Formula C.** Formulas that distribute equalization transfers based on some "needs" indicators. Fiscal capacity is not considered in these formulas often because such data are difficult to obtain. India, Italy, and Spain use this type of formula.

• **Formula D.** Formulas that distribute equalization transfers on an equal per capita basis. Such formulas are used in Germany's VAT sharing, Canada's Established Programs Financing (EPF), [and] England's income from Non-domestic Rate (NDR).

47. **The preoccupations evident in these formulae are two: one is the equalization of fiscal capacities across jurisdictions and another (with the exception of Canada) is to adjust for differential expenditure needs.** However, in none of these formulae is performance a factor in determining resource allocation across regions or subnational governments. This is justifiably so, as effective use of the resources, once allocated, is accountable to the local constituents who are best placed to punish poor performance of their local government.

48. In some cases, however, a central or local government may wish to encourage better service delivery performance across its jurisdiction in one or more sectors and offer grants as incentives accordingly. Additional resources may be available within specific sectors if certain targets are achieved. In a study of the use of performance measurement in local governments in the U. S., this category of reward ranked fourth and fifth of seven types of rewards offered for meeting performance targets. 30 Furthermore, additional resources may be available to encourage coordinated or joint programs between central and subnational governments or between subnational governments, especially where multi-jurisdictional bodies are involved in program implementation. These types of incentives are often used in the context of conditional grants or in the context of several of the Transition Countries where many local governments are small and are

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29 Jun Ma, *Intergovernmental Fiscal Transfer: A Comparison of Nine Countries (Cases of the United States, Canada, the United Kingdom, Australia, Germany, Japan, Korea, India, and Indonesia)*, prepared for the Economic Development Institute, World Bank, May 1997.

overwhelmed by their nominal responsibilities, and where these types of incentives might help improve institutional coordination.

49. In summary, as the OECD report notes: 31 “P (erformance) I (nformation) does not tend to have a significant impact on resource allocation. When performance information is used by the MOF in budgetary decision making, it is one factor in the decision making process used along with other information to inform rather than determine budget allocations. Rarely on a government-wide scale is there any mechanical link between performance and funding. The MOF rarely uses PI to cut or eliminate programmes.”

50. If they are not used in resource allocation, what then are outcome measures used for? In general, performance results are mainly used as a management tool in (i) program justification during budget discussions, and reporting to parliaments and to the public; (ii) improving program performance; and (iii) to assess citizens’ response and satisfaction with respect to an array of services provided, especially at the local government level. Agencies that provide resources for other bodies to spend—whether these are central governments providing resources for subnational governments, or ministries of finance to operational departments, or parliaments to administrations, or taxpayers to governments—want to know if they are receiving appropriate value for resources consumed. Similarly, managers or Ministers who are being held accountable for the performance of the entities under their control wish to ensure that resources are used well, and service providers care about whether their efforts are achieving the maximum effect. In a virtuous circle, good performance thus results in greater efficiency in the utilization and allocation of scarce resources. Countries with distinctively different characteristics – ranging from Uganda to the United States to Indonesia—seem to use outcome performance measurement in these respects to varying degrees.

51. Finally, three broad categories of financial and non-financial instruments are used to induce better performance outcomes of local governments: i) financial rewards or sanctions; ii) increasing or decreasing financial and/or managerial flexibility; and, iii) making results public – naming or shaming poor performers and recognizing good performers.32 33 As noted before, the first option is not widely used. With regard to the second option, in practice, greater control is apparently the preferred choice of response at the central government level, but some flexibility in the use of surplus funds appears to have a little traction with local governments. The most popular measures are with regard to public recognition, and this option is most frequently applied, along with enhancement of individual compensation,34 especially with regard to locally provided services. Developing countries that have decentralized systems have shown this tendency as well, often through the use of service delivery surveys, the results of which are published and good performers recognized.35

31  OECD, op cit, p55.
32  Ibid, p47.
33  Melkers and Willoughby, op cit.
34  Ibid, Table 1.
35  Uganda, Indonesia and the Philippines provide examples.
(ii) Use of Intermediate Measures of Performance (Portfolio Performance) in Resource Allocation

52. **Countries with decentralized government systems do not usually review their intergovernmental fiscal relationships and mechanisms on an annual basis.** Resource distribution formulae may be adjusted based on changes in parameters such as population size and composition, and ongoing sectoral programs may be adjusted at the margin between major review periods—usually of multi-year intervals—but significant periods, measured in years, pass before central-local allocation formulae are adjusted, especially with regard to unconditional grants and tax authority assignments.

53. **Yet, one measure of implementation that is widely used by the central government in monitoring expenditure against targets is portfolio performance,** a crucial intermediate indicator of implementation for the resource providers, particularly the Ministry of Finance. Portfolio performance itself is measured by the rate of disbursement of funds ("burn rate"), a key input in project and program success. The way it is linked to resource allocation decisions is that, often, program disbursements are replenished on a quarterly basis and, if undisbursed, the balances cancelled at the end of the fiscal year. In this set up, in addition to using up replenished funds, subnational governments with good portfolio performance—i.e. governments whose disbursements perform well in a current year—may receive block grants that include an incentive pool of additional funds that will be distributed as part of their future years’ allocation. In contrast, subnational governments with poor portfolio performance may not only forego such additional funds but also may actually lose the unused funds at the end of the year. Limited evidence to date suggests that this is indeed the most often used measure of performance with direct financial consequences for subnational governments.

**B. Comparison with the Use of Performance Measurement in Development Aid**

(i) Use of outcome measures in resource allocation

54. **As in intergovernmental fiscal systems, outcome measures have not been used to date in allocating development aid across countries.** In recent years, however, there has been much debate about the need to reform, for example, IDA’s performance based allocation formula so that the formula explicitly includes development outcomes. However, this debate appears to be in stark contrast to what OECD countries are practicing in the context of their own intergovernmental fiscal transfer systems to subnational governments. As the review in the previous section shows, none of the OECD countries use development results in their resource allocation decisions. When performance information is used by the Ministry of Finance in budgetary decisions, it is

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36 The State Government of Karnataka, India, is a recent example.
37 Technically, this may be authorized for disbursement in the final quarter of the budget year to be used in the following year, or may be accumulated over more than one year to be added to subsequent years.
38 See, for example, Kanbur, Ravi, 2005, “Reforming the Formula: A Modest Proposal for Introducing Development Outcomes in IDA Allocation Procedures”.
one factor in the decision making process used along with other information to inform rather than determine budget allocations. Rarely on a government-wide scale is there any mechanical link between outcome performance and funding.

55. **Multilateral aid agencies face a similar—and perhaps even more complex—set of challenges in making aid conditional on development results.** As noted in the previous section, among the reasons why even OECD countries do not use outcome indicators in their resource allocation decisions are technical, managerial, and political considerations. The technical problems include the inherent problems of accurate measurements; the problems of pinpointing accountability for outcomes; and the comprehensiveness or lack thereof of satisfactory indicators. Managerial problems include the cost of establishing and maintaining a credible and useful outcome system that provides timely and actionable results. Among similar challenges faced in the context of aid allocation are: (i) a results based system would penalize countries for the effect of exogenous variables (e.g., terms of trade shocks such as those arising out of the current global financial crisis; natural disasters; climate related problems e.g., droughts and floods; pandemics e.g., HIV/AIDS and avian flu); (ii) for aid agencies operating in several low income countries, results based allocations require data which is comparable across both time and across countries, and given the weak and unreliable statistical and monitoring systems in many developing countries, such data may be very difficult to obtain; and (iii) countries with the highest needs may be those least likely to be making progress on development results (e.g., post-conflict and fragile states) and would be penalized by focusing only on outcome based aid allocation decisions.

(ii) **Use of Intermediate Measures of Performance in Resource Allocation**

56. **However, several development agencies, in particular the multilateral development banks,** use intermediate measures of performance—as measured by policy and institutional assessment—in their resource allocation decisions. This method of allocating resources, known as the Performance Based Allocation (PBA) system, has formed the basis for distributing resources since the late 1970s. Each MDB’s allocation system, however, has evolved over time, often through their respective successive replenishment negotiations, where donors have extensively discussed, refined and changed the PBA system.

57. **While the exact PBA formula may vary across the MDBs, its salient features include two components—country performance and country needs—as key determinants of aid allocations.** Country needs are proxied through population (allocations increase with higher population) and GNI per capita (allocations decrease as GNI per capita increases) while country performance is largely measured by the

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39 These include the African Development Bank (AfDB), the Asian Development Bank (AsDB), the Caribbean Development Bank (CDB), the Global Environmental Facility (GEF), the Inter-American Development Bank (IADB), the International Development Association (IDA) of the World Bank, and International Fund for Agricultural Development (IFAD).
country’s policy and institutional performance (CPIA). The CPIA measures the quality of a country’s policies and institutions—i.e., the extent to which a country’s policy and institutional framework supports sustainable growth and poverty reduction, and consequently the effective use of development assistance. IDA’s CPIA, for example, consists of 16 criteria grouped into four clusters: (A) economic management; (B) structural policies; (C) policies for social inclusion and equity; and (D) public sector management and institutions. The criteria are focused on policies and institutional arrangements that are within the country’s control, and scores depend on actual policies, not intentions. For each of the 16 criteria, countries are rated on a scale of 1 (low) to 6 (high), where the ratings are validated through an extensive and rigorous peer review system. The scores are then averaged within each cluster to yield the cluster score; and a composite score is obtained as the mean of the four clusters. The CPIA does not directly measure development outcomes but it measures intermediate steps—the quality of the policy and institutional framework—that are critical to achieving development results. Typically, a higher weight is placed on the “governance” cluster (cluster D) of the CPIA in the aid allocation formula.

In addition to the CPIA, portfolio performance rating, reflecting the health of the respective MDB’s active portfolio of development projects in a country, form a key component of country performance. Most multilateral aid agencies use portfolio performance rating as a proxy for the absorption capacity of the recipient countries and how well they’re using the money. The focus of the rating is therefore on the proportion of projects facing implementation problems in total project portfolio (instead of the rate of disbursement of funds in intergovernmental finance). The manner in which the rating enters the allocation decision is that, typically, portfolio rating would have a weight in the aggregate score of a country’s performance rating discussed above, which directly determines the annual aid allocation that country receives. While this is obviously different in some respects from how portfolio performance is used in intergovernmental fiscal systems, the essence of both systems remains similar, i.e. both systems seem to rely on portfolio performance as a prerequisite to receiving additional resources.

In the IDA allocation system, the CPIA carries a 92% weight whereas the performance of the existing IDA portfolio carries an 8% weight.

While the bulk of multilateral aid resources are allocated through the PBA system, four considerations have historically merited exceptions to the PBA system. These include: post-conflict/fragile states emerging from severe conflict; multi-country/regional projects that have received a special dedicated funding; small states and islands (with a population of less than 1.5 million) often experiencing greater vulnerability to economic events and natural disasters; and, capped-blend countries whose per capita GNI is well within the classification of poor countries, but where such countries have access to market-based resources because they are creditworthy.

For IDA, country teams prepare proposals for each criterion accompanied by written justifications. These are initially vetted by the Regional Chief Economist and then go through an extensive and rigorous peer review process led by OPCS with participation of the networks and central departments to ensure consistency and comparability across countries and regions. Furthermore, country authorities are involved at two stages—when the proposals are being prepared and at the end of the CPIA process when country teams communicate to the authorities the results of the rating.
59. **In summary, the comparison underscores two key points:** (i) Outcome measures are used neither in intergovernmental fiscal systems nor in development aid in resource allocation decisions; and, (ii) Just as in intergovernmental fiscal systems, portfolio performance is used as an indicator for allocation decisions in development aid. While outcomes, the ultimate manifestation of results, are the goals of programs, these are not feasible measures for determining the effective allocation of resources *ex ante* between subnational regions or countries. On the other hand, intermediate measures of performance—such as policy and institutional performance and portfolio performance—are more suitable for resource allocation decisions not only because they can be measured on an ongoing but also because they are a proxy for prospective results and outcomes.

### IV. CONCLUSIONS AND LESSONS

60. **This study has reviewed two key aspects of the intergovernmental fiscal systems in a diverse set of countries to look for possible lessons and implications for ODA.** The first is the balance between discretionary and non-discretionary transfers in total subnational government resources, and how that compares with that in the global aid flows to developing countries. The second is whether and how outcome performance measurements are used in determining resource allocation in intergovernmental fiscal systems, and how that experience compares with that of global development aid. The key findings can be summarized as follows.

61. **On the question of the balance between discretionary and non-discretionary resources of subnational governments, the review shows that:** (i) in OECD countries, many national governments make more than 50 percent of their national revenues available to subnational governments (the average share of discretionary resources is about 53 percent) as discretionary resources, while non-discretionary resources in the form of conditional transfers have been much more limited in their use to an average of around 8 percent; (ii) In developing countries, most national governments make over one-third of national revenues available to subnational governments as discretionary resources, while conditional transfers have averaged around 6 percent (with a range of between 0 -17 percent); and (iii) In transition countries, discretionary resources of subnational governments tend to be lower in general and average about 20 percent, while conditional transfers have averaged around 3 percent (with a range between 0-9 percent). Furthermore, in recent years, the share of discretionary resources to subnational governments has been increasing, both in OECD and developing countries, and much of this discretion has been provided through greater taxing authority for subnational governments in exchange for smaller unconditional grants.

62. **In contrast, in global development aid, non-earmarked ODA, which is analogous to discretionary resources in intergovernmental fiscal systems, has remained much lower at only 25 percent of total ODA**—slightly lower than the discretionary resources of subnational governments in intergovernmental finance—but it has increased in recent years just as discretionary resources have increased. More importantly, the share of earmarked or “conditional” ODA is much higher—at more than three times that of conditional grants in intergovernmental systems. It appears therefore
that donors in international aid rely more on earmarking to influence the spending decisions of the recipient countries than the federal governments of both OECD and developing countries rely on conditional grants to induce policy changes in their own subnational and local governments. Whereas there are often sound reasons to target a particular sector or subsector in both systems, and not all conditional grants or earmarked aid can be considered bad, the application of too many of these targeted operations—particularly in global development aid—may distort the overall priorities of development programs, reduce the autonomy and ability of the recipients to respond to their constituencies, and severely clog the institutional capacity of the recipients. The lesson for the international aid architecture is that the delivery of ODA would need to move in the direction of more discretionary (non-earmarked) and less earmarked aid.

63. **With respect to the use of outcome measures in resource allocation, the experience of OECD countries shows that outcome measures do not directly determine resource allocation decisions.** The reasons for not using outcome performance data into resource allocation decisions include technical, managerial and political considerations. Among the technical reasons are what to measure—outputs or outcomes-and the inherent problems of accurate measurement; the difficulty of pinpointing accountability especially for outcomes; and the comprehensiveness or lack thereof of indicators. Managerial issues include the cost of establishing and maintaining a credible and useful system that provides timely and actionable results without information overload, or without diverting managerial attention from other important priorities. Political considerations include the fact that performance results are usually open to interpretation and thus open to misuse, misunderstanding or mistrust.

64. **Yet, the review also shows that intermediate measures of performance, in particular portfolio performance, are used as an incentive in resource allocation decisions of OECD countries.** Portfolio performance itself is measured by the rate of disbursement of funds, a key input in project and program success. The way the incentive system works is that, often, program disbursements are replenished on a quarterly basis and, if undisbursed, the balances cancelled at the end of the fiscal year. In this set up, in addition to using up replenished funds, subnational governments with good portfolio performance—i.e. governments whose disbursements perform well in a current year—may receive block grants that include an incentive pool of additional funds that will be distributed as part of their future years’ allocation.43 In contrast, subnational governments with poor portfolio performance not only do not receive such additional funds but also may actually lose the unused funds at the end of the year.

65. **On the aid side, while outcome measures are not used in allocating development aid across countries, several multilateral development banks use intermediate measures of performance in their resource allocation decisions.** Most multilateral development banks allocate the bulk of their aid resources in accordance with a recipient country’s policy and institutional performance, known as the Performance Based Allocation (PBA) system. While the exact PBA formula may vary from one

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43 Technically, this may be authorized for disbursement in the final quarter of the budget year to be used in the following year, or may be accumulated over more than one year to be added to subsequent years.
institution to another, its salient features include two components—country performance and country needs—as key determinants of aid allocations. The CPIA does not directly measure development outcomes but it measures intermediate measures—the quality of the policy and institutional framework—that are critical to achieving development results.

66. **In addition to the CPIA, portfolio performance is used as an indicator for aid allocation decisions.** While portfolio performance is used to determine the replenishment of funds in the intergovernmental fiscal systems, most multilateral aid agencies use portfolio performance rating as a proxy for the absorption capacity of the recipient countries and how well they’re using the money. The focus of the rating in development aid is therefore on the proportion of projects facing implementation difficulties in total project portfolio instead of rate of disbursement of funds in intergovernmental finance. The manner in which the rating enters the allocation decision is that, typically, portfolio rating would have a weight in the aggregate score of a country’s performance rating discussed above, which directly determines the annual aid allocation that country receives. While this is obviously different in some respects from how portfolio performance is used in intergovernmental fiscal systems, the essence of both systems remains similar, i.e. both systems seem to rely on portfolio performance as a factor influencing how much additional resources are allocated.

67. **In recent years, there has been much debate about the need to reform the multilateral aid allocation system, including that of IDA, so that the formula explicitly includes development outcomes.** However, this debate appears to be in stark contrast to what OECD countries are practicing in the context of their own intergovernmental fiscal transfer systems to subnational governments. As the review in this paper shows, none of the OECD countries use development results as an indicator in their resource allocation decisions. The reasons for not using outcome measures include technical, managerial, and political considerations. When performance information is used by the Ministry of Finance in budgetary decision making, it is one factor in the decision making process used along with other information to inform rather than determine budget allocations. Rarely on a government-wide scale is there any mechanical link between outcome performance and funding. Notwithstanding the debate, the insight to be drawn from this for aid allocation is that multilateral aid agencies including IDA face a similar—and perhaps even more complex—set of challenges that would make it impractical for aid allocations to be made conditional on development outcomes. These include the same technical, managerial and political considerations that have proven relevant in the context of intergovernmental fiscal systems.
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Abstract:

This paper reviews the experiences of intergovernmental fiscal systems (IGFS) to look for possible lessons for how Official Development Assistance (ODA) is delivered. Specifically, it compares IGFS and ODA in two specific respects. The first is the proportion of public resources that central governments make available to sub-national governments on a conditional basis, and how that compares with the proportion of non-earmarked ODA given to low income countries. The second is the role of performance outcome in resource allocation to sub-national governments and how that compares with the role of performance in ODA, particularly multilateral ODA allocation. The comparisons show that (i) the share of earmarked ODA is more than three times higher than that of conditional grants in intergovernmental systems, suggesting that donors in ODA rely more on earmarking to influence the spending decisions of the recipient countries than their federal governments do on conditional grants to induce policy changes in their own sub-national governments; (ii) none of the OECD countries currently use outcome measures in determining resource allocation to their sub-national governments for a variety of good reasons, and the recent debate as to whether multilateral ODA allocation should be based on development outcomes seems to ignore this experience.

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