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Fiscal Incentives and Local Government Performance

Literature Review

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Fiscal Incentives and Local Performance

This note reviews the literature on fiscal incentives that aim to enhance the performance of local governments.

The literature on the subject focuses mainly on two instruments by which central governments (or international actors) can foster local government performance. The first instrument, and the most emphasized tool in the literature, is performance-based grants. The second instrument is the design of the fiscal structure. Both instruments, and the empirical lessons that have emerged from the international experience, are described below.

It is important to keep in mind that the literature concentrates on cases of countries that are of relatively recent formation, and/or in transition from central planning, and/or are relatively some of the poorest, and/or have low capacity, and/or are new to decentralization. It should be noted that the experience in relatively more developed countries is in general not covered in the literature and hence there could be things affecting the experience of the relatively developed countries that do not apply to the poorer countries and vice versa.

Performance-Based Grants (PGs)

The most emphasized fiscal incentive instrument discussed in the literature is PGs (Steffensen 2004; Steffensen 2005; UNDP 2005; Steffensen 2006). The essence of PGs is that they aim at promoting a positive change in some aspect of the performance of local governments by conditioning the access to a grant to the achievement of certain desirable goals (generally set by a central authority or foreign actor in the form of minimum conditions and/or performance measures). Local governments, in order to get access to the grant must show that they have met the goals established in the grant legislation or rules. In short, performance-based grants penalize undesirable behavior (as defined by the central government), and reward desirable one.

PGs have been piloted and mainstreamed in several countries as a national initiative and also as a donor driven initiative. Some authors recommend as an entry point for PGs, fiscal responsibility acts (Howes 2005). In the international community, the "Saxton Report" –a report from the Joint Economic Committee of the Congress of the United States— recommends The World Bank to change its lending scheme for a PG scheme as the report argues that the same amount of aid could be provided through PGs as through loans at the same economic cost. The difference, it is argued, is that the grants would be much more effective in attaining results without leaving heavy debt burdens (Lerrick 2002; Congress of the United States 2002).

The literature documents that in general the PG experience has been successful. Some factors stand out as important in promoting good results. Among those factors, the following are highlighted and are discussed below: capacity building policies; good performance indicators; flexibility in the usage of funds; commitment and credibility of

all actors involved (citizens, NGOs, local governments, central governments and other contributing agencies/donors) and involvement of all key stakeholders in the grant implementation schemes; and strong communication of the objectives behind the system.

The international experience has shown that PGs initiatives are more likely to be successful when their design includes capacity building components. This is in order not to overwhelm, the very likely to be low, local capacity. This capacity building component should be relatively easy to get access to by local governments as opposed to the grant component, which should be relatively harder to obtain.

Good performance indicators are basic to the functioning of the PGs system. With good indicators, the assessment of progress is simplified and the overall credibility of the PGs system is improved.

Flexibility in the usage of funds has proven to be important because it fosters efficiency in resource allocation based on local priorities and tastes. It should be noted that there is a trade off between national targets by central governments (or also donor objectives) and flexibility. In practice, typically more autonomous systems in resource utilization carry stronger performance measures.

Commitment on behalf of the PGs stakeholders is important for its success perspectives. If central governments or donors do not commit to reward/punish according to the set rules, then there is no real incentive for local governments to comply with the acquired commitments. Furthermore, citizens, NGOs, CSOs, and local government participation is important to ensure that the assessment of progress is done in an integral and credible way.

Strong communication of the objectives of the PGs system has proven to be important. Local governments and citizens should be informed of the objectives, and what is expected from them in a PGs system, as there has been cases in which some local governments have not been aware of the existence of optional PGs schemes that could have benefited them.

As mentioned above, PGs have shown good results. The following positive outcomes have been emphasized in the literature. First, improved institutional performance: PGs have provided local governments with incentives to comply with statutory institutional requirements (for example in Uganda, Tanzania, and Kenya). Second, improved governance and accountability: PGs have fostered competition and discussions on ways and means to improve performance across the local governments and has been a tool for improved dialogue between citizens and authorities on how to address the local challenges in the most efficient way. Third, improved investment and service delivery: PGs have encouraged expenditure on local priorities and participation as well as strengthened the focus on investments in key poverty alleviation areas such as small roads, education, health, water and sanitation. Fourth, fostered capacity building: The assessment systems have provided the local governments with a tool to identify their

main functional gaps, providing ground for dialogue between center and periphery on ways to address deficiencies.

Even though PGs have shown good results, there are areas in which work is still needed. The following are some areas mentioned in the literature. First, on the encouragement to improve local government revenue mobilization: Even though the PGs systems have considered the linkages between local government own source revenue mobilization and grants (and in principle have been designed to incentive mobilization of resources), the lessons have been that these initiatives cannot alone ensure that the local revenue potential is fully realized. Second, on the sustainability and links between investments and operation and maintenance: PGs have led to an increase in investment, nonetheless the maintenance implications of the local investments have been a great challenge in most developing countries, especially in cases where own local government revenue has declined as a consequence of the grant scheme. Third, on the risk that rigid conditionalities may create a shift away from local accountability towards upwards accountability: Focusing entirely on compliance with the central government reporting requirements and targets could leave citizens out of the policy dialogue (Ahmad 2005). Fourth, on the challenge for central governments and donors to move from a role of controllers to one of guides: capacity building and gradual devolution of functions should be considered in order to tap on the information advantages of local governments on local needs. Fifth, on the issue that incentives have been directed on its majority towards the performance of the local government as a whole, and the incentives for individual staff performance have not been properly addressed: Rewarding individuals could help local administration to develop faster, in some cases, than incentives to the locality as a whole. Sixth, on the issue of mainstreaming PGs pilots: In some cases, it has been a challenge to find political will to implement PGs on a large scale.

The Design of Fiscal Structure as Incentive

Another type of fiscal incentive that is discussed in the literature is the *design* of the fiscal structure as a whole.

The literature discusses two ways in which fiscal structure can act as an incentive mechanism. One way is by allowing local governments to keep a large fraction of the taxes collected locally. This serves as a fiscal incentive for local governments to develop the local economy and increase tax effort. Just as PGs penalize/reward, this fiscal structure mechanism implicitly rewards local governments that have a good local economy and that show good tax effort – as the greater their performance and effort would lead to greater resources – while it penalizes local economies that have a weak local economy and show low tax effort. Another way in which the fiscal structure could affect local government behavior is by closely linking local revenues and expenditure (Wildasin 1997). In this fashion local governments again have incentives to develop the local economy and to increase tax effort, being implicitly penalized if they choose not to increase effort and foster the local economy.

The main examples discussed in the literature regarding the fiscal structure as incentive, are the Chinese and Russian experiences. It is important to keep in mind that these countries are in transition from central planning and hence their experiences might not be typical.

The Chinese case is an example in which the fiscal structure acts as good tool for local development by providing the "correct" incentives (Chang 1998; Jin 1999; Bahl 2003; Hsu 2004; Ping 2005). The literature reviews that China's fiscal contracting system provides local governments with strong fiscal incentives and at the same time improves horizontal distribution across provinces in budgetary spending. The review of the Chinese experience in the literature shows that strong fiscal incentives — in the form of high marginal revenue retention rate — has lead to a fast development of non-state enterprises and reform in state-owned enterprises. Furthermore, it is also argued that in China governments face strong fiscal incentives to pursue local prosperity, as their local expenditures are made closely linked to the revenues they generate.

The Russian experience is contrasted to the Chinese experience (Slider 1997; Zhuravskaya 1998; Freinkman 1999; Alexeeva 2005). It is argued that the existing revenue sharing schemes between the Russian regional and local governments have provided the latter with no fiscal incentives to increase their tax base and effort as increases in local government revenues have been almost entirely extracted by the regional government. This also has broken the link between local revenue and local expenditure. It is argued that this situation has lead to the observed predatory behavior of local governments toward private businesses, and to the lack of effort by local governments to develop the local economies.

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<u>Appendix:</u> Summary of Selected Documents

CONCEPTUAL BASIS FOR PERFORMANCE BASED GRANT SYSTEMS AND SELECTED INTERNATIONAL EXPERIENCES

Jesper Steffensen
Henrik Fredborg Larsen
2005

In this essay, the authors introduces the concept of performance-based grant systems (PGs), present a brief overview of the international experiences and major design issues for any PG system, and outline some of the key design issues to be considered in future applications of PGs.

The authors mention that the innovative feature behind the new PG funding schemes is the linkage between the transfers and the performance/capacity of the local governments. The authors claim that these systems have shown encouraging results and have great potential for further application (discussed below).

<u>Discussion of links to capacity building</u>

The authors argue that to be most effective, a performance based (capital) development transfer scheme needs to be supported by a strongly coordinated capacity building process and capacity building support to the local governments. They argue that a way of achieving this is by introducing, alongside the capital component of the PG, a capacity building grant. This grant would be of a much smaller amount than the capital grant (it will be used to fund various capacity building activities such as training, smaller equipment, etc., rather than 'hard' investment), and should be more easily accessible than the PG to enable all local governments (LGs) to improve the performance.

The authors mention that whilst one expects a certain number of LGs to fail to access the capital grant every year, the capacity building component should be structured to ensure that all LGs can access it, provided that they have shown signs of commitment, for example through elaboration of plans and budgets for capacity building.

The authors also mention that LGs should be allowed significant discretion both over what sort of capacity needs to be built and where the inputs should be sourced.

<u>Discussion of grant objectives and focus</u>

The authors write that in terms of their orientation and focus, PGs can be distinguished from one another along two basic dimensions:

- First, by the type of performance that the grant is trying to leverage. That is, multisectoral/institutional versus sector performance.

- Second, by the flexibility of the use of funds (the extent to which the funds are earmarked for specific purposes or have a broad menu/LG discretionary funds).

The following specific objectives of PGs are mentioned: Promote strong incentives for LGs (as corporate bodies) to improve in key performance areas

- Supplement needs assessment and monitoring and evaluation systems
- Improve management and organisational learning
- Strengthen the capacity development efforts (focus and incentives)
- Improve accountability (up/down), participation and citizens' access to information
- Shown to be a good tool to bring funds on-budget and streamline/mainstream/ coordinate donor support

Discussion on indicators

What LGs would need to demonstrate to access PG funds would tend to be improvements in broad, crosscutting areas such as financial management and planning. The authors give as example of this: requirements to have clean audit reports, submissions of development plans in time, transparency and open citizen access in planning and budgeting preparations etc. It is mentioned that in *sector* specific systems the performance criteria would tend to focus on achieving certain service-delivery targets, such as number of classrooms constructed or measures of various unit costs.

It is mentioned that initially the most used performance indicator was tax effort (e.g. in Ghana). The types of indicators used has widened:

- Institutional – Broad improvements in LG "generic performance" (e.g. good governance, planning and financial management, resource mobilization, expenditure management, opinion in audit reports, transparency etc)
- Output focused – rewards for achieving specific targets – e.g. number of classrooms constructed, unit costs etc. (for more mature systems)
- Principles for indicators: Support the objective of the system, measure areas within LG control, simple, ensure balanced performance and clear "signals"

Discussion on usage of funds

There are many points on a spectrum whose end points are defined by very highly specified usages and by very flexible usages. It is pointed out that there is a trade off here, as tight control and earmarking of funds will constrain the space for the emergence of efficiency in resource allocation based on local priorities achieving the overall objectives of devolution.

Issues on monitoring of fiscal and financial management performance

The following monitoring issues are highlighted: the challenge of customizing indicators that are usually available at the central level to the local governance level; how to link local indicators with other types of indicators; scoring and weighting of various areas: the establishment of composite indicators; explore how the fiscal environment interact with and impact on the LG fiscal performance indicators; how to harmonize and avoid multiple systems; how to link the general fiscal indicators to the grant and incentive system and ensure that they are applied and continuously updated.

International Experience

Grant allocation and poverty targeting

It is mentioned that there are advantages in formula based grants. They are more transparent, predictable and equitable than are ad hoc transfers and more suitable for the local planning process.

The author mentions that what most countries have done is to include poverty or poverty proxy measures in the basic allocation criteria prior to the adjustment for the results on the performance measures.

The author point out that some of the, in other aspects poor, LGs (e.g. in terms of poverty count and or revenues) have actually performed better than more well endowed LGs e.g. Uganda and Kenya. These experiences have shown that there is no direct link between general poverty and possibilities to improve on institutional performance as long as the indicators for performance are reasonable and well designed.

Assessment system and administration

It is emphasized that the mechanism through which this performance is assessed is vital to the functionality of the PG system: PGs are usually managed and overseen by a central government ministry or department, such as the Department of Finance or Local Government (or sector ministries if sector-oriented) and are funded from central revenues and/or donor loans or grants.

Other International Experiences

The authors state that the experiences from innovations with PG systems in various countries have generally been very positive. They write that the combination of MCs (minimum conditions), PMs (performance measures), capital grants and capacity building grants have provided LGs with strong incentives to improve on performance within key institutional generic performance areas like planning, budgeting, financial management and project implementation, but also within areas of good governance.

As examples, they mention Uganda and Kenya where local development plans and budgets are now being elaborated with larger involvement of the citizens, more transparency and inclusiveness than prior to the introduction of the systems.

The authors asses that most of the piloting and national roll out of grant schemes, which include performance based allocations, have been made within the area of non-sectoral capital grants, often supplemented by various forms of capacity building support to the LGs. There are few examples of large-scale performance based sector specific recurrent and development grant schemes.

They also mention that there are also plans in some countries, e.g. in Uganda and Tanzania, to link the *flexibility* in the utilization of funds and /or the level of autonomy against the LG performance within key financial management areas.

With respect to performance measures, the authors point out that most of the PG systems have applied generic institutional measures, within areas such as planning, financial management, fiscal capacity and tax effort, expenditure prioritization (reward for poverty focus in expenditure allocation), transparency and accountability.

The authors also mention that a number of countries have initially applied only minimum conditions for eligibility and during subsequent phases some of these have introduced more qualitative and complex performance measures like the ones in Uganda, Tanzania and Bangladesh.

With respect to the assessment of achieved goals, it is mentioned that a lot of effort has been made to ensure that the actual assessment of the LGs is surrounded by a strong credibility and integrity and accepted as valid and highly professional by all parties involved, i.e. the citizens (and NGOs/CSOs), the LGs, the central governments and other contributing agencies/donors.

They finish this section by mentioning that most countries have combined the PG systems with various types of capacity building measures.

Lessons learned from PG systems

Institutional performance

The authors mention that performance linked funding has proved to provide LGs with remarkably strong incentives to comply with statutory requirements and has led to improved performance.

Improved governance and accountability

They argue that PG systems have created an environment conducive to dialogue on the performance of LGs, promoted competition and discussions on ways and means to improve on performance across the LGs and been a tool for improved dialogue between the citizens and councilors on how to address the local challenges most efficiently

Investments and service delivery

They argue that PGs, if that the right incentives have been in place, have encouraged local priorities and participation as well as strengthened the focus on investments in key poverty alleviation areas such as small roads, education, health, water and sanitation.

Sustainability: Links between Investments and Operation & Maintenance (O/M)

The authors argue that PG systems have been mainly applied within the field of capital investments. However, the O/Ms implications of the local investments have been a great challenge in most developing countries, especially in cases where LG own source revenue has declined. Sustainability of projects is still an area, which leaves some room for improvement (the authors argue).

Capacity Building (CB)

Assessment systems have provided the LGs with a tool to identify their main functional gaps. The systems have also strengthened the LGs incentives to utilize the capacity building support more efficiently than was previously the case.

Incentives to improve LG revenue mobilization

The authors mention that the lessons in this area have been that PG initiatives cannot alone ensure that the local revenue potential is realized in times in which there are strong pressures against local revenue mobilization.

The authors propose that the revenue incentives should be combined with reforms to make a more conducive environment for LG taxation combined with improvements in the efficient utilization of the collected funds.

Assessment of performance

It is argued that experiences have shown that the credibility of the assessment of LG performance is vital for success of the system.

Possible pitfalls in design

The authors identify as design and operational challenges:

i) identify the specific indicators for LG performance
ii) design the institutional arrangements
iii) ensure a strong communication of the objectives behind the system
iv) involve all key stakeholders in the grant implementation schemes
v) ensure high credibility of the assessment
vi) decide on possibilities for QA of the assessment, options for complaints , etc.

Emerging issues and basic conditions for implementation

The authors suggest considering more output-oriented indicators with an eye on keeping the system manageable and simple and the performance indicators within the areas of LG control (that is areas on which LGs have leverage).

They also suggest that other type of incentives may also be considered to supplement the financial incentives such as wide public announcements of LG performance.

The authors also mention that there is always a risk that rigid conditionalities may create a shift away from local accountability towards focusing entirely on compliance with the central government reporting requirements and targets. The design of the PGs should address this shift towards upward accountability and away from downwards accountability.

It is discussed that it has been an overarching challenge for central governments and donors to move away from a role of controllers to one of guides and mentors.

Another mentioned issue is that the incentives have been mostly directed towards the performance of the LG as an institution/entity, and the elaboration of incentives for individual staff performance has been less in focus, although it is equally important.

They also argue that mainstreaming the PGs pilots has been a challenge and will continue to be one.

Finally, the authors conclude that the reforms of LG systems are most efficiently implemented in a situation of peace and stability.

Key Design Issues to be addressed in Performance Grants

The authors enumerate the following issues to be considered:

1) Are the basic conditions in place for the functioning of the system?
2) The vertical and horizontal universe (level/type and number) of LGs to be eligible for the new grant schemes
3) The size of the grants and the matching fund contribution from the LGs
4) Utilization of the capital/development (or recurrent) and capacity building grants ('the menu') and the grant application – is it for development grants and/or recurrent grants, what are the conditions attached, etc.
5) The horizontal allocation formulae for the grants (distribution of funds across the LGs)
6) The vertical distribution of grants, if systems of LGs have several tiers of government, like e.g. Uganda and Nepal
7) The performance indicators, assessment process, assessment manual, costs and links to other grant systems

8) The links to other performance monitoring systems.

Fiscal Decentralization and Poverty Reduction
UNDP Primer: Fiscal Decentralization and Poverty Reduction
November 2005

The document asserts "the development of systems for performance-based allocations of intergovernmental fiscal transfers has proven to be a key instrument for encouraging sound financial behavior by local governments and for improving the service delivery outcomes of devolved functions, including making these increasingly pro-poor." The UNDP/UNCDF have assisted central and local partners in developing performance-based approaches to fiscal transfers.

The performance-based approach usually combines two instruments:

i) Minimum conditions, which typically link local governments' compliance with basic requirements (as defined by laws and official regulations) to their access to grants

ii) Performance measures, which are applied to provide additional 'top up' grant allocations to the extent that local governments have met broader policy goals (such as poverty reduction).

The documents argues that the capital development grants and technical support provided by UNCDF programs have, in many cases, provided an entry point for developing such performance-based approaches to fiscal transfers.

The document mentions as examples of this approach:

- In **Mali**, minimum conditions were tested for access to annual block grants from the Local Development Fund, and performance assessments take place within two broad categories, with the possibility of obtaining an additional block grant allocation (French only).
- The Anseba Local Development Fund in **Eritrea** contained a set of minimum conditions introduced and applied progressively in years 1 and 2 of the pilot program. Performance criteria are applied to reward good technical performance and pro-poor outcomes.
- Local government access to the District Development Fund in **Uganda** was conditional upon compliance with a set of minimum conditions and the country now has one of the most sophisticated systems for performance-based allocations, allowing annual grants to vary +/- 20 percent.
- In **Ethiopia**, the access of the *woredas* to capital funding is based on satisfactory compliance with a number of minimum conditions.
- In **Nepal**, and based on experience in Uganda and elsewhere, the Government and UNDP/UNCDF are currently piloting a model of minimum conditions and performance criteria through the Decentralized Financing and Development Program.
- In Bangladesh, the Government and UNDP/UNCDF have been piloting a mechanism whereby *union parishads* receive block grants for the first time, subject to their meeting basic standards of management and

governance. This approach is now being replicated by on a wider scale by the Government.

UNDP/UNCDF Support to Decentralization Program (SDP)

Bangladesh: Two innovations being piloted are participatory local government planning and budgeting, and performance-based block grant funding of Union Councils, providing incentives for local institutional change and accountability. The Government has now endorsed this approach, and has requested support to expand it nationally.

Uganda: The 'District Development Program' (DDP) has focused on helping Government implement its ambitious decentralization policy by introducing the local planning, management and performance-linked financing procedures that are now part of official policy.

Case description: Uganda (2005/06), Minimum Conditions for Access to Development Grant Three years rolled development plan

- Functional district technical planning committee
- Linkage between the development plan, budget and the budget framework paper
- Draft final accounts for previous FY produced
- Internal audit function in place
- Revenue performance improvement plan
- Three year CB plan in place and approved by council
- Co-financing for previous year + budget for new + up-front for the first quarter (10 %)
- Significant impact on key performance areas such as planning and financial management
- Improved legal compliance
- Identified weaknesses and areas in need of capacity building
- Publication of results have created healthy competition and discussions on ways and means to improve performance
- Dialogue tool between CG –LGs, LGs and citizens
- LGDP -funds have been used for service delivery: Grants can be non-sectoral with higher level of LG autonomy if the incentives are right
- Can reinforce the decentralization objectives and help orient LGs towards
- efficient service delivery and better accountability

Issues Remaining:The need for better coordination and common agreement on the purpose or objectives, indicators and collection and application methods.

- How to establish proper linkages between national statistics, local statistics, performance-based grant systems and other reviews

Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style
Hehui Jin, et al.
1999

In this paper, the authors show that by allowing local governments to keep a large fraction of the taxes collected locally, serves as a fiscal incentive to develop local economy and tax effort.

The authors argue that providing government with the incentive to promote markets is especially important for developing economies or those in transition from central planning. The authors argue that in these countries, governments have often been the central barriers to economic development.

It is argued that reforming government is a crucial component of both the transition from a planned to a market economy and economic development. The authors argue that the creation of working markets in these economies typically requires transforming a highly centralized and economically interventionist government into one that complements the market and fosters decentralized economic activities.

It is mentioned that federalism can provide governments with better incentives to support market development and economic prosperity. They mention that by devolving authority from the central to local levels, federalism places limits on the interventionist role of the central government. The authors highlight two mechanisms that help align local government's interests with economic prosperity. First, they argue that interjurisdictional competition implies that heavily interventionist local governments may lose valuable factors of production to less interventionist jurisdictions. Second, they argue that strong links between local revenues and expenditures imply that local government officials may have strong fiscal incentives for fostering a prosperous local economy.

They argue that China's fiscal contracting system provides local governments with strong (marginal) fiscal incentives and at the same time improves horizontal distribution across provinces in budgetary spending. They find that stronger fiscal incentives — measured in terms of higher marginal revenue retention rate — implies faster development of non-state enterprises and more reform in state-owned enterprises. It is argued that governments face strong fiscal incentives to pursue local prosperity, as their local expenditures are made closely linked to the revenues they generate.

They finalize the paper by comparing federalism, Chinese style (China's transition to markets has long been associated with the devolution of authority from the central to local governments Montinola, Qian, and Weingast, 1995; Chang and Wang, 1998; Xu and Zhuang, 1998), with federalism, Russian style. They mention that Zhuravskaya (1998) found that the existing revenue sharing schemes between the Russian regional and local governments provided the latter with no fiscal incentives to increase their tax base: increases in local government revenues were almost entirely exacted by the regional

government. They argue that this leads to the predatory behavior of government toward private businesses.

They also point out that Russia has done more than China in terms of privatization of state-owned enterprises and liberalization of markets. Notwithstanding, it has failed –the authors claim— to provide local governments with good incentives to pursue local prosperity. The authors suggest the critical importance of government incentives for successful economic reform. The authors highlight the importance of incentives by mentioning that liberalization and privatization without changing government incentives are insufficient to produce meaningful economic reform.

Introduction to the Principles for Design of Intergovernmental Fiscal Transfer Systems - an international comparison of allocation criteria
Jesper Steffensen
2005

The author argues that there are no clear theoretical economic reasons for inclusion of LG tax effort in the transfer schemes (the author mentions that in some of the literature on grants the usefulness of the tax effort as criteria is disputed, cf. e.g. Richard M. Bird and Michael Smart: "Intergovernmental Fiscal Transfers: Some Lessons from International Experience, University of Toronto, January 2001 and Anwar Shah: "The Reform of Intergovernmental Fiscal Relations in Developing Countries and Emerging Market Economies, The World Bank, l994. It should only be used with caution and under certain conditions). Nevertheless there may be various political and administrative reasons, founded in the way the LG political system functions in a specific country context and the LG politicians' incentive system. Therefore, fiscal effort may be included as one of the criteria in the allocation system in order to encourage LGs to exploit their tax potential.

The author mentions that this may generally only be appropriate under certain strict conditions and assumptions among which the most important are:

a) The basic data on the LG revenue statistics is available (preferably data detailing the LG utilization of their tax potential) or at least good statistics on the development in revenues over the years
b) A clear knowledge that all LGs have a great non-utilized tax potential
c) A strong political wish to "boost" LG taxation in cases where the level (public sector) may generally be sub-optimal and provide a sub-optimal level of LG services
d) Where there is a lack of strong local accountability, i.e. certain country specific conditions deriving from the features of the relationship between the politicians and the constituencies and a clear indication that the transfer systems create problems with the tax incentives.

The author mentions the Ugandan Local Government Development Program as one of the good examples of this performance-based system. In this example, good performance within areas such as planning, budgeting, accounting, accountability and transparency is rewarded and poor performance sanctioned through adjustment of the size of the capital grants.

The author also mentions that in Tanzania similar systems are being rolled out and other countries are currently developing the criteria. It is mentioned that typically these criteria are based on certain minimum access criteria such as the existence of development plans, approved budgets and accounts and compliance with certain functional capacity requirements and more qualitative performance measures, which are put in place to reward good performance and sanctions poor performance.

The author points out that lessons from these initiatives show that it is important to:

- Develop the Minimum Conditions (MC) and Performance Measures (PM) in full cooperation with the LGs – both the technical and political level of the authorities to ensure full understanding and support to the selection
- Keep the MC and PM simple to understand, transparent, realistic and achievable
- Ensure that the areas reflected can be influenced by LGs (endogenous factors), i.e. not dependant on exogenous factors, like legal changes, draught, etc.
- Ensure that the MCs and PMs are closely related to the legal framework and supports the compliance
- Ensure an appropriate link between the various indicators, avoid overlaps and contradictions
- Technically possible to apply (i.e. objective, measurable and information is available)
- Politically durable – endorsed by councilors as fair and credible to be applied
- Easy to interpret in a standardized manner
- Ensure that the system is well known to the citizens and ensure that the system facilitates dialogue and accountability
- Ensure that the LGs are supported to improve on the MCs and PMs, particularly through a strong capacity building support from the central government.
- Neutral, independent and fair assessment of the performance

The author also mentions that the management of these indicators and the assessment of the performance is a great challenge and good organization, information dissemination, feed back and quality assurance is critical for the success of the system. It is also pointed out that LGs should be well aware about the criteria and perceive the system as credible and fair. Systems based on performance criteria have typically been introduced on a project specific basis, related to generic performance and targeted to development grants, but some countries have rolled the systems out to cover the entire country, and others are planning to do so. The author mentions among the forerunners Uganda, which is considering to extend the principles to other national grants and to allow the LGs, which have proved to have better performance within key defined areas, more autonomy over the allocated sources, and within certain grant schemes, a higher per capita allocation.

From Social Funds to Local Governance and Social Inclusion Programs
May 2007
World Bank Report

In this document, performance based grants are proposed as complements of social funds as tools for development fostering in Eastern European and Central Asian (ECA) countries.

In the document it is stated that for the future, there are really only two overarching and distinct policy objectives that social funds in ECA may pursue:

i. improving local governance and infrastructure provision
ii. addressing vulnerability and social inclusion.

Piloting performance-based grants to complement the fiscal transfer system is identified as an entry point in order to reach the above-mentioned objectives. Whether this would be appropriate or not would depend on the country's context.

It is mentioned that creating a separate financing and programming facility as a social fund can serve to pilot a Performance-Based Grant System (PG).

It is stated that unlike grants where funds are distributed to LGs simply to give them the means to execute specific functional mandates, PGs create incentives for improvements in performance by linking the LGs' performance in pre-determined areas with the access to and the size of funding. LGs can access the allocation only after fulfilling certain minimum conditions.

Most systems operate with performance measures, which are used to adjust the grants up and downwards based on performance.

It is suggested that once the pilot is successful, scaling them up should be done through the intergovernmental fiscal system, and staff absorbed by the agency responsible for managing performance assessments and the capacity development component.

Piloting a PG through a social fund makes sense in contexts of weak public sector governance systems (where the fiscal transfer system does not inspire much confidence) and/or where government is ambivalent about decentralized development and needs proof.

It is recommended that in countries that have stronger governance systems and that are engaged in decentralization, the pilot should be mainstreamed from the start through the treasury system.

CONGRESS OF THE UNITED STATES
JOINT ECONOMIC COMMITTEE
PRESS RELEASE

This press release refers to the "Saxton report" that stated that the World Bank should move toward providing international development aid in the form of performance-based grants instead of loans (by Joint Economic Committee (JEC) Chairman Jim Saxton). It is stated that the analysis, "Grants: A Better Way To Deliver Aid", shows that performance-based grants, "would cost the same as traditional loans, but would deliver more benefits to the global poor."

"This analysis demonstrates how World Bank grants would offer the best approach to improving living standards and reducing poverty in the world's poorest nations," Saxton is quoted saying. "The traditional World Bank/IMF approach of saddling poor countries with loans they often cannot repay has failed. Moreover, the high failure rate of World Bank projects reflects a terrible waste of resources that could have been used to alleviate poverty."

Saxton's argument is that the same amount of aid can be provided through grants as through loans at the same economic cost. The difference is that the grants will be much more effective in attaining results without leaving heavy debt burdens.

Fiscal responsibility legislation at the state-level in India: what has been achieved to date, what are the challenges?

Stephen Howes
World Bank

The author discusses the transition from fiscal responsibility act (FRA) policies to a fiscal incentive system by the gradual introduction of "minimum standards" in the fiscal responsibility requirements.

The author proposes greater use of FRA potential:

- for fiscal prudence
- for better public expenditure quality

The author concludes that transitioning from FRA policies to fiscal incentives system in India is still premature. Among the difficulties the authors points out:

- Lack of political will.
- Lack of teeth in most FRA legislation
- Targets of Revenue & Fiscal deficits unrealistic.
- Incentives from Government of India to undertake fiscal reforms in the States not attractive.