UNCDF
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PERFORMANCE-BASED GRANT SYSTEMS

CONCEPT AND INTERNATIONAL EXPERIENCE

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Contents

Foreword

Implementing the environmental, social and economic policies necessary to achieve the Millennium Development Goals implies considerable financial resources. It also raises the complex question of how the resources can be deployed to greatest effect. Too often resources come pre-labeled or pre-packaged. A 'thematic' problem is identified and measures are designed – and resources assigned – to deal with it. This can be the case for health, education, agriculture, sanitation or a wide range of single issues.

Yet, it is at the local level – where people live – that the challenges of development are most keenly felt. Development challenges are by nature complex and interrelated. They can rarely be resolved through the mandate of one central agency or through tight central control. They require holistic responses, by the people closest to them, people at the local level. UNCDF local development programmes encourage local government systems to deliver such responses. Can they do so consistently? What measures can be taken to ensure that local capital is deployed for the most effective development purposes?

In this context, in recent years, a number of innovative reforms with performance-based grant systems have been applied in various Least Developed Countries to create incentives for enhanced Local Government capacity and performance. They have acted as important tools for improved links between Central and Local Governments on the one hand and for closer engagement between local governments and citizens on the other hand.

UNCDF, the UN's capital investment agency for the world's least developed countries, through its support to the introduction of performance-based grants in many countries since the early 1990s, has been at the forefront of the development of innovative practices within the areas of intergovernmental fiscal transfers and the capacity development of local governments. These innovations have helped to ensure that, as local financing increases, local government capacity to deliver the goods is also enhanced.

This publication shares the experiences of UNCDF and others in designing and implementing performance-based grants. The piloting of performance-based grant systems demonstrates how local catalytic capital can be deployed to bring about real improvements in local development and poverty reduction by encouraging local governments to improve their capacity and focus on results.

"Performance-Based Grant Systems – Concept and International Experience" is the result of experiences from design and implementation of these new innovative grant systems by UNCDF, often in collaboration with the World Bank, the Asian Development Bank, other development partners and governments. It is the fruit of over a decade of experience and I trust it will prove useful to both governments and development practitioners engaged in the challenge of meeting the Millennium Development Goals.

David Morrison
UNCDF Executive Secretary

Acknowledgements

This UNCDF publication has been drafted by Jesper Steffensen, affiliate UNCDF Technical Adviser. It is aimed at central and local government practitioners, development agencies and institutions, consultants and researchers interested in intergovernmental fiscal transfers in general, and in performance-based grant systems in particular.

The author would like to express his gratitude for the assistance provided by several leading agencies, a variety of ministries and local governments, and the many consultants and researchers who have provided him with invaluable input and ideas during the preparation of this publication.

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The author would especially like to thank Mike Winter, who has edited the entire book and provided valuable contributions and insights on the basis of his own involvement in the design and implementation of grant systems in several countries.

The author would also like to thank the following people for invaluable input, feedback on and comments to earlier draft versions of the publication and/or support throughout the work on PBGSs in some of the countries where such systems have been applied: David Jackson, Jill Engen and Alexandra Walcher (UNCDF); Emmanuel Ssewankambo (Mentor Consult); Hans van Rijn (Asian Development Bank), Holger Pyndt (LGDK), Sharad Neupane and Henrik Larsen (UNDP); Lance Morrell (previously World Bank TTL, now consultant); Per Tidemand, Gerhard van't Land and Hans B. Olsen (Dege Consult); Yadab Chapagain (consultant); Adam Balale (LGFC in Uganda); Charles Magala (Danida); Kwame Owusu Bonsu (Decentralisation Secretariat, Ghana); William Amoah (consultant); Roy Kelly (Duke University); Roger Shotton and Bishnu Puri (previously UNCDF, now consultants); Martin O. Olaa, Roland White and Yongmei Zhou (World Bank), K.L. Devkota, specialist in the Ministry of Local Development, Nepal as well as UNCDF programme officers and project staff in a number of countries.

Executive Summary

Background

1. As Intergovernmental Fiscal Transfers (IGFTs) are one of the main sources of local government (LG) revenue in developing countries, often accounting for more than 60% of total LG revenues, it is of utmost importance for the success of the overall decentralisation process that such transfers achieve their objectives and provide the right incentives. The way the transfer systems are designed impacts the likely success of the overall system of local-government finance and decentralisation as a whole.
2. This publication is aimed at providing a detailed overview of, and evidence-based insights into, the design and implementation of Performance-Based Grant Systems (PBGSs) for LGs. PBGSs are intended to be integrated into national IGFT systems, providing LGs with tangible incentives to improve their institutional, organisational and functional performance, thereby reducing the risks associated with IGFTs and making decentralisation more effective, efficient and responsive as a strategy for delivering public goods and services. Among other agencies, UNCDF has been involved in piloting the use of performance-based grants. The experience gained from UNCDF-funded and -supported projects and programmes has generated significant lessons about the design and implementation of PBGSs in developing, low- and middle-income countries.

Overview

3. What is a PBGS? For the sake of conceptual clarity – but at the risk of over-simplification – the following textbox provides a summary of its main features.

Performance-Based Grants for LGs: a "Simplified" Synopsis

What does a "typical" PBGS look like? Although there are many variants, in essence a PBGS operates such that the extent to which LGs access transfers from central government is conditioned upon their overall performance.

In most PBGSs, LGs need to show that they have complied with basic or Minimum Conditions (MCs) in order to access their grants (or part of them). MCs, which are usually based on statutory provisions and are either complied with or not (there is no "half-way house"), are intended to measure the basic capacity of a given LG to perform its functions. Unless LGs can demonstrate this performance, they are unable to access all or part of their (most often, capital development) grants. However, when LGs are able to demonstrate compliance with MCs, which are designed to ensure a minimum capacity to handle grants, they become eligible to receive their grants. Many MCs are designed as basic safeguards to bring down fiduciary risks to an acceptable level.

Many PBGSs, however, go one step further – by either increasing or decreasing the size of basic LG grants in relation to the assessed performance of LGs. This performance is usually based on assessing pre-determined and agreed Performance Measures (PMs).

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Here, and in marked contrast to MCs, the measurement of performance is more nuanced and "qualitative" – LG performance (as measured through PMs) is *more or less* good/bad, whereas MCs are not relative but absolute (the LGs either do or do not "qualify" to receive all or part of their grants). PMs are assessed for all LGs, but assessment results impact only LGs that (by virtue of having demonstrated compliance with MCs) are eligible to receive grants, the size of which depends upon their performance across a range of measures.

What is vital to note here is that a PBGS is intended to operate as a set of incentives for improved LG performance. Good LG performance, whether "absolute" (as in the case of MCs) or "relative" (as in the case of PMs), is rewarded through eligibility for grants and/or through access to larger or smaller grants.

4. By linking the level of fiscal transfers to performance, a PBGS can provide incentives for LGs to improve themselves in a range of areas (such as revenue collection, planning, budget execution, downward/upward/horizontal accountability, financial management, and good governance in general). Given the "right" arrangements and context, the calibration of IGFTs to LG performance can give LG capacity-building more meaning and greater purpose, encourage LGs to do better all round, and significantly reduce the fiduciary and other risks associated with fiscal decentralisation. However, as this publication argues, getting things "right" (and avoiding some major pitfalls) is indispensable in making the most of the potential offered by PBGSs and the incentives that they provide for improvements in LG performance.
   PBGSs, as described and discussed in this publication, need to be distinguished from other types of LG performance measurement (such as credit-rating systems or performance budgeting), which can often be complementary but which operate in very different ways. It is also important to properly situate and contextualise PBGS precepts within the overall framework of intergovernmental grants. PBGSs can be distinguished from one another along two dimensions: i) the type of performance which they try to leverage – generic performance (such as overall LG financial management, governance, and the like) or sector output performance; and ii) the use of funds (discretionary as opposed to earmarked or conditional). PBGSs have most often been developed for multi-sector (or general purpose) block grants, the use of which is largely discretionary but generally directed at financing capital investments. In addition, PBGSs tend to focus on leveraging generic aspects of LG performance (such as planning, budgeting, public financial management (PFM), governance, etc.), where improvements to such "processes" can impact on a broad spectrum of end-outputs or outcomes. Nonetheless, PBGS principles can be applied to more sector-specific grants – which may focus on such generic performance areas and/or more sector-specific dimensions to performance (such as sector-specific deliverables).

5. PBGSs typically consist of several inter-related and mutually reinforcing elements, *inter alia*:

   - The capital grant scheme itself, which usually covers multi-purpose and largely discretionary grants. Transfers need to be of a size such that gaining access to them (or part of them, or increases/decreases in them) operates as a significant incentive for LGs to meet conditions that determine their access to the grants (or variations in the size of grants);

- A performance-assessment process, which most commonly relies on the use of indicators that measure general, institutional or functional performance, and which are measured on a regular annual basis. PBGSs usually rely on two types of indicators: (i) Minimum Conditions (MCs), which are categorical ("yes/no" triggers), and which need to be complied with in order to gain access to basic grants; and (ii) Performance Measures (PMs), which are more "qualitative" and "calibrated" than MCs, and which allow LG performance to be assessed in a scaled manner, resulting in increases or decreases in the size of any grants allocated to LGs. Getting the indicators "right" is fundamental here, so as to ensure that LGs are being assessed against actions or failures for which they are genuinely responsible and to ensure that the indicators are targeting intended performance areas in a balanced manner. And, perhaps as importantly, the process whereby indicators are assessed/measured needs to be robust, technically sound, credible, transparent and politically neutral;
- LG capacity building (CB), which is usually a combination of: (i) supply-driven and mandatory activities; and (ii) demand-driven, more discretionary activities (tailored to the needs of individual LGs). Demand-driven CB is increasingly ensured through the provision of CB grants to all LGs (irrespective of their compliance with MCs). The CB component of a PBGS is important because it enables LGs to respond to weaknesses identified in the regular performance assessments. It also enables non-compliant LGs to obtain the CB services they need to improve their performance and thus access basic grants or receive larger grants. Moreover, the PBGS approach also provides concrete incentives for LGs to utilise CB support more efficiently.

International Experience

6. Although the use of incentives in IGFT frameworks is not new, their systematic inclusion as an integral part of the grant allocation process (as is the case with PBGSs) is relatively recent. Uganda was an early innovator, and (with UNCDF support and technical backstopping) began piloting its PBGS in the mid/late 1990s in four districts with a gradual expansion in the number of LGs covered. By 2003, Uganda's PBGS had been scaled up to a nationwide basis, covering all of the LGs in the country. Other countries have since followed suit. Today (2009), at least 15 countries are using a PBGS approach, either on a pilot basis or nationwide, and several other countries are planning similar approaches. There is now considerable on-the-ground international experience with PBGSs, providing many evidence-based lessons about how such systems function, what their impact has been, and the conditions under which they seem to work optimally.

General Patterns and Common Issues

7. Looking at 15 developing and middle-income countries in which various PBGS approaches have been used, a number of patterns and issues emerge, *inter alia*:

    - Although a few countries have tried (or are in the process of trying) PBGSs that apply to specific sectors and earmarked grants, the majority have applied PBGS principles to multi-purpose capital (or "developmental") grants, and mostly relied upon generic indicators (e.g. planning, financial management, fiscal effort, transparency, etc.), rather than output-based indicators of service delivery, to assess local government performance;

- The grants to which PBGSs apply have been of varying size, but have usually been relatively modest (averaging around USD 1–4 per capita per year). Nonetheless, the size of the grants appears to have been sufficient to generate adequate incentives;
- All countries have included a capacity-building component in their PBGS, with a tendency over time to move toward the allocation of CB grants to LGs and more demand-driven CB approaches;
- The use of Minimum Conditions (MCs) has been near-universal, thus providing LGs with incentives to demonstrate compliance with indicators that point toward a basic level of absorptive capacity. This, in turn, implies that basic fiduciary and other safeguards are in place before grants are made available to LGs. In almost all cases, MCs have been derived from statutory requirements for LGs;
- A majority of the countries included in the survey use Performance Measures (PMs) to assess qualitative differences in performance – with individual LG scores resulting in alterations to their grant allocations. LG performance against PMs is usually measured through a "balanced" scoring system (which encourages better performance across the board, rather than just in specific areas), with a few countries measuring individual LG performance relative to that of other LGs. PMs have tended to focus on planning and public financial-management processes, improvements in LG accountability and transparency;
- Most PBGSs have been progressively refined over time, with more MC/PM indicators being introduced and with modifications to budgetary "consequences" taking place (in some countries) to ensure that LGs access minimum levels of funding regardless of their performance, but ideally accompanied by more intensive mentoring and supervision;
- Although most countries use fairly robust and relatively intensive performance-assessment processes (detailed assessment manuals, outsourced assessment teams, training of assessors, etc.), some have sought to "internalise" the process by making assessments into "in-house" functions (with the risk of forgoing impartiality);
- Over time, there has been a tendency for governments to tie their own budgetary allocations to PBGS procedures and for the share of development-partner (DP) funding to decrease – signifying an important degree of national buy-in;
- In several countries, PBGSs (precisely because of the safeguards that they establish) have helped encourage donors to opt for direct budgetary support and sector-wide approaches (SWAps) as a way of financing decentralised service delivery.

Lessons Learned: Achievements and Benefits

8. Although many PBGSs have been in place for only a few years, there is considerable evidence that the incentives they provide have resulted in genuine improvements in LG performance, especially in core administrative and financial areas. Major areas in which LG performance has improved include:

    - Core administrative functioning (meeting culture, keeping of records, etc.) and compliance with basic statutory requirements, both of which are invariably used as indicators for MCs;
    - Public financial management by LGs appears to have improved sharply following the introduction of PBGSs, which use indicators such as quality of the planning process, compliance with procurement regulations, timely accounting, audit processes, outcomes and responses, etc. to measure LG performance;

- Where improvements in fiscal effort and increased local financial contributions have been included as indicators of LG performance, there is evidence (in some countries) that LG own-source revenues have increased – although this has sometimes been undermined by inconsistent changes in the revenues assigned to LGs;
- LG transparency and accountability (both of which are invariably measured – through a variety of indicators – by MCs and PMs) also seem to have improved in many cases, enhancing interface between LGs and citizens, informing dialogue, and improving downward accountability. Horizontal accountability (between local civil servants and elected officials) also appears to have improved as a result of the introduction of PBGSs, which provide elected officials with a good indication of how well (or badly) LG employees have been performing. Finally, upward accountability has been strengthened through PBGS, which provide incentives for LGs to comply with national laws and regulations, to report on a more timely basis, etc., and which provide opportunities for greater dialogue between the central and local levels;
- Incentives established by PBGSs have also led to improvements in the way that LGs handle cross-cutting issues such as gender, social inclusion, poverty targeting and the environment. Such issues have often been embedded in the performance indicators used by PBGSs – and have thus contributed to greater sensitivity toward them by LGs;
- PBGSs, by design, can be powerful tools for making capacity-building (CB) more effective and efficient. Firstly, performance assessments help in identifying the areas within which LG performance is weak, thus enabling CB activities to be better targeted. Secondly, the linkages between performance and grants that are an integral part of any PBGS provide real incentives for LG officials to apply their acquired skills and knowledge – and thus improve performance. Finally, and when combined with CB grants, the PBGS approach provides LGs with the resources to procure CB services and facilities on a demand-driven basis – which enables each LG to meet its specific (rather then generic) needs;
- There is considerable evidence to the effect that PBGSs facilitate greater coordination between and among development partners – the safeguards associated with PBGSs allow DPs to more easily enter into basket-funding arrangements, which may evolve into genuine "sector" budget support for decentralisation (using SWAps). In addition, PBGSs often provide an entry point for wider decentralisation reform processes;
- Although it is early days yet, there are indications that the use of a PBGS usually leads to positive infrastructure and service-delivery outputs – in terms of allocative efficiencies, better implementation, cost efficiency and sustainability. Underlying these outcomes are two key factors – the extent to which a PBGS (through the safeguards that it ensures) encourages Central Government and DPs to provide discretionary grants to LGs (thereby fostering local-level prioritisation and greater allocative efficiencies) and the incentives provided for improved planning, budgeting & costing, design, contracting, project implementation & supervision, and operations & maintenance.
- Despite the evidence for these achievements and benefits, it remains important to bear in mind that most PBGSs are still in the early stages of implementation – and that many other factors may also be at play.

Lessons Learned: Challenges and Limitations

9. **Experience has shown that there are a number of challenges for and limitations to performance-based funding systems for LGs, *inter alia:***

   - Because of their tendency to focus on "process" and "intermediate output" indicators, PBGSs cannot directly measure service-delivery outcomes (such as poverty reduction); to do so would require considerably more sophisticated and costly assessment methods. Moreover, measuring outcomes is highly problematic given attributional problems. In addition, measuring the outcomes of local service delivery may also be antithetical to the discretionary nature of multi-sector block grants by "steering" local decisions in certain directions, rather than leaving priority setting to locally accountable institutions. Finally, value-for-money audits and other reviews have shown a clear link between improvements in LG processes (PFM, governance etc.) and service delivery;
   - A range of external factors can also dilute the impact of PBGSs and impede their implementation. Such factors include severe conflict, very weak "horizontal" controls over LG staff, poorly defined expenditure assignments (which blur LG accountabilities), inappropriate or inadequate revenue assignments (which constrain LG resource mobilisation), significant levels of parallel funds which are not tied to performance (thus reducing the leverage exerted by PBGS-modulated grants), delays in disbursements and disjuncts with the annual budgeting cycle, and so on. An overwhelming focus on the technical aspects related to PBGS design runs the risk of overlooking such fundamental challenges and reform issues;
   - Implementation of PBGS-type arrangements in some countries has also run into difficulties associated with weak management capacities at the central level, resulting in delays and uncertainties. Although this is by no means unique to PBGS-type reforms, it is particularly challenging for them as they often require more robust institutional and support arrangements than do other, simpler, grant systems;
   - A major challenge faced in some countries has been the lack of political will to implement the consequences of poor LG performance – which usually take the form of funds being withheld or cut back. Political pressures from LGs often weaken the resolve of central-level officials or politicians to follow through with sanctions or funding reductions – and this can seriously compromise the integrity of the system. While measures can be taken to make politically tough decisions more palatable, ultimately central government needs to discipline itself here.
   - Designing the assessment methodology (indicators, scoring system) requires careful thought so as to avoid a variety of pitfalls and inconsistencies. Selecting the wrong indicators, for example, can be unfair (when they measure actions beyond the control of LGs) or led to perverse outcomes (when they encourage LGs to focus on certain things but not others);
   - Ensuring that the assessment process and its results are of high quality is also a challenge common to PBGSs. The process needs to be seen (by all stakeholders) as credible and impartial if the PBGS incentive structure is to function properly. Establishing adequate quality-assurance systems is of great importance here;
   - Finally, and perhaps most importantly, the PBGS approach – in isolation – should not be seen as a panacea for all the problems associated with decentralisation. The overall policy environment, confusing or contradictory institutional arrangements, civil-service constraints and other such factors can make it very difficult for a PBGS to achieve the desired results. This highlights the need to keep sight of the wider picture in designing PBGSs for LGs.

Conclusions and Recommendations

Conclusions

10. There are plenty of reasons to argue that PBGSs can and do have a positive impact on LG performance and thus on decentralised infrastructure and service delivery. Over a relatively short space of time and in several countries, the implementation of PBGS approaches has produced tangible and positive results, *inter alia*: i) better LG compliance with legal and statutory requirements; ii) improved planning and public financial management at the local level; iii) greater attention to, and improved performance in, cross-cutting areas such as gender mainstreaming, environmental management, good governance and transparency; iv) more-focused LG capacity building; and v) consistent use of capital grants to finance investments in core poverty-alleviation areas. There is also encouraging evidence that PBGSs impact positively on areas such as the cost efficiency of service delivery and targeting of poverty alleviation.

11. Although the PBGS approach is not the only way to promote improvements in LG performance, it should seen as an innovative and encouraging move away from systems of central government ex-ante, micro-management to a more targeted, ex-post, and results-based framework. By moving away from systems characterised by tightly earmarked sector grants and toward systems based on relatively discretionary cross-sectoral grants, PBGSs foster local autonomy. On condition that such flexibility is accompanied by sound and unambiguous guidance, clear requirements, capacity building and other support, PBGSs can help central governments move away from heavy-handed and transaction-costly ex-ante oversight. Experience has shown that if the right incentives are provided to LGs, sector-wise control and earmarking of funds can be relaxed without compromising national targets and priorities, while at the same time fostering good local governance. Hence, the PBGS approach can enhance local discretion while strengthening downward, upward and horizontal accountability.

12. International experience has also shown that PBGSs are valuable and innovative elements in overall reforms of intergovernmental fiscal relations, and that they can impact positively on the overall reform agenda in many countries.

13. However, it is important to note that the PBGS approach is not a panacea – and that PBGS reforms need to be complemented and coordinated with other measures, such as HR and payroll reforms, as well as legal, fiscal and institutional reforms. PBGSs are not equally effective in all environments or circumstances, and are most useful and effective when the following **pre-requisites**, among others, are in place:

    - strong policy support for performance incentives and the political will to cope with pressure from LGs that perform poorly;
    - based on solid analytical work, documentation of strengths and weaknesses of previous approaches;
    - the PBGS is robustly and carefully designed (see below) with significant involvement and buy-in from key stakeholders – core ministries, development partners, LGs, etc.;
    - the overall LG framework is conducive to a PBGS approach, particularly in terms of HR management (LG staff are at least partly accountable to local political bodies, or there is some means of encouraging LG officials to pay attention to the assessment results), LG finance arrangements, the legal framework and the overall coordination

of decentralisation. LGs must have a certain level of autonomy to improve their performance;
- capacity-building arrangements are appropriate, linked to performance assessments, and allow for a sensible mix of supply- and demand-driven approaches;
- PBGS operations, measures and outcomes are highly transparent and publicly disclosed, particularly with respect to the results of regular LG performance assessments;
- the support provided to LGs – both fiscal and non-fiscal – by government and DPs is stable, timely, long-term, predictable and well-coordinated.

14. Needless to say, the "perfect" environment for a PBGS is far from the norm – and it is important to note that the actual implementation of PBGSs can itself help establish the "right" context.

Recommendations

15. Beyond those prerequisites (many of which are "external"), there is a need to adhere to a variety of fundamental principles and considerations in the design and implementation of any PBGS. Although there are many challenges to face and potential pitfalls to avoid in designing and implementing PBGSs, experience to date provides the basis for a series of key recommendations. These are summarised below.

Recommendations for the design of PBGSs:

- Invest sufficient resources and time in proper design, as PBGSs are technically demanding;
- Ensure effective linkages between the PBGS and other dimensions to the overall decentralisation process (the IGFT system, public-sector reforms, particularly in the field of human-resource development and management);
- Ensure – from the outset – that all stakeholders understand the potential benefits, but also the challenges, associated with implementing a PBGS approach;
- If pilots are being tested, these should be realistically and strategically designed so as to optimise opportunities for subsequent roll-out;
- Ensure that the indicators used in a PBGS are appropriate, measure performance that can be genuinely attributed to LGs, focus on key LG performance areas *and* PBGS objectives, and – as far as possible – are derived from statutory and regulatory frameworks;
- Start with a relatively simple system, focusing on critical and core LG performance areas (PFM, governance, planning, etc.), which can be adjusted, refined and expanded in the light of experience;
- Ensure that all guidelines and procedures (for assessments, for grants, etc.) are clear, coherent, user-friendly and widely disseminated;
- Establish a robust, neutral, transparent, predictable, fair and highly professional/credible performance-assessment process that is aligned with the LG planning and budgeting cycle and subject to external quality assurance;
- Ensure (and, if need be, establish) effective coordinating bodies to endorse assessment outcomes and oversee implementation of the system;
- Integrate into PBGS design a clear strategy for CB support, which combines supply/demand-driven approaches and ensures high-quality CB services;

- Given the innovative nature of the approach, establish sound Monitoring & Evaluation (M&E) systems to track their results and outcomes, and to thus provide the basis upon which to adapt, adjust and fine-tune the processes, procedures and methods associated with PBGSs.

Recommendations for PBGS implementation:

- Seek to minimise exemptions and deviations from the general "rules of the game," as these tend to establish precedents and compromise the integrity of the entire system;
- Ensure transparency and extensive communication in all phases of PBGS implementation (e.g. public disclosure of assessment results);
- Provide well-coordinated, effective and continued technical and CB support to core agencies responsible for PBGS implementation;
- Ensure that the PBGS is institutionally well-anchored in central policy-making bodies;
- Ensure a gradual expansion of multi-sectoral grants (vis-à-vis sector grants) as LG capacities grow. The challenge experienced by many countries is to increase LG discretionary powers (thereby optimising decentralisation outcomes) either by expanding the size of multi-sectoral grants or by linking them to sector grants;
- Regularly review and follow up on implementation arrangements;
- Follow up and use M&E information, address complaints and regularly adjust the system in transparent ways and in consultation with all stakeholders.

Overall, it is important to note that PBGS implementation is (and should be) an iterative exercise in itself. Governments and their development partners must continuously monitor activities and impacts, learn from experience and – in the light of lessons learned and experience gained – review and adjust PBGSs and related processes and procedures (assessment methods and approaches, performance indicators, incentive frameworks, IGFTS, and the like).

Abbreviations & Acronyms

ADB: Asian Development Bank
Bn: Billion
BRGF: Backward Regions Grant Fund
CB: Capacity Building
CBG: Capacity Building Grant
CG: Conditional Grant
CG: Central Government
CO: Community Organisation
CSO: Civil Society Organisation
DACF: District Assemblies' Common Fund
DDC: District Development Committee
DDF: District Development Fund/Facility
DDP: District Development Project
DFDP: Decentralized Financing and Development Programme
DP: Development Partner
DTCO: District Treasury Controller Office
EBG: Expanded Block Grant
ETC-EA: ETC-East Africa
FCGO: Financial Comptroller General Office
FY: Fiscal Year
GoK: Government of Kenya
GoG: Government of Ghana
GoN: Government of Nepal
GoT: Government of Tanzania
GoU: Government of Uganda
GBS: General Budget Support
GNHC: Gross National Happiness Commission
HLG: Higher Level Local Government
HR: Human Resources
IGFT: Inter-Governmental Fiscal Transfer
IGFTS: Inter-Governmental Fiscal Transfer System
LABSF: Local Authorities Budget Support Fund

LATF: Local Authority Transfer Fund

LDF: Local Development Fund

LB: Local Bodies

LBFC: Local Bodies Fiscal Commission (Nepal)

LG: Local Government

LGAs: Local Government Authorities

LGCDG: Local Government Capital Development Grant

LGCDP: Local Governance and Community Development Programme

LGDG: Local Government Development Grant

LGDK: Local Government Denmark

LGDP: Local Government Development Programme

LGFC: Local Government Finance Commission

LGPMS: Local Government Performance Measurement System

LGSIP: Local Government Sector Investment Plan

LGSP: Local Government Support Project

LGUs: Local Government Units = Local Governments

LIC: Learning & Innovation Component

HDI: Human Development Index

HR: Human Resource

IGFT: Intergovernmental Fiscal Transfers

IGFTS: Intergovernmental Fiscal Transfer System

MoU: Memorandum of Understanding

M&E: Monitoring and Evaluation

M: Million

MCs: Minimum Conditions

MRDP: Mindanao Rural Development Project

MTR: Mid-Term Review

NA: National Assessment

NAT: National Assessment Teams

NCG: Nordic Consulting Group

NGO: Non-Governmental Organisations

NRs: Nepali Rupees

OECD: Organisation for Economic Cooperation and Development

OED: Operations and Evaluation Department

OM: Operational Manual

O/M: Operations and Maintenance

PB: Performance-Based or Performance Budgeting

PBG: Performance-Based Grants

PBGS: Performance-Based Grant System

PBGSs: Performance-Based Grant Systems

PCDF: Provincial Capacity Development Fund

PDR: People's Democratic Republic

PEM: Public Expenditure Management

PFGCC: Provincial Fiscal Grant Coordination Committee

PFM: Public Financial Management

PG: Performance Grant

PGs: Performance Grants

PM: Performance Measure

PMs: Performance Measures

PMU: Project Management Unit

RGoB: Royal Government of Bhutan

RAA: Royal Audit Authority

RI: Rural Infrastructure

SLGDP Sirajganj Local Governance Development Project

SOI: Solomon Islands

SWAp: Sector Wide Approach

TA: Technical Assistance

TSH: Tanzanian Shilling

UG: Unconditional Grant

UGSH: Ugandan Shilling

UNCDF: United Nations Capital Development Fund

UNDP: United Nations Development Programme

UP: Union Parishad

USD: United States Dollar

VDC: Village Development Committee

WB: The World Bank

1. Introduction

While there is much international literature describing the general theory, principles and practices with respect to intergovernmental fiscal transfers (IGFTs), there is considerably less information and analytical work available on a more recent phenomenon – the trend toward establishment of performance-based grant systems (PBGSs) in a number of countries[1].

This publication attempts to address this knowledge gap. It introduces the concept of PBGSs, presents an overview of international experience and major lessons learned in the design and implementation of PBGSs, with a particular focus on 15 low- and middle-income countries, supplemented with a few examples from other countries, all seen from a practitioner's perspective. It is intended to be of use to people in governments who are considering developing or refining PBGSs and institutions/people providing support to these governments. The document outlines some of the key design issues and recommendations to be considered by governments contemplating the introduction, replication/roll-out and/or refinement of these systems. The publication does not, however, attempt to cover all IGFTs that have performance-based features, but focuses particularly on the more recent innovative approaches used in a number of low- and middle-income countries within the multi-sectoral grant systems, typically in the form of capital/development grant schemes.

The publication consists of six chapters and a number of annexes with detailed and specific country experiences and references. It is based on practical experience in the design and implementation of PBGSs, mid-term and final reviews, and interviews with numerous stakeholders from ministries, LGs, programme managers, consultants, development partners, NGOs/CSOs and other organisations.

Chapter 2 presents the background for the introduction of PBGSs, and the challenges these systems aim to address. It provides a detailed introduction to the concept, objectives, design principles and core components of such systems, the various types and standard modalities of PBGSs, and their linkages with other funding systems.

Chapter 3 provides an overview of international experience in the design and implementation of PBGSs, with a particular focus on Africa and Asia, where more than 15 countries are at various stages in applying, testing, replicating and refining PBGSs. Annex 2 provides further details on the 15 case studies included in this overview.

Chapter 4 provides a more in-depth analysis of the lessons learned from the various countries, analysis of cross-country lessons, as well as lessons learned about specific issues influenced by the country context. Although the potential benefits of introducing a PBGS are very high, there are risks and pitfalls that must be taken into account in design and implementation. Most countries, whether piloting or applying a PBGS country-wide, have experienced very positive outcomes. Various studies and evaluations have demonstrated that PBGSs can and do have a significant impact on core areas of LG performance. However, there is always room for improvement – and the many lessons learned over the past few years (as documented in this publication) may help guide the process whereby existing PBGSs are gradually refined to become more effective "second- and third-generation" schemes. Experience with PBGSs has also shown that there are risks associated with certain aspects of their design and

1 Exceptions being Steffensen & Fredborg Larsen (May 2005); Shotton & Winter, eds, (2006: 66–77); Shotton, ed (February 2004); UNCDF (2007): and Shah (2006, A); Broadway and Shah (2009), and by a forthcoming note on experience in OECD countries by Kai Kaiser, the World Bank: "Intergovernmental Performance Grants – A Synthesis and International Experiences for the 13th India IFC", Revised Draft 31st, 2009, amongst others.

implementation – and that these need to be factored into the crafting and introduction of new schemes and refinement of existing schemes.

Based on the experiences described and analysed in Chapter 4, *Chapter 5* briefly revisits and recapitulates the core issues that need to be addressed in the design of any PBGS.

Finally, *Chapter 6* outlines the major conclusions and recommendations concerning the design and implementation of PBGSs and provides practical, step-by-step guidance on their development.

2. PBGS – Background and Concept

2.1 Background

As IGFTs[2] are one of the main sources of local government (LG) revenue in developing countries, often accounting for more than 60% of total LG revenues[3], it is of utmost importance to the success of the overall decentralisation process that such transfers achieve their objectives and provide the right incentives. The way the transfer systems are designed impacts the likely success of the overall system of LG finance. Despite this, many projects and programmes aimed at promoting fiscal decentralisation have been introduced without sufficient attention to the *incentives* (or disincentives) they create with respect to dimensions such as local revenue mobilisation, administrative performance, accountability and governance[4].

There is growing evidence that large increases in grants, without sufficiently considering the incentives/disincentives they create, are likely create unforeseen problems in terms of LG performance and longer-term sustainability[5]. Governments and development partners have become increasingly aware that simply upping the level of LG funding – without ensuring that LG absorptive capacity is in place or that funds are spent with a degree of efficiency or effectiveness – may not solve the problems or address the challenges associated with local service delivery.

The literature on intergovernmental fiscal transfers is largely silent on this latter issue, and is often limited to mentioning that grants should not create "disincentives" for the mobilisation of local revenues or undermine sound financial management. There is also clear agreement that grants should not be designed to "bail out" poorly performing LGs, or be designed as deficit grants or promote inefficiency. But recent experience shows that there is scope to re-think the traditional grant theory. There is clearly a need to explore much more thoroughly how grant systems (through the incentives/disincentives they generate) impact LG performance and how they can be used more actively to strengthen and promote core LG functions and good governance. The question being asked here is simple: Why not turn the "do-no-harm approach" into something more pro-active and innovative?

Furthermore, there is increasing recognition that traditional, supply-driven CB support, often applied as part of an area-based approach (targeting specific and often only a few LGs), has serious flaws and has not achieved its objectives[6], often because it is unable to accommodate the needs of each LG and does not address issues related to incentives.

2 The terms "transfers" and "grants" are used interchangeably in this publication and are defined as transfers of fiscal resources from central to local governments.

3 See Shah (2006).

4 See e.g. OECD (2004); World Bank, OED (2005). Also refer to: Steffensen & Trollegaard (May 2000); Steffensen & Tidemand August (2004).

5 See Prud´Homme (2003: 24–26); Steffensen (2004); NCG/IDP (2008: Vol 1); and Shah (2006, B).

6 See World Bank, OED, (2005) and Land, Gerhard van't and Ssewankambo Emmanuel: "Programme Review Ireland Aid District Support in Uganda Decentralisation, Local Governments and Donor-coordination", June 2002 and ETC East Africa (Gerhard van't Land and Emmanuel Ssewankambo) in: "Ex-post Evaluation of Irish Aid to Kilosa District, Tanzania Lessons from a long-term partnership", December 2004 (unpublished).

LGs which have received intensive supply-driven CB support over many years have often proved unable to perform any better than LGs which have not received such support[7].

Finally, the issue of muted systems of accountability – downward (LGs vis-à-vis citizens), horizontal (internally in an LG) and upward (LGs vis-à-vis central government) – has not been sufficiently addressed by traditional intergovernmental fiscal arrangements.

A number of innovative reforms, based on lessons learned, have been introduced in some countries to address these challenges and issues. Reforms based on the use of PBGSs are amongst the most recent initiatives, and have been introduced to provide LGs with greater incentives to enhance their capacity and performance. They have acted as important tools for: (i) improved vertical links between Central Government (CG) and LGs; (ii) strengthened horizontal links between the political and administrative arms of local government; and (iii) promoted greater downward accountability between the LGs and their electoral constituencies[8].

2.2 Definition of a PBGS

The innovative feature behind the new PBGS approach is the way in which it creates linkages between the transfers from CG to LGs and the performance/capacity of the LGs to absorb and manage fiscal resources.

PBGSs vary in design from country to country, but the common defining characteristic is that they are aimed at promoting a positive change in some aspect of the performance of LGs receiving or seeking intergovernmental fiscal grants. PBGSs may also be used to identify the capacity building (CB)[9] gaps and needs of LGs and to provide input to the overall M&E and supervision systems.

Unlike grants where funds are distributed to LGs simply to give them the means to execute specific functional mandates, performance-based grants *incentivise improvements in performance by linking LGs´ performance in pre-determined areas with both access to and the amount of funding.* The system is a move away from tight ex ante (prior) control of LGs to a system with strong performance-based incentives, coupled with ex post monitoring and assessments[10].

7 E.g. in Uganda and Tanzania, when the PBGSs were introduced, prior assessments showed that some of the districts which had benefited from intensive capacity building funded through bilateral programmes performed no better (in core areas such as planning, budgeting and financial management) than districts that had not been provided with such support. As a specific example, Rakai District (Uganda), despite significant CB support from Danida over several years, did not perform better in the first national assessment of the MCs/PMs than other districts and – indeed – failed to comply with the Minimum Conditions for access to grants.

8 See: Shotton, ed. (1999: 68); Shotton & Winter, eds. (2006); and Pyndt & Steffensen, (July 2005).

9 Please note that this document refers to 'Capacity Building' following the practice in most literature on Performance-Based Grant Systems. However, the author fully subscribes to and endorses the shift in emphasis implied by 'Capacity Development', which is the terminology used within UNDP.

10 Another definition is provided in a recent publication by Broadway and Shah (2009: 314–316), which defines performance-oriented transfers as "output-based grants": "*Output-based transfers link grant finance with the service delivery performance. These transfers place conditions on the results to be achieved while providing full flexibility in the design of programs and associated spending levels to achieve these objectives*". This definition is rather narrower than that used in this book, which also focuses on improvements to systems and procedures (and not only outputs). In a forthcoming note from Shah (Shah, 2009), the definition is also broadened to "results-based intergovernmental finance".

2.3 Rationale and Objectives of PBGSs

Rationale

The overall rationale for a PBGS is that it provides **tangible incentives** for LGs to improve their performance by **linking their access to grants and/or the amounts disbursed to their performance** in pre-determined areas. It supplements other grant objectives and complements other incentive frameworks, e.g. salary and career incentives.

Specific Objectives

There are a number of specific objectives of a PBGS. Generally, a PBGS:

1. provides strong **incentives** for LGs (as corporate bodies) to improve in key **performance** areas and adhere to national standards (core objective);
2. ensures that spending takes place where there is a clear **absorptive capacity** – it provides basic safeguards against misuse of funds and reduces fiduciary risks to an acceptable level, which then often leads to a greater willingness to support LGs on the part of central governments or development partners. Given the safeguards provided by PBGSs, greater discretion can be devolved over the use of grants – which, in turn, may imply that local priorities are more likely to be addressed.
3. supplements **capacity-building (CB) needs assessments** and monitoring and evaluation systems. The PBGS assessment is a very useful tool for identifying the functional capacity gaps in any LG and an effective tool for linking the needs assessment with actual support;
4. improves **management** and **organisational learning,** as the initiatives will continuously be monitored and assessed. This is the case at the administrative as well as at the political levels;
5. strengthens **capacity-development** efforts (focus and incentives). With the PBGS, LGs have stronger incentives to use CB support efficiently, as their performance is linked to funding. CB initiatives are thus more targeted toward addressing identified weaknesses and more likely to be "translated" into actual practice. The PBGS is a CB mechanism in itself. Many LG staff may have the skills and knowledge to perform the mandated functions (if not, they will also be supported in this process), but may simply lack the proper attitude and behaviour to use them – and the PBGS approach provides such staff with incentives to do so.
6. improves **accountability (upward, downward and horizontal),** the transparent publication and dissemination of assessment results, and the use of indicators promoting good governance and participation; strengthen the relationship between tiers of governance and citizens; improves citizen access to information, enhancing accountability;
7. proves to be a very useful tool to bring funds from development partners (DPs) on-budget and promotes a greater level of **streamlining**, mainstreaming and coordination of DP support.

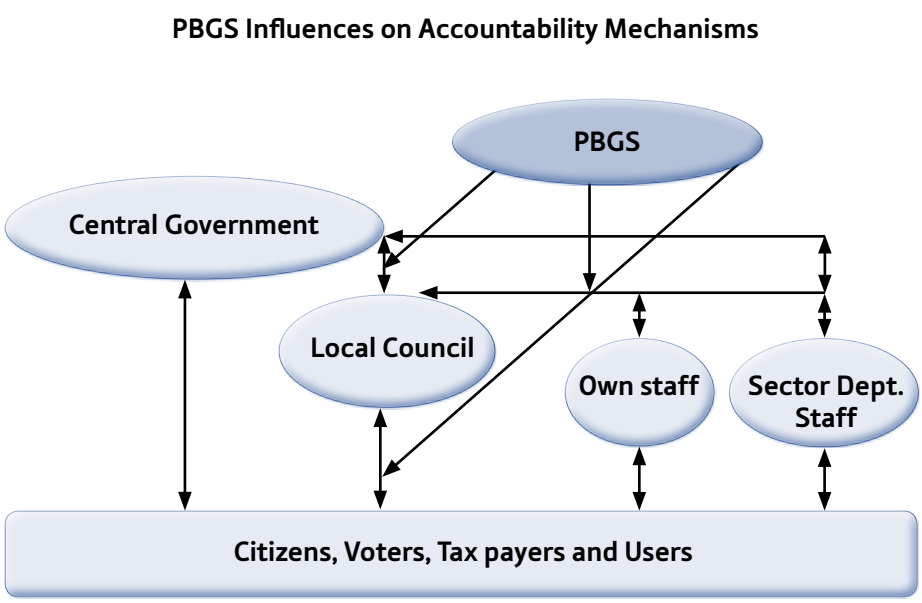
The PBGSs supplement other more traditional ways and means to ensure LG performance, such as rules and regulations, awareness-raising and communication, audit and inspection,

minimum standards and output control[11], agreements between central and LGs[12], and other core elements in the overall architecture of the intergovernmental fiscal transfer system. Annex 4 provides an overview of some of these instruments.

2.4 PBGS and the Overall LG Accountability Framework

As mentioned earlier, one objective of the PBGS is to strengthen LG accountability, which in many countries is very weak[13]. The figure below graphically summarises upward, downward and horizontal accountability relationships (signified by the arrows) :

Figure 1: PBGSs' Impact on Accountability



Source: Adjusted model from Shotton & Winter, eds (2006: 67). The figure shows the dual accountability of sector staff in many countries where not all staff at the local level are devolved to LGs, but report to both central and local government decision-makers.

LGs often do not comply with central-government prescriptions, legal requirements, regulations, guidance and minimum standards. Typically, central-government supervision, audit and follow-up measures are weak. Central governments often lack sufficient tools to ensure achievement of overall policy objectives and targets. They tend to issue a plethora of acts, regulations and guidelines on LG operations, but such measures commonly have limited impact on what happens on the ground[14]. Annex 4 provides an overview of the various instruments used to influence LG performance.

The same is often the case at the beneficiary level. Citizens frequently lack tools to monitor and influence LGs, and – given the relatively low proportion of LG revenues derived from

11 See Mochida in Shah, ed. (2006, C) for an overview of the challenges in using this tool in Japan.

12 Often used in the Nordic Countries, see Lotz, Jørgen in Shah, ed. (2006, B).

13 See e.g. Shotton and Winter, eds. (2006).

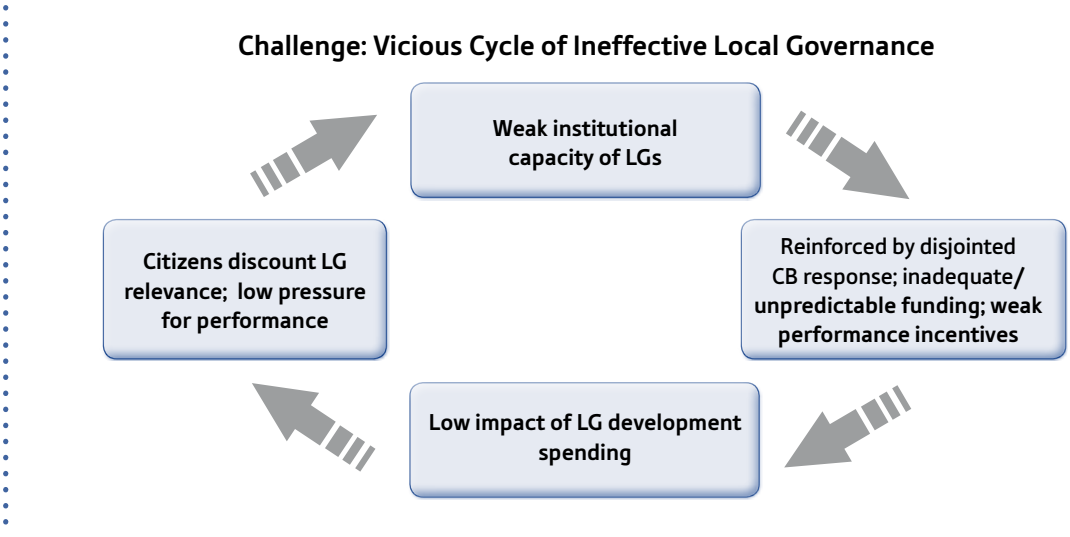
14 See e.g. Steven (2004). This paper explains some of the problems that occur when there is a lack of incentives for LGs to adhere to reform programmes and revised legal frameworks.

local taxes, fees and charges – have weak personal incentives to do this. In addition, local citizens often have limited access to decision-making processes and basic information needed to voice their concerns in meaningful ways. There are few tools with which citizens can compare the performance of their own LG with other LGs. Citizens are often not aware of the size of fiscal allocations from the centre, local plans, budgets, accounts and audit reports, and LGs, in turn, have few incentives to ensure that this information is publicly and regularly disclosed[15]. These are some of the reasons why citizens have limited incentives to engage with LGs. Even where civil-society or non-governmental organisations (CSOs/NGOs) are in place (to ensure checks and balances, advocacy, monitoring of performance and lobbying on behalf of local constituencies), these are often underdeveloped and weak. In addition, CSOs and NGOs sometimes prefer to be contracted as direct service providers on behalf of the LGs, which may compromise their "watch-dog" function.

Moreover, and with regard to the relationship of horizontal accountability between local politicians and local administrations, tools to measure the performance of the latter are frequently underdeveloped. Where they do exist, there have been relatively few incentives to apply and take them seriously, as funds will flow in any case without any adjustments[16]. In many cases, elected councillors are not aware of the absolute and comparative performance of local civil servants, and lack the necessary tools to measure this performance[17]. An additional problem in many countries is the dual subordination of the sector staff, who often report to both the local councils and to their parent line ministries in a system of dual sub-ordination with unclear responsibilities.

There has been a tendency for LGs to move into a so-called vicious circle of mistrust, perceived irrelevance and poor performance (see figure 2, below, which illustrates the "trap" that many LGs find themselves in).

Figure 2: Vicious Cycle of Ineffective Local Governance



Source: Adapted from Yongmei Zhou, the World Bank, presentations at the Kigali Workshop, 2007.

15 See e.g. Ahmad & Shantayanan, et al. (2005) for a detailed discussion of these problems and the various accountability links; Dege/NCG/ETC-EA/Mentor (February 2007); and Steffensen, Tidemand, et alia (2004).

16 Very comprehensive and costly M&E systems have been developed in many countries (e.g. Uganda, Tanzania and the Philippines) but it has been difficult to ensure that these are applied by the LGs and that information is made available to local politicians and citizens. In Denmark, the Ministry of Local Government had to legislate in order to ensure that LGs produced information on service standards and information on compliance with these standards and targets.

17 Shotton & Winter, eds. (2006: 68).

The argument that LGs have weak capacity may sometimes be correct, but this should not lead to the response shown in the figure above, leading to a negative spiral. Instead, steps must be taken to get out of the trap and even create a positive spiral through proper design of the IGFTS combined with a strong CB support system.

An appropriately designed PBGS can influence all three accountability systems at the same time, strengthening the relationships shown in Figure 1 and addressing the problems indicated in Figure 2:

1. Upward: by strengthening the links between LGs and the central government (e.g. in terms of improved reporting and accountability for the use of funds);
2. Downward: by reinforcing links between LGs and local citizens (downward accountability), through improved information (e.g. assessment results are published) and through rewards to LGs that involve citizens and improve transparency; and
3. Horizontal: by deepening the dialogue between local councils (typically elected politicians or decision-makers) and LG staff and employees.

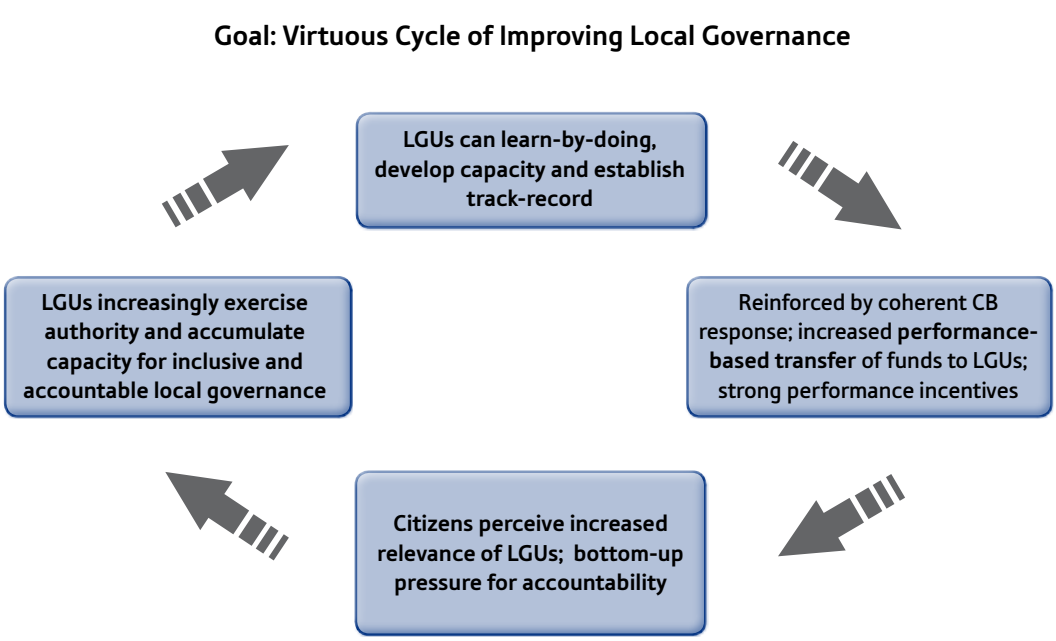
Although PBGSs are designed with some top-down modalities, they ensure that LGs have stronger incentives to improve on the extent to which they are downwardly accountable.

Many countries reward LGs which: (i) involve citizens in participatory planning and budgeting processes; (ii) ensure transparency in terms of the publication of plans, budgets, audit reports, project information and assessment results; and (iii) have transparent public administrations. Publication of the assessment results may even be a minimum condition for access to the funds, or a mandatory function. Other performance measures include the existence of signboards with project information, social audit, project-monitoring committees and involvement of relevant stakeholders.

Furthermore, the involvement of LGs, associations of LGs, CSOs/NGOs and other stakeholders in the design of a PBGS (including the definition of performance measures) ensures a strong sense of ownership, legitimacy and buy-in to the system. The PBGS may also enhance the relationship, efficiency and effectiveness between LGs and the private sector. Often PBGS designs include training in procurement management for public managers/procurement officers as well as private contractors. The private sector also knows that the performance of the LGs may benefit them as well in terms of handling of procurement, payment of contracts etc. Involvement of user committees in supervision and monitoring of work is also promoted in many places.

One of the objectives of the PBGS is to break the vicious circle illustrated in Figure 2 and to transform it into a virtuous circle, with mutually strengthening links, as shown in Figure 3.

Figure 3: Virtuous Cycle of Improving Local Governance



Source: Adapted from Yongmei Zhou, the World Bank, presentations at the Kigali Workshop, 2007. LGUs= Local Government Units.

As much as PBGSs are important in helping to create such a virtuous cycle, it should be noted that the overall framework for efficient decentralisation – such as conducive political, legal, institutional and fiscal frameworks for LGs – remains crucial. Examples of these are the need to ensure coherent and consistent links between expenditure and revenue assignments, a proper balance between autonomy and supervision/control, sound HR management systems and procedures and effective coordination of support to LGs. And, as documented in various reports[18], there are many other factors which give LGs incentives to provide services efficiently and to perform better within areas such as good governance and financial management.

2.5 Links to Various Types of Performance Measurement Systems

Before moving onto the specifics of PBGSs, it is important to locate them in the overall frameworks of performance, monitoring and accountability. The performance-based grant systems are closely related to other performance-based systems, such as performance-based budgeting[19], credit-rating systems, user surveys, human-resource (HR) performance-appraisal systems, benchmarking, contract models with conditions on performance, and various monitoring and evaluation (M&E) systems. It is important also not to neglect the *overall* intergovernmental relationship between CG and LGs and the incentives or disincentives it provides for LG performance.

18 See Ahmad (2005), Steffensen (2000), Steffensen & Tidemand (2004), Dege/NCG/ETC-EA/Mentor (2007).

19 See McGill, ed. (2006).

As will be shown below, there is definitely room for strong links and synergies among all of these systems. However, it is important to bear in mind that these systems have their own specific objectives and design principles.

- *Performance-based budget systems* are internal management tools to ensure that funding follows the performance, activities and results in a given organisation or level of government, e.g. within a ministry.
- *Credit-rating systems* are assessments of the creditworthiness of LGs, and include risk assessments of the entire external and internal fiscal environment with the aim of ensuring that loans are protected against lack of absorptive capacity and high fiduciary risks. Basically, they are tools for lending institutions to ensure repayment and profit in their lending operations. Credit rating is often a comprehensive and costly exercise and follows a clearly prescribed methodology applied by each credit-rating agency[20]. Although many of the indicators used are similar to those in PBGSs, credit-rating systems not only review indicators attributable to LG actions and performance but also review the wider environment for investments. Secondly, they tend to focus more narrowly on fiduciary risks (as the point of departure), whereas PBGSs may look at many other performance areas as well.
- *User surveys* and user-satisfaction surveys, citizen scorecards, social audits[21], etc. are tools increasingly applied to help inform LGs about areas for improvement in service delivery and governance. These instruments supplement PBGSs by bringing client-based feedback. A PBGS can actually promote these initiatives through its performance measures and reward system.
- Related to the above are various forms of client/citizens charters which are put in place to ensure basic rights and services. In Uganda, for example, the Ministry of Public Service has developed guidelines and is supporting the formulation of client charters by LGs as mechanisms for introducing the notion of client focus in the public service.
- *Value-for-money audits*; technical audits, procurement audits, etc., (in addition to the traditional focus on financial management audits) – these instruments typically focus on technical elements of LG performance and provide important information for dialogue and follow-up on performance gaps and/or sharing of good practices;
- *Human-resource (HR) performance and appraisal systems*, particularly if linked to performance-based budgeting and performance-based salaries, are potentially powerful tools and may be linked to the PBGS. However, this is not straightforward, as a number of more basic issues (such as payroll management, organisational structures, job descriptions, etc.) are often more urgent reform initiatives, which have to be in place prior to launching a system of performance-based salaries. Although PBGSs have tended to focus on institutional performance, linking them more strongly to HR appraisal and payment systems[22] is a potentially useful option.
- *Systems of LG performance benchmarking* use many of the same indicators as the PBGS, but are not linked to intergovernmental fiscal transfer systems – and thus rely almost entirely on public disclosure to lead to greater pressure on (and thus incentives for) LGs to improve their service-delivery performance. Benchmarking of LG performance

20 Most credit-rating institutions are reluctant to disclose full details of their assessment tools, and there are qualitative elements in these assessments which are used to arrive at the formal score (e.g. AA+).

21 E.g. Guidelines have recently been issued in Nepal on procedures for the conduct of public audits and many states in India have significant experience in the use of social auditing processes.

22 A variation of this has been introduced in Nepal since FY 2008/09, whereby civil servants working at the district level can obtain fixed bonuses and additional staff benefits when their DDCs qualify for a performance-based top-up grant, provided this is approved by the LG council. But to the knowledge of the author none of the other PBGS countries mentioned in this publication have started this process.

is practised in many OECD countries, with benchmarking results published in various books/publications/web-pages, often in the form of "league tables" and user-friendly comparisons across LGs. In some countries, like the United Kingdom, these results are used by the central government as a dialogue tool vis-à-vis the LGs. In cases of serious under-performance, LG autonomy may be reduced by stronger supervision and more direct control of certain LGs by the central government[23]. In other countries, it is mandatory for LGs to publish their service-delivery targets and their actual achievement of these targets on an annual basis[24]. The assessments in the PBGS also serve as a benchmarking tool in the sense that LGs themselves can judge where they stand compared to others in similar settings and review their achievements compared to previous years.

- *Contract management* is also a tool, which links funding with performance. However, it is more "micro-managed" and often not part of the overall grant system, but more directly related to meeting agreements on specific services to be delivered. It is applied in several countries (e.g. in West Africa[25]) in the relationship between central and LGs and may include an agreement on specific reforms to be pursued against the allocation of additional funding. Closely related to this are more project-specific reward schemes whereby the LGs that have submitted the strongest or most relevant projects (in terms of needs, design and other features), receive financial support for their implementation from the central government/DPs. This is the case for various "challenge funds" in many countries (e.g. the Philippines). Other examples are reward/recognition schemes, such as "green rewards" for the most environmentally concerned LGs, or rewards for specific innovative reforms[26]. There are also numerous examples of contract arrangements between various units within the same authority (e.g. a Ministry of Social Affairs and its institutions) about specific results and related funding. However, these initiatives will not be classified as PBGSs in this publication, which focuses on intergovernmental fiscal transfers.
- Many general M&E systems and PBGSs are mutually beneficial. M&E systems usually have the broad objectives of monitoring outputs, outcomes and impact to enable authorities to adjust and better target their activities and inputs. There are numerous, related performance-measurement systems that are not linked to the actual transfer of funds to LGs. First, examples include various forms of citizens' evaluations and "report card" methods[27] for assessing the performance of LGs, applied in a number of Asian countries[28]. These systems are put in place to monitor development and identify areas in need of improvement. Second, many countries have developed more project specific M&E systems that track progress in specific areas. Third, many countries have used detailed compliance inspection and supervision systems, with performance indicators, typically carried out by the Ministry of Local Government, which are important in the relationship between central and local government; and more-or-less sophisticated M&E systems to track outputs (e.g. service delivery) and outcomes/impact (e.g. poverty

23 Another example is in Denmark, where the ministry responsible for local governments monitors the liquidity level of all LGs and intervenes with stronger rules and control procedures where the LGs are below certain defined levels/benchmarks.

24 If they do not comply with the legal framework, councilors in Denmark can be sanctioned personally.

25 An example of this is municipalities in Senegal.

26 The Ministry of Finance in Sudan established a system whereby the first LGs to submit their accounts after the end of the FY would receive a television as a gift to the locality. In the Philippines, there are more than 30 reward schemes, each with their specific objectives.

27 Refer to: **http://www.tugi.org/reportcards/general.PDF** for an introduction to this tool and suggestions for some indicators for each sector.

28 Examples are the Philippines, India, Pakistan and Thailand.

reduction). Finally, there are a number of countries (e.g. the Philippines[29], Uganda and Tanzania) which are developing comprehensive and computerized M&E systems (as general management tools), with the aim of informing decision-makers (LG and centrally) about areas in need of attention.

Experience has shown that although these systems may supplement each other in a mutually strengthening manner, it is important to make the objectives clear in the design phase and ensure clear links between the indicators for measurement in each system and its objectives, particularly to ensure robust linkages between the indicators in the PBGSs and in the overall M&E systems.

PBGSs are, to various degrees, linked to the overall public-administration reform process, and to the more specific HR management reform programmes in each country. As is the case for all other decentralisation reform programmes, it is an advantage to ensure these linkages and to pursue a stronger role for decentralisation (and of the PBGS initiatives) in the overall government-development partner dialogue, e.g. under the framework for general and sector budget support, progress reviews and related M&E systems.

2.6 Links to the Overall Grant System and Typology of Grants

2.6.1 Grant Typology

Systems of performance-based allocations are not equally suitable for all types of grants and for all expenditure areas. It is therefore important to define how PBGSs fit into the overall architecture of intergovernmental fiscal relations and to show how the PBGS can be articulated with other grant schemes.

Below is a grant typology (see table 1), based on an internationally recognized categorization, adjusted to take into account the new features associated with the PBGS approach[30]. Grants can be classified by:

1. The way the overall *size of the pool* of resources is determined, and;
2. The way the *grants are distributed horizontally* across LGs.

Transfers can be distributed to LGs as (conditional or unconditional) formula-based transfers (Type B1, B2 or B3 transfers). Alternatively, transfers can be designed as "ad-hoc" grants where central government has discretionary power (Type D1, D2 or D3), or as full or partial reimbursement of actual local expenditure (Type C1, C2, or C3 transfers). The formula-based transfers are sometimes based on detailed calculations of the overall expenditure needs of the local governments (Type B3)[31] Even the size of the overall ad-hoc distributed transfer pool (no clear formula applied) may be based on some overall measure of the total need of all LGs (Type D3), but this model is rare.

Transfers can also be provided in the form of revenue sharing, whereby local governments receive a share of certain revenues collected within their boundaries (Type A). Revenue sharing is considered a form of transfer when the LG has no control over the tax base, the tax rate, tax collections or the sharing rate (e.g. the Local Development Fee in Nepal or the sharing of wealth taxes in the Philippines).

29 The Local Government Performance Measurement System (LGPMS), which has 107 indicators (and more than 200 sub-indicators), has been piloted and rolled out since 2004.

30 The table is an adaptation of the typology used in Bahl & Linn (1992) and Bahl (1999), adding the PBGS features.

31 Attempts to make these overall calculations of expenditure needs have been undertaken in a number of countries, e.g. the Philippines, Indonesia, Uganda, Latvia and Estonia. Although it is hard to define detailed needs, these surveys have provided some indication of outcomes of existing revenue sharing arrangements and future directions in the allocations.

Table 1: A Taxonomy of Intergovernmental Transfer Programmes and Examples

	Method of determining the total divisible pool			
Method of allocating the divisible pool among eligible units	Share of national tax revenues	Ad hoc decision or programme specific	Reimbursement of expenditures	Allocation based on estimates/measures of the relative total LG expenditure needs and revenue mobilisation capacity
1) Origin of collection of the tax	A Philippines	–	–	–
2) Formula	B1 Philippines** Indonesia Ghana (DACF) Rwanda (LASBF)	B2 India-BRGF	–	B3 Some of the Nordic countries Philippines**
3) Total / partial cost reimbursement	C1	C2	C3 Many countries in OECD, e.g. Denmark	–
4) Ad hoc decision	D1	D2 SOI-recurrent grants	–	D3
5) Performance-based (may be combined with 1–4.)	E1 (Ghana-DDF) Tanzania (2009)***	E2 E.g. Uganda (LGD) Tanzania- (LGSP)*** Nepal -(LGCDP) Bangladesh Indonesia Pakistan and many others, see Annexes 2.1–2.3	E3 (E.g. Denmark, Japan and Canada)*	E4

Source: Adapted from Bahl (1999) and Bahl & Linn (1992), combined with the features of the PBGS.
* Kind of performance-based funding through the many conditions attached to some of the grants.
** A rough estimate of the expenditure needs of each tier was conducted at the start of devolution, but this is being updated. The adjustment has been in group B1, as it is now a fixed % of national revenues. The coming PBGS (planned) will be based on a rough estimate of the required size, i.e. (E2)
*** Government of Tanzania has moved from a project-specific allocation to an allocation based on a specific % of public revenues.

Finally, and more recently, a number of countries[32] have introduced more performance-based grant allocation systems, where the size of the grants is adjusted against LG performance (type E1, E2, E3 and E4), typically based on calculations of the appropriate expenditure needs to be covered by the system, rough estimates or availability of funding, reviews of absorptive capacity, minimum level required for meaningful investments, etc.

As most PBGSs have been launched by specific projects or national programmes, they are classified as **category E2** – the size of the allocation is based on overall *programme-specific* considerations. A formula-based allocation formula is used and allocations are adjusted

32 E.g. Kenya, Uganda, Tanzania, Ghana, Nepal and Bangladesh. Other countries, like the Philippines and Indonesia, are preparing similar schemes.

against LG performance. Some countries could move toward types E1 or E4 when further studies of the overall fiscal system are conducted[33] and when the overall LBs' fiscal need versus their revenue potential is further defined. In Ghana the system approximates to type E1 features, as the PBGS is funded partly from the revenue-sharing grant (the District Assemblies' Co mmon Fund). Tanzania has also recently moved toward this type of system, with GoT's contribution to the overall PBGS funding pool set as a specific percentage (2%) of the total government budget[34] (model E1), although the size has not been based on detailed calculations.

2.6.2 Capital versus Recurrent

The targeting of PBGS toward capital and/or recurrent expenditures has been the subject of intense discussion in most countries.

Grants can be divided in the following way, reflecting two dimensions:

1. Recurrent – capital; and
2. Sector – non-sector specific.

Table 2: Recurrent versus Capital and Sector versus Non-Sector Specific

Table 2: Grant – Taxonomy	Sector – Specific*	Non-Sector Specific
Recurrent (operational and maintenance costs)	A.1. E.g. grants for salaries to finance school teachers.	A.2. Non-sectoral grants with earmarking for recurrent expenditures, but LG discretion to use the funds across the sectors according to local priorities.
Capital	B.1. E.g. grants for the construction of class rooms.	B.2. E.g. capital-investment grants for discretionary spending on various sectors (typically various forms of local development funds).
No limits on the type of expenditure to be funded in terms of capital or recurrent costs	C.1. Grants to finance all kinds of expenditure within a specific sector (sector specific conditional grants).	C.2. Unconditional grants with no limitations on utilisation (or a very short "negative list").

(*) In some cases, spending may be further "earmarked" for specific purposes. In other cases, modifications of these standard types are practised, e.g. capital-grant schemes may allow a certain percentage for preparation and monitoring of projects (so-called investment servicing costs) or a share for administrative costs.

Most of the PBGSs are in **group B.2**[35] as the objective is to promote larger investments in infrastructure and service delivery, but with a maximum percentage set aside to finance investment servicing costs (planning, appraisal, M&E, see Chapter 3). These grants are especially attractive to LGs, as they are largely discretionary in nature and thus allow for a higher level of autonomy on the part of local decision-makers. They are typically targeting capital grants, as they are easier to adjust than recurrent grants (such as those for salaries), which have a high fixed-cost element.

33 Indonesia and Uganda (2004–05) have invested considerable effort into analytical work aimed at defining the expenditure needs of various LG functions.

34 Excluding budget expenditures for debt-servicing and the like.

35 However, there are examples of PBGS with a broad investment menu, including both capital and recurrent costs (e.g. the LATF in Kenya).

A grant may finally be defined along another dimension – as: 1) **"development grants"**, which include some capital investments, but also other types of expenditure (see below)[36]; and 2) non-development-oriented grants.

Table 3: Capital versus Development

Capital/development distinction	Development expenditures	Non-development-oriented expenditures	No distinction between dev. and non-dev.
Capital expenditures	**A.1. Capital investments in development-oriented areas like health centres. schools, roads, agriculture (construction and rehabilitation).** **Capital grants**	A.2. Luxury vehicles and administration buildings (depending on the needs).	A.3. All capital expenditures without limits.
Recurrent expenditures	**B.1. Capacity building** Awareness raising campaigns. Expenses related to the operations and maintenance of core capital investments, (health, education, water etc.) **Capacity building grants.**	B.2. Administrative expenses in non-core areas.	B.3. All recurrent expenditures without limits.
No distinction between capital and recurrent	C.1. Grant to finance all development- oriented expenditures Development grants.	C.2. Grants to finance all non-development oriented expenditures.	C.3. All expenditures allowed.

Development transfer schemes are frequently supported (or co-funded) by various donor programmes, and may have a restricted investment menu with a "positive" list (of eligible expenditures) and/or a negative list (of non-eligible expenditures, such as expenditures on religious activities or luxury items).

The PBGSs usually focus on **capital expenditures** (group A.1.), with incentives to use the funds for development-oriented expenditure areas[37]. One reason is that it's easier to adjust flexible capital investments than "fixed" recurrent costs.

The **capacity-building grants** to LGs are defined as recurrent (development-oriented)[38] expenditures in group B.1, and are often part and parcel of the overall PBGS.

36 See Tidemand, Steffensen, Pyndt et al. (December 2003: Volume II) for a discussion of these issues. Some countries therefore categorize certain grants as "capital development grants", mixing the two concepts to enlarge the investment menu (e.g. Tanzania).

37 Some countries, like Ghana, Nepal and the Solomon Islands allow LGs to spend a certain percentage of their PBGS allocations on recurrent costs but exclude other types of expenditure, defined in a negative list.

38 Except in Bhutan, where expenditures for training are classified under "capital expenditures".

2.6.3 Focus of the PBGS

The focus of PBGSs may vary – and, accordingly, performance-based grants can be categorised along two basic dimensions:

1. The type of performance which the grant is trying to leverage, particularly generic **institutional** versus **sector**-specific performance; and
2. Use of funds, i.e. either **sector-earmarked** or broad non-sectoral/LG **discretionary** funds[39].

Table 4, below, identifies four options along these two dimensions:

Table 4: Type of Performance and Use of Funds

I. TYPE OF PERFORMANCE THAT IS TARGETED IN THE INDICATOR SYSTEM	II. USE OF FUNDS – MULTI-SECTOR VERSUS SPECIFIC (EARMARKED) ⟷	
	MULTI-SECTOR USAGE	**SECTOR-SPECIFIC USAGE**
SERVICE DELIVERY	**A. Multi-Sector Usage** Service Delivery Focus (e.g. pilot testing in Nepal of grants to urban authorities).	**B. Sector- Specific Usage** Service Delivery Focus (e.g. Uganda – School Facility Grant, Philippines- Health Grants). Numerous grants within the education area, such as grants linked with enrolment rates (capitation grants in Kenya and Ghana) and/or specific outputs (level of students passing exams with certain quality, etc.)
INSTITUTIONAL ↕	**C. Multi-Sector- Usage** Institutional Focus (e.g. Uganda, Tanzania, Kenya, Mali, Sierra Leone, Nepal, Bangladesh, Ghana, Indonesia, Solomon Islands, Bhutan and emerging systems in the Philippines and India).	**D. Sector-Specific Usage** Institutional Focus (e.g. Philippines (Health), new sector-development grants in Tanzania (Agriculture, Health, Water).

Source: Adapted and updated from a table developed by Roland White and Jesper Steffensen in 2005.

I. Multi-sector versus sector-specific performance indicators

PBGSs may be designed as "*multi-sectoral*", aimed at improving the overall generic institutional and organisational performance of LGs, or *"sector-specific"*. Most experience in developing countries has been within the first category. If the focus is on multi-sectoral performance, the PBGS typically tries to leverage broad improvements in overall *institutional capacity* and performance, in areas of benefit for all sectors – the type "C" grants in Table 4[40]. Access to performance-based funds would here tend to be dependent on LG improvements in broad, cross-cutting areas – such as planning, financial management and good governance. Examples of this could be requirements to have clean audit reports,

39 In some countries these LG discretionary funds are called "block grants" or non-sectoral/non-categorical grants.

40 Institutional strengthening is here taken to mean the combination of enhanced organizational capacity (achieved mainly through improvements in functional/administrative systems and human resources) and deepened accountability (bottom-up, top-down and horizontal). The particular focus will vary from country to country.

timely submission of development plans, transparency and open citizen involvement in planning and budgeting processes, etc.

In *sector*-specific systems, the performance criteria would tend to focus on achieving certain service-delivery targets, such as the number of classrooms constructed or number of pupils passing various exams, or measures of various unit costs[41] (the focus being more on specific – and often more short-term – improvements in sector outputs). It is important that goals are not too numerous or too mixed within the same grant mechanism. Laying multiple sectoral delivery objectives over institutional development objectives may send conflicting messages to the target LGs, and will either set the bar too high for them to clear or will tend to incentivise mediocrity (as local authorities will shoot for the middle on most things). Choosing between an emphasis on B and C type grants (see table 1) involves a decision about the extent to which one wishes to focus on developing institutional capacity, versus a more output-oriented focus on sectoral delivery goals.

It is important to bear in mind that unless basic institutional capacity is built at the sub-national level, sustained sectoral service delivery is unlikely to emerge.

In countries where decentralization is a relatively recent phenomenon, and LG capacity remains a major challenge, focusing on cross-cutting *institutional* strengthening is probably the key priority – **type (C)** systems are therefore often applied in such contexts. Type (A) grants are most appropriate for more mature institutional environments where (i) the basic structures have relatively few weaknesses; (ii) local systems are robust, effective and accountable; and (iii) when sectoral responsibilities are fully devolved to and under the control of the LGs. Where sector decentralisation is strong, and sector-specific grants are in place, models B and D are often more feasible. However, there is also an important interplay with the next dimension, the use of funds.

II. Use of funds

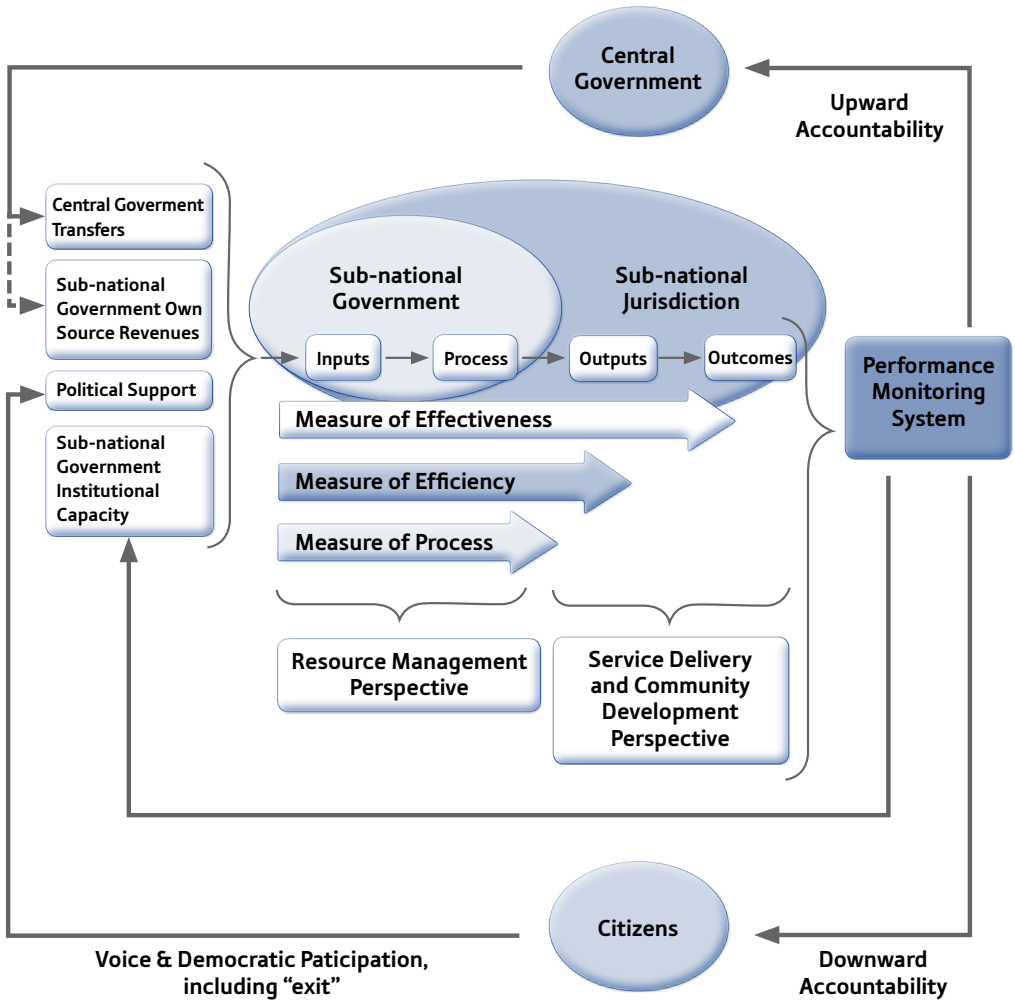
This dimension reflects the extent to which the PBGS should allow local discretion over the use of the grant funds and to what extent these funds should be earmarked for expenditures determined by the centre. Invariably, national governments (and/or donors) will apply parameters for local discretion in some areas to ensure adherence to national targets. They may specify that funds should be used for capital investment and/or they may proscribe certain types of expenditure (e.g. purchase of motor vehicles for the use of elected officials). Beyond this, there are many points on a spectrum whose end point is defined by very highly specified usages (such as a grant where the funds may be spent only on, for example, classroom construction). However, 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, thus compromising the overall objectives of devolution. Systems with more autonomy in resource utilization will typically be supported by stronger incentive systems/performance measures.

41 As mentioned by Shah (2006: B), very few countries are using these output-oriented transfer schemes, despite their obvious potential. Shah mentions the dearth of incentives for politicians and administrators to introduce these systems as the main reason for this. However, there may be other reasons, such as technical challenges in design and monitoring, as there are some areas where service outputs can be more easily compared than in others. Secondly, a focus on sector-specific outputs requires that such services are fully devolved to LGs.

III. Trade-off between various focus areas

A PBGS may focus on inputs, processes, outputs and outcomes. However, it is important to note that results in one phase of the process, such as final audit reports, will be perceived as inputs in the service-delivery chain, but will be outputs in another chain – the public financial management performance cycle, where there are a number of other inputs prior to this result (such as accountants in core positions, production of accounts, etc). The figure below illustrates this.

Figure 4: Performance Monitoring Framework



Adapted from Kai Kaiser in a forthcoming publication on: "*Intergovernmental Performance Grants – A Synthesis of Issues and International Experiences*", prepared for the 13th India IFC, Revised Draft, July 31st, 2009

Many of the PBGSs focus on the resource-management perspective, systems, procedures and processes.

Moving toward sector output or outcome indicators may be a great temptation, but is not without caveats, particularly in multi-sectoral grant systems.

First, it may tend to distort the use of funds toward certain sector outputs (hard to balance these) and thereby move the system toward non-discretionary sector grants with strongly "guided spending"[42], i.e. an LG may be sanctioned if it focuses on water instead of roads, or vice versa.

Second, there is the question of attribution, as LGs can often legitimately claim that such outputs and (especially) outcomes are not under their direct control, but influenced by other (external) factors, e.g. the efforts of the line ministries or the level of resource available.

Third, the LGs may use funds for quite different purposes, making it hard to compare their performance in terms of outputs, particularly for multi-sectoral grants.

Fourth, the assessment will require a very detailed assessment tool with specific definitions and targets, and this is likely to lead to a very complex and expensive assessment process with significant field work on a regular basis.

It may be argued that strong systems of process indicators (those reflecting planning, budgeting, financial management, good governance, etc.) will be important prerequisites in any case for the achievement of all service- delivery outputs[43]. If these systems are stronger and more robust, there is a greater likelihood that the actual services will be produced more efficiently and transparently. It may finally be argued that certain processes, particularly in areas of good governance, can be seen as ends in themselves – e.g. if people participate in decision-making and monitoring. However, it is also a question of sequencing, getting the basics right and then moving on toward the next stage. Sector-specific output indicators are easier to handle in *sector-specific grants*, where they will be aligned with the specific sector needs and targets, and where they will not distort local priorities across service-delivery areas.

For these reasons, unconditional block grant funding within the PBGS has been more closely tied to performance seen through the prism of "process indicators", as more easily measured proxy measures for likely performance outcomes, but also because some of these indicators constitute benefits in themselves (e.g. participation of citizens in local decision-making, involvement of women and disadvantaged groups, targeting of investments and empowerment vis-à-vis the LGs[44]).

It is also possible to combine the systems in the sense that the PBGSs for multi-sectoral grants focus on generic institutional performance improvements, whilst sector grants also include more sector-specific and output-oriented indicators (see the diagram below)[45].

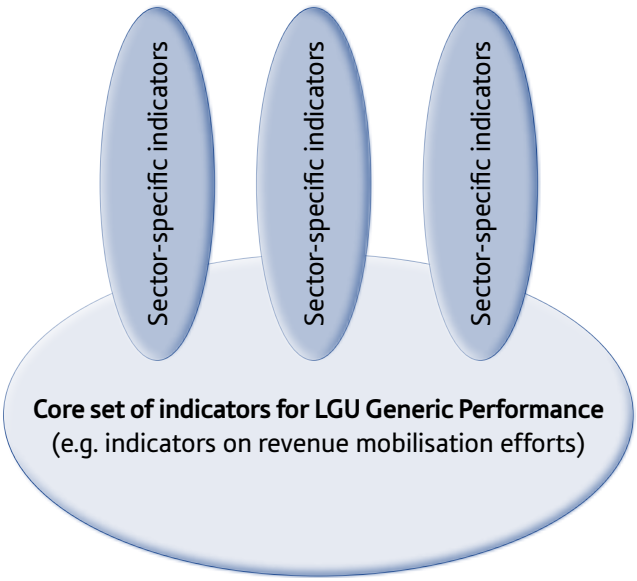
42 LGs will rapidly work out in which sectors they will obtain high performance scores and thus target their investments toward these, compromising and blurring the local priority setting process.

43 This was also convincingly argued in a recent review of LGDP in Uganda (World Bank 2008) and was a key assumption underlying the entire review of General Budget Support under OECD (see IDD et al 2006). In the review of GBS, the PFM results were treated as immediate effects leading to outputs such as improved service delivery and accountability.

44 In many measures of poverty reduction (the end target for many grants),"empowerment of citizens" is one of the core dimensions and an end it itself.

45 This is the case for the system in Tanzania and is also under development in countries like Uganda and the Philippines.

Figure 5: Links between the Multi-sectoral and Sector Performance-Based



2.7 Main Components in a PBGS

2.7.1 Overview of the Main Components

Ideally, a mutually reinforcing triangle should be established among three components: 1) the capital-development grant scheme; 2) the performance-incentive system (including the assessment system and process); and: 3) the capacity-building support (demand- and supply-driven), facilitated by robust institutional arrangements (including support to a sound system for assessment – in a neutral, objective and professional manner) and supported by an effective coordination of the entire system by the central government in close consultation with LGs and other stakeholders.

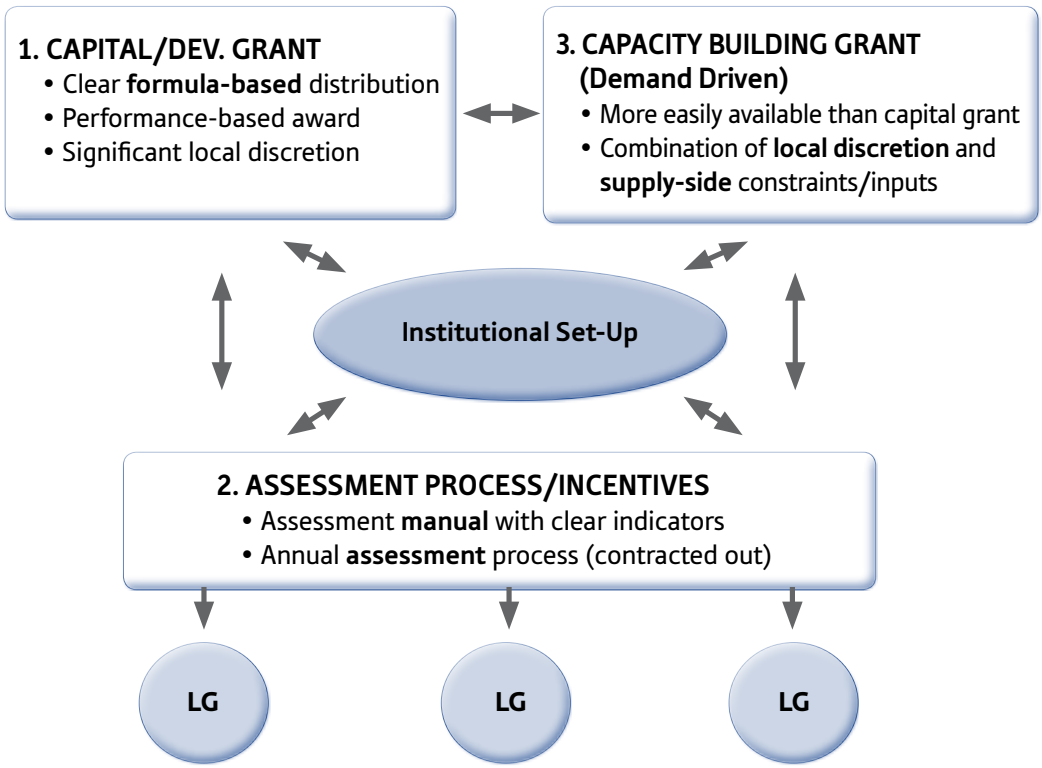
A general description of each of these components is given below. Chapter 3 will provide more information on country-specific experience, as these systems do vary across countries.

2.7.2 Capital-Development Grant Component

The capital-development grant component (performance grants) is the cornerstone of any PBGS. These grants need to be of a sufficient size (relative to other sources of finance) to give LGs a real incentive to improve their performance. Although the aggregate transfer amount will obviously be partially determined by the total number of LGs targeted and the total available funding pool, each LG needs to benefit (or lose) meaningfully if it is to comply (or not comply) with the system[46]. The investment menu (eligible expenditures to be funded from the grant) may vary from country to country, but generally includes a broad non-sectoral menu and a short negative list of non-eligible expenditures.

46 It should be noted that many countries have started with limited and modest PBGSs and then gradually expanded the system.

Figure 6: Mutually Strengthening Components of a PBGS



2.7.3 Assessment System and Process

Assessment system and measures

PBGSs generally include an annual assessment of LG performance using a set of indicators that are clearly defined in an assessment manual/tool. The process of assessment is equally crucial for the success of any PBGS.

Most countries (see Annexes 2.1–2.3) have divided these indicators/measures into two categories:

Minimum conditions (MCs) – these are the basic conditions with which LGs need to comply in order to access their grants, and they are formulated to ensure that a minimum absorptive capacity/performance (e.g. in terms of planning, financial management and administration) is in place to handle additional funds. They are most often formulated as on-off triggers for the release of funds, and ideally the entire set of MCs should be complied with before LGs can access their performance grants.

Performance measures (PMs) – are more qualitative and variable measures of LG performance, and will typically go into more detail within each functional area, such as the

quality of the planning, **quality** of environmental management, etc. The measures are used to adjust the level of funds made available to LGs as and when they have complied with the basic MCs.

There are many pitfalls in the design of these indicators. In defining indicators for minimum conditions and performance measures, the following principles need to be borne in mind:

- Utilise the experience gained from **previous testing** and piloting, and from other countries which have introduced similar systems with encouraging results;
- Support LG compliance with **statutory** requirements (government laws and regulations). Although this is a guiding principle in most places, the performance measures may also target areas outside of these (be ahead of the legal framework), particularly with respect to good governance and transparency indicators. But in these areas it is important that LGs, through capacity-development activities or other kinds of guidance, receive support and advice on how to improve performance before the assessment is conducted. It is not advisable to assess compliance with very complicated new requirements and systems if LGs have not been sensitized and trained in their utilization and/or informed about these;
- Try to ensure good coverage of the **existing government assessment systems and M&E** indicators and results (such as those used by the inspection function, statistical surveys, available audit reports, etc.), and make use of these results to the extent possible with sufficient quality assurance. This will reinforce subsequent efforts to harmonise and align the systems and ultimately help move toward the use of a single common assessment tool for LG performance;
- Use a combination of **minimum conditions (MCs)**, designed as on-off triggers, with which compliance provides some basic safeguards against the misuse of funds, and more qualitative **performance measure** (PMs), used to adjust the size of the grants) to promote better performance. However, as will be seen in Chapter 3 and Annexes 2.1–2.3, some countries have begun their PBGSs by focusing only on the core MCs to keep things simple in the first phases;
- Endeavour to ensure that the **core areas** are well-targeted and avoid too many indicators of minor importance. However, some such indicators may be included to raise future awareness and identify capacity building gaps, and these may be increased over time;
- Start with the **core generic areas** of performance under LG control, such as financial management, participation, transparency and good governance. Generally, it seems more appropriate to avoid indicators of service delivery outputs in the initial stages of establishing a PBGS, as these types of indicators (i) often cover aspects of performance that are not under LG control; (ii) can make the system overly complex; and (iii) can bias LG-funded investments into certain sectors and away from others;
- All the indicators should cover functions or activities that are **under the control** of **LGs** and for which performance is genuinely attributable to LG management. In other words, the system should not use indicators of sector outputs and outcomes in countries with a limited level of decentralisation, precisely because these areas are still largely outside of LG control. However, as and when sector functions are genuinely devolved to local governments, it may become appropriate for a PBGS to use indicators of sector outputs and outcomes as measures of LG performance, particularly for sector grants;
- Seek to identify **performance priorities** and then weight the indicators accordingly. Thus, participatory planning and revenue mobilization may be seen as some of the core areas where improvements are most urgently required – and indicators for them can therefore be allocated a higher scoring weight relative to other, less important,

performance indicators. Identifying such performance priorities and then according them greater prominence is one of the key PBGS design issues to address. This will often require a detailed prior review of LG performance in various areas, and identification of weaker areas, benchmarked against international/regional standards;
- Whilst a PBGS is designed primarily to provide incentives for improvement in LG performance, it is also intended to identify capacity-building gaps and provide input to the overall M&E system of LGs. Ensuring linkages between the PBGS and other M&E systems and their indicators is therefore critical;
- Ensure that a PBGS addresses LG functional weaknesses, as identified through consultations with various stakeholders and through previous piloting;
- The requirements imposed by minimum conditions and performance measures should be realistic, achievable and objectively verifiable, i.e. clearly defined, but still sufficiently demanding to promote improvements;
- Try to design a PBGS in a manner whereby the system can progressively cover specific sectors (and sector grants), using the generic indicators as the core basic framework, but adding sector-specific indicators for sector grants,
- The system should be based on a clear and **simple scoring system**. More-qualitative indicators (e.g. levels of participation in planning) require more field testing and control than do simpler, quantitative indicators.

The definition of MC/PM indicators and the way the scoring system is structured have an important bearing on the acceptance and credibility of the PBGS when applied at the local level. The main guiding principles for the final selection of appropriate indicators will typically be the need to achieve grant *objectives*, combined with practicality and *simplicity* in the selection of various options and the need to harmonise different assessment systems so as to avoid duplication and confusion. Too simplified a system may hinder buy-in and lead to alternative (and more sophisticated) performance-measurement systems, designed by other agencies. In any case it is important that the indicators are clear, transparent and cover key performance areas consistently, promoting the overall objectives of the transfer scheme.

Assessment Process

The mechanism by which LG performance is assessed is of vital importance for the functioning of a PBGS: if it does not work properly, or lacks (or is seen to lack) integrity and objectivity, the incentive structure, which constitutes the real added value of the PBGS, will be seriously compromised, and the grants will be robbed of their core purpose. Structuring the administration of a PBGS in order to minimize conflicts of interest – by keeping the performance-assessment process as *independent* and *neutral* and as far away from the rest of the grant administration machinery as possible – is therefore very important.

> The assessment process should be **neutral** and conducted with a high degree of professionalism and integrity.

PBGSs are usually managed and overseen by a central government ministry or department, such as the Ministry of Finance or Local Government (or sector ministries if sector-oriented) and are funded from central revenues and/or donor loans or grants. The success of the incentive system depends very much on the allocation of roles and responsibilities within the assessment process. The core problem is that the ministry which normally administers such grants also tends to be subject to considerable political lobbying to ensure the release

of funding, and is thus vulnerable to pressure to dilute and influence the assessment process. The ministry is often also in charge of capacity building and monitoring of the LGs, and has a vested interest in demonstrating good performance. This is particularly relevant where the work of the inspectors/monitoring staff from the central government is organised on a regional basis and where staff are responsible for certain districts or where there is regular staff rotation between central and local levels of government.

There are various ways to manage this risk. Inter alia, the assessment process can:

- include only indicators which can easily be verified
- be contracted out;
- be carried out as team-work;
- be audited;
- undergo quality assurance;
- be made transparent;
- can involve LG representatives and other stakeholders.

For a PBGS to be effective, the performance of the targeted units has to be regularly (e.g. annually) assessed and aligned with the local planning and budgeting process.

It is important that the assessment process is well-prepared and accompanied by capacity-building, awareness-raising and subsequent quality assurance (see Section 4).

It is also important to note that while associated administrative and other costs will amount to only a small fraction of the overall PBGS funding pool, this kind of grant system requires a more substantial administrative infrastructure than, for example, an unconditional block grant. However, and as already mentioned, a significant proportion of the increased work load (in the form of the assessment process itself) can be outsourced on a short-term contractual basis.

Annexes 2.1–2.3 provide an overview of the various methods used, and Annex 3 provides a review of the advantages and disadvantages of various assessment approaches.

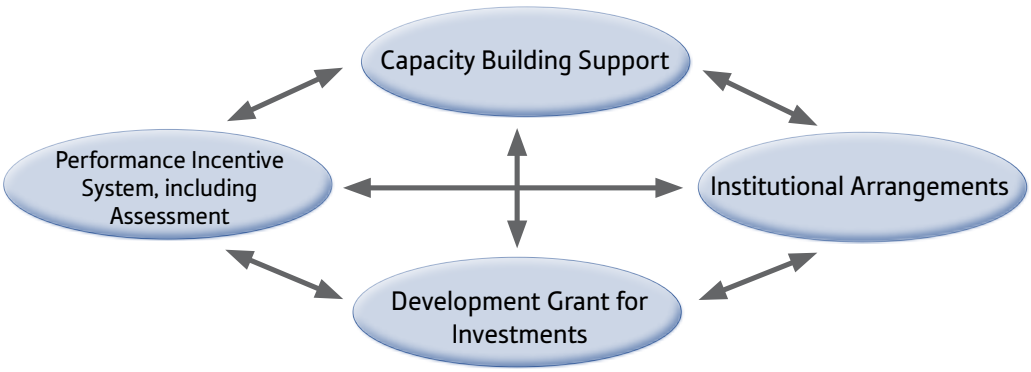
2.7.4 Capacity Building

To be most effective, a performance-based (capital) development-transfer scheme must be backed up by well-designed options for capacity building (e.g. in the form of CB grants) that enable LGs to address weaknesses in capacity and improve performance, and to support them in preparing appropriate capital-investment projects (planning, feasibility studies, monitoring, etc.).

The performance measures should promote better LG performance in the area of development activities, whilst the CB support should enable LGs to address functional gaps, identified during annual assessments, in an efficient and targeted manner. Furthermore, the assessment system provides good incentives for LGs to utilise CB support in an efficient manner. The PBGS will typically require more sophisticated *management arrangements*, including staffing capacity in the responsible agencies, than simpler, formula-based systems. Assessments and monitoring alone will require planning and implementation capacities – whilst the CB component also requires significant support and coordination. But experience has shown that investing in a well-managed PBGS yields a high rate of return in terms of improved LG performance in core areas of importance for the management of development projects (from planning, budgeting to project implementation and monitoring).

As it appears from the figure below, CB support will provide the necessary means and incentives to improve LG performance:

Figure 7: Components in a Performance-Based Grant Allocation Scheme



The local development grant for investments, the CB support and the built-in performance-incentive systems should ideally be designed to be mutually reinforcing and have a significant impact on LG service delivery. One way of doing this is to introduce, alongside the capital component of the performance-grant system, a *capacity-building grant scheme*. This grant will often be much smaller than the capital/development grant and would be used to fund various capacity-building activities (such as training, purchase of minor equipment, etc.), rather than "hard" investment activities. CB grants should be more easily accessible than the capital grants, to enable **all** LGs to improve their performance. In other words, whilst one expects a certain number of LGs to fail to access the capital grant every year (due to non-compliance with MCs), all LGs will usually be able to access their CB grants, provided they have shown signs of commitment (for example, through developing simple plans and budgets for capacity building).

The idea pursued in the PBGSs is that LGs should be allowed significant discretion both over what sorts of capacity need to be built and where the inputs should be sourced – precisely because they are often better-placed than central government to identify needs and inputs.

For quality-control purposes, certain limits may be placed on this discretionary power, with central ministries playing a fundamental role in determining training standards and vetting vendors/suppliers, ensuring transparency in procurement, etc. In addition, there may also be scope for some supply-driven CB efforts as long as supply- and demand-side imperatives are balanced and mixed[47].

The supply-driven side of CB typically also provides LGs with mandatory training in priority areas and usually includes support for developing basic systems and procedures for *core* activities, such as planning, budgeting, procurement and reporting. LG participation in these supply-driven CB activities may even be considered a prerequisite for access to development grants under certain circumstances (e.g. the case of Solomon Islands). It is for their residual CB needs that LGs will need sufficient autonomy for local choice and decision making.

The following chapter will review how these principles have been applied in practice, focusing particularly on 15 low- and middle-income countries (see Annex 2).

47 E.g. the design of Ghana's PBGS includes a combination of supply-driven/mandatory CB support and demand-driven discretionary capacity building grants in the ratio 40%/60%.

3. International Experience – Comparison of Design Features

3.1 Development in Performance-Based Grants

Building conditionalities and incentives into intergovernmental fiscal transfer systems is not a new phenomenon. Many countries (including some OECD countries) have had embedded fiscal incentives into their IGFT systems for years, to stimulate spending in particular areas – through matching grants, grant access conditions, minimum service standards, and requirements for specific actions to be undertaken in order to get access to grants (see the box below).

Box 1: Experience From the Use of Incentives in Grant Systems – OECD Countries

There are several examples of IGFT incentives in OECD countries. One is the Canadian Federal Government's health grants to the provinces, provided only if the provinces observe a number of minimum conditions, such as open and equal access to health facilities and no billing of clients. Failure to meet these conditions can lead to the withdrawal of federal support or a reduction in the grants[48].

The Danish system of local government features a reimbursement scheme in which the percentage reimbursed depends on the extent to which LG spending is consistent with specific policy aims. If an LG simply provides passive social-benefit payments to an unemployed client, it receives a smaller reimbursement percentage than if it tries to re-activate the client through employment schemes/training, thereby ensuring a more sustainable use of welfare payments. Testing and piloting have been conducted in various sectors to identify support schemes/reimbursement percentages that optimally balance fairness, equity and incentive. These instruments have been effective in influencing LG expenditures. Nordic central governments have used sanctions – such as reduced block grants – to discourage LGs from raising taxes above ceilings deemed consistent with certain macroeconomic targets[49].

In other countries, central governments have tried to influence LG actions by attaching output conditions to certain types of grants. In Japan, for example, road grants come with certain minimum standards, such as the number of lanes that must be built.[50].

There are also activity-based grant allocations, such as funding based on the number of enrolled school children or students passing exams. A good example is the "Race to the Top Competitive Programme" launched in the U.S. by President Obama in June 2009. It allows states to apply for education grants if, among other things, they comply with requirements for progressive improvement in standards and access, including reforms in procedures for certification and evaluation of teachers and principals.[51]

Continues...

48 Shah: (2006, A).

49 Jørgen Lotz in Shah: (2006, C, p. 255 -265)

50 Mochida, in Shah, ed. (2006, C: 168).

51 Shah (2009)

Continued

Finally, there are grants which have many of the same features as those described in this publication, such as (i) the grants under the Australian National Competition Policy (NCP), which link untied performance grants to states that achieve certain reform objectives intended to promote economic growth; (ii) the UK initiative on Local Public Service Agreements, whereby local authorities – in agreement with the central government – select a number of indicators for measurement and can then receive up to 2.5% of their total budgets as reward for good performance; and (iii) the Italian "topping up" of EU structure funds (the performance reserve funds) to regions which demonstrate good performance, initially focusing on process indicators, and now more on final outcomes[52].

China also has experience using LG incentive schemes and is designing a pilot PBGS (see the textbox below).

Box 2: Incentive Schemes for LGs in China

China operates a number of performance-based grant systems with specific targets, and is planning new initiatives with a broader focus. One scheme concerns the allocation of fiscal rewards to provinces and municipalities that reduce fiscal gaps at the county and township levels. Rewards are calculated on the basis of a coefficient applied to the fiscal performance of individual LGs. A second scheme provides incentives for townships or district administrations to merge, thus becoming more administratively efficient and "rational". Through yet another scheme, the central government provides fiscal rewards to counties which increase spending on education, health, agriculture, forestry and water, using coefficients which account for variable financial capacities. Finally, the central government provides specific rewards to counties, which produce large amounts of grain, in order to promote national food security (MoF, Budget – 2008, Number 364).

These schemes are expected to be supplemented by other PBGSs in the near future. The National Development and Reform Commission of (NDRC), for example, is considering a pilot aimed at enhancing the effectiveness of China's investments in the rural sector. The goal is to link LG funding to improved service delivery, monitoring & evaluation, and/or other functional areas. This PBGS is expected to be piloted in a number of counties and will be designed on the basis of preliminary surveys and initial analytical work under way as of October 2009. It is likely that the PBGS will include (i) a Development Grant, which will allow eight pilot counties to finance local development investments; and (ii) a Capacity Grant, which will allow pilot counties to finance CB activities aimed at improving their performance and the preparation of appropriate development projects.

Source: Terms of Reference – IDF Improving Rural Public Expenditure Management, 2009.

In many countries there has been considerable debate over the need to ensure that the overall intergovernmental fiscal architecture is conducive to LGs. It is, for example, important that there is a coherent link between expenditure and revenue assignments, that LGs retain a significant share of the tax revenues collected, that there is a clear and conducive legal framework, and so forth. Several studies have shown the importance of such links

52 K.Kaiser (2009)

in encouraging LGs to improve systems, procedures and practices on own-source revenue mobilisation and general performance[53].

However, the systematic use of grant-based incentives to improve general LG performance in generic areas is a fairly new practice, one that has been seriously tested, applied, replicated and refined for only two decades, most comprehensively in several low- and middle-income countries. One of the first countries to introduce this type of grant system was Uganda, through the District Development Programme (DDP). The DDP began piloting a PBGS approach in four districts in 1997 (with Kotido District added in 1998)[54]. The PBGS was expanded in 2000/01 to cover 37 (later 41) districts and, from 2003, became a countrywide system covering all types of LGs. In 2007–08 development- and capacity-building grants were funded entirely out of the Government of Uganda's consolidated budget, but other components, such as assessments, were financed by a joint donor/basket-fund arrangement. From FY 2008/09, local development grants were "topped-up" with funds from a development partner/GoU basket-fund arrangement, although most of the funding is still provided by the Central Government.

Following Uganda's example, several countries have introduced or piloted PBGSs. Some are introducing new PBGSs or revising earlier types (the Philippines, Bhutan, China, Pakistan, Indonesia, India[55]) while others have started to roll out pilot schemes (Nepal[56], East Timor, Laos, Bangladesh). More than 15 countries have some form of PBGS in place – either as a pilot or on a country-wide basis (see Annexes 2.1, 2.2 and 2.3.)

3.2 Comparison of Experience[57]

A number of Asian and African countries have experimented with performance-based grant allocation incentives, largely addressing generic elements of LG performance. Experiences from 15 countries are summarised in Table 5 below[58].

Annexes 2.1 – 2.3 detail the experience of countries with PBGSs across a range of dimensions.

Table 5: Summary of Selected Country Experiences (15 countries) *

Design Issue	Country Design
Grant programme (start)	Most countries (14 out of the 15) have introduced the system within the past 10 years or are planning to introduce it, and all countries have a defined programme to support the systems directly or indirectly.
Piloting versus country-wide	Most (10) countries have started the PBGS as a pilot and scaled-up within a few years to cover the entire country.

Continues...

53 E.g. in Hsu, S. Philip (2004), p. 567 -599.; Prud'Homme (2003); Ahmad et al. (2005); Steffensen & Tidemand (2004).

54 Some of these districts were later divided, hence some publications mention seven.

55 Specifically, the State of West Bengal.

56 From FY 2008/09 the system covered all District Development Committees, and 2,000 of the 3,915 Village Development Committees will be covered from FY 2009/10.

57 Information for this chapter derives from the author's direct involvement in programme design, input from programme managers, consultants and representatives from ministries in charge of the schemes, mid-term and final evaluation reports and annual assessment reports.

58 For countries with systems in the "pipeline", such as the Philippines, draft concept notes and draft design documents have been used for the sake of comparison in the overview table as if they were started already.

Continued

Design Issue	Country Design
Type of grants and use of the grants	All countries apply (or will apply) a multi-sectoral PB capital/development grant system. A few countries have started with sector PB grants. Many countries allow LGs to spend a certain percentage on investment servicing costs, and most countries have clear positive/ negative lists of eligible/non-eligible investments.
Grant size	Most countries (14) use between USD 0.4–4 per capita as the basis for their PB capital/development grants.
Allocation criteria	All countries use a formula-based system with clear criteria for allocation. Size of the LG population is the single most important factor, combined with performance measures. Some countries ensure a minimum allocation and/or equal share per LG either as a "floor" and/or even if the LGs are not complying with the MCs. In some countries, these minimum allocations are referred to as entitlements.
Capacity building	All countries have some form of CB support incorporated in the PBGS design. Only five of the countries have specific CB **grants** included in the system.
Number of minimum conditions (MCs)	14 countries apply a set of MCs. The number varies from three to 30 MCs, but most countries (11) use five to 10.
Typical MCs	The typical MCs are: • Development plan approved by the LG council on time • Core LG staff positions and decision-making committees in place, e.g. staffing of the internal audit unit • Final accounts produced on time • Regular financial statements from last year submitted on time • Cash books and bank reconciliations kept and up to date • No adverse audit report or all serious audit queries from previous audit report settled • Procurement entity in place
Number Of performance measures (PMs)	In countries using PMs, the number of PMs varies from three to 121.
Types of PMs	Most countries use generic/institutional and cross-sectoral performance measures such as planning, budgeting, PFM and good governance. A few countries have started to include **sector**-specific indicators in non-sectoral grants (e.g. Uganda), and a few others have started with sector-specific PMs for sector grants (Tanzania and the Philippines).
Examples of PMs	Some of the common PMs are indicators of: • Participatory planning processes • Quality of planning and links with budget and longer-term forecasts • Expenditure allocation for core service areas • Degree of budget implementation and/or degree of project implementation • Publication of plans, budgets, accounts, project progress and audit reports (transparency measures) • Social audits conducted • Citizen charters produced • Revenue mobilisation initiatives, e.g. strategy and plan for own-source revenues

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Design Issue	Country Design
Adjustment mechanism	Typically, grant allocations are made using the basic formula, then adjusted upwards or downwards against LG performance (with, for example a 20% to 40% variation, depending on performance). The MCs decide the minimum level and the overall access to the grants. Some countries (Ghana, Solomon Islands and – in the future – the Philippines) integrate performance results directly into the allocation formula, assigning them a specific weight.
Counterpart (LG) contribution	About half of the countries (eight) require LG counterpart contributions (matching funding), often in the range of 5% to 10%, but this is often project-specific.
Method of assessment	The method of assessment varies by country: • Six countries use external consultants (contracting out) • Four use committees or combined teams managed by the leading ministry • Six use internal government systems, sometimes with a degree of external quality assurance. • Most use field visits (on-the-spot) and only a few rely exclusively on desk reviews from the central office in the ministry/programme.
Assessment manual	Thirteen have developed comprehensive assessment manuals or operational guidelines, and the two others have simple guidelines in place.
General experience	There has been a particularly strong positive impact on LG performance areas such as: • legal compliance and documentation • planning and budgeting • spending in core service areas • PFM and procurement (major areas) • good governance, such as involvement of citizens and publication of core information/transparency • gender and environmental concerns in LG processes • interaction between politicians and staff • dialogue on how to improve performance and linkage with CB support • fruitful competition across the LGs The PBGS has also improved CB support in terms of the needs assessment and targeting, and has led to more effective use of CB resources. It has improved focus on performance and dialogue in this important area, strengthened accountability patterns in most countries, and improved coordination of support from development partners in many countries. Despite these positive results, there are several challenges, such as: • quality of assessments • political will and pressure to ensure follow-through on assessment outcomes • design of specific indicators and scoring systems • links to other grant systems and reform initiatives • delays and administrative bottlenecks • constraints in the overall LG framework and environment • sustainability of institutional arrangements for the systems Refer to Chapter 4 for further details on achievements and challenges.

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Design Issue	Country Design
Funding source	Most countries have combined funding from central government and DPs, and in some cases the government's contribution is 50% or above. A few countries (e.g. Kenya, East Timor, and to a large extent Uganda[59]) finance the PBGSs entirely from their consolidated state budget.
Systemic support to reforms	Most PBGSs (13) include an element of support for other decentralisation elements. The remaining two countries intend to use their PBGSs to have an impact on the overall grant system.
Coordination initiatives impact	The PBGSs have had a strong impact on overall coordination between governments and DPs, and have spearheaded strong joint funding arrangements and movement toward budget support in most countries. In 12 of the countries, the systems are supported (or soon will be) by more than one DP.

*** Sources:** Based on a review of 15 countries, see Annexes 2.1, 2.2 and 2.3. The sources are mid-term reviews of programmes, final reviews, assessment reports (see list of literature), interviews with project staff, LGs and other stakeholders. Information is based on data available from 2008 or 2009.

Below is an overview of some of the core PBGS design features in the countries covered by this review.

General Overview

Annexes 2.1–2.3 provide examples from 15 countries on how the various key design parameters have been handled, where these systems have been tested and applied in recent years or where systems are ready for implementation in the near future. Although there are many similarities, they provide a broad overview of the experiences – from piloting, testing and roll-out of systems – which will be of great benefit for countries considering such systems.

The system in Uganda – the Local Government Development Programme (LGDP-I) and LGDP-II[60]) –- which has been implemented over several years, is of particular interest, especially because it has served as a rough template for other PBGSs.

The experience with innovative PBGS systems in various countries has generally been very positive[61]. In particular, the combination of MCs, PMs, capital/development grants and CB grants has provided LGs with strong incentives to improve on performance within key areas (like planning, budgeting, financial management and project implementation) but also in "softer" areas such as transparency and gender equality/social inclusion. Chapter 3 will go into more depth on the quantitative and qualitative impact of PBGSs in various countries

59 From FY 2008/09, Uganda's DPs are supporting a topping up of the PBGS through a basket-fund arrangement that accounts for about 10% of the scheme's total funding. In the Philippines, funding is still being discussed, but it is expected that the GoP will finance the major share. In Bhutan, the RGoB is contributing 80% to 90%.

60 The underlying principles of PBGSs were originally developed through the DDP/KDDP in Uganda (implemented with support from UNDP/UNCDF) and were successfully tested in a few districts from 1997 onward. PBGS funding principles were replicated by the first Local Government Development Programme (LGDP I, funded by the World Bank and others), and scaled up through LGDP II from 2004–2007. LGDP II was jointly supported by the World Bank (IDA), DANIDA, Austria, the Netherlands and Ireland (to the tune of USD165 million). The Project Appraisal Document (PAD) of May 2003 provides details of LGDP II design. Other donor agencies (e.g. DFID, USAID) have aligned their support for this PB transfer scheme, which – since 2007, after project completion – has been largely funded by the Government of Uganda.

61 See, for example: 1) Shotton, ed. (2004); 2) Shotton & Winter, eds. (2006); 3) Steffensen, Land & Ssewankambo (2002), 4) K2 (2005); 5) Gardener et al. (2003); 6) Stanley et al., (2006); 7) Tidemand, Steffensen, Pyndt et al. (December 2003: Volume 1–3); 8) PMO-RALG (2008); and 9) DEGE Consult, NCG et al (February 2008). The finding is also based on reviews of the numerous national assessment reports from the respective countries and interviews with core stakeholders. See Chapter 3 for further details.

and lessons learned. What follows is a brief description of some of the core characteristics of the systems.

Grant Programmes – Piloting Versus Country-Wide Systems

Most countries (nine out of the 15) have started their PBGSs as pilot schemes and then scaled-up within a few years to cover the entire country (e.g. Tanzania, Uganda, Nepal and Bangladesh). Others (e.g. Sierra Leone, the Solomon Islands and Ghana) started on a nation-wide basis. The systems and procedures have typically been refined during piloting and scaling-up (e.g. in Uganda, Sierra Leone, Tanzania, Nepal and Bangladesh). Some countries (such as the Philippines (piloting), China (piloting) and India (West Bengal) and Bhutan (country-wide) are planning to introduce new PBGSs within a short time, while others (Indonesia, Pakistan, Laos and East Timor[62]) are in the process of piloting and gradual roll-out. There are, then, an increasing number of pilots, country-wide systems, and pipeline PBGSs.

It is important to note that none of the countries included in the survey has regretted having introduced a performance-based grant system or reverted to the previous system. On the contrary, most countries have placed increased emphasis on performance incentives and steadily refined their PBGSs over time, based on the lessons learned.

Whether introduced as a pilot or country-wide, the PBGSs have been launched after thorough analytical work, studies of LG performance and assessments of the defects of existing intergovernmental fiscal transfer systems. Significant resources have been put into PBGS design, and in many countries teams of consultants and government officials have collaborated over several months to design an appropriate system. In several countries, UNCDF has been at the forefront of these efforts, and has frequently assisted governments in the first round of piloting (e.g. Mali, Tanzania, Uganda, Nepal, East Timor, Laos and Bangladesh). Other DPs have subsequently joined or contributed, often providing more funds for roll-out and refinement of the systems. In other countries, the systems have been designed jointly by several DPs and the central government (e.g. the Solomon Islands and Bhutan) or with technical support from the World Bank (Sierra Leone, Indonesia and upcoming programmes in the Philippines and Pakistan) and ADB (Pakistan).

Although only a few countries (such as Uganda, Nepal and – from FY 2009 – Ghana) have integrated the PBGS approach as part and parcel of their general IGFTS, this is expected to happen more frequently, and there are discussions in several countries on how to move from a project/programme approach to budgetary support.

Types of Grant

Most PBGS schemes have been designed to cover *non-sectoral capital grants* (see Chapter 2), often supplemented by various forms of CB support to LGs.

Although less frequently, some countries have experimented with large-scale performance-based, **sector-**specific recurrent and development grant schemes (see section 2.6.2. above). In Uganda, for example, LGs demonstrating good school-construction performance (measured in terms of input/output ratios) have been rewarded with top-ups to their school facility grants. There are similar initiatives in Uganda within other sectors. In other countries,

62 In East Timor, the system will be refined after the elections to the new municipalities in 2010.

such as Tanzania, LG access to a number of sector grants is based on the MCs applicable to multi-sectoral grants, as well as PMs relevant to the sector in question (see below).

Box 3: Sector Grants and Multi-Sectoral Grants

Tanzania has gradually begun using PBGS modalities for some of its sector grants. Today (2009) these schemes cover agriculture, health, water and education. The table below summarises the ways in which different sectors (i) assess LG performance; and (ii) allocate funds as grants.

Sector	Performance assessment method	Grant mechanism
LGDG (multi-sector discretionary grant)	PBGS (generic MC/PMs)	LGDG
Education	PBGS (generic MC/PMs)	LGDG
Health	PBGS (generic MC/PMs)	Sector grant
Water	PBGS (generic MCs)	Sector grant
Agriculture	PBGS (generic MCs) **plus** some sector specific performance measures	Sector grant

Thus, the capital-grant schemes to LGs in the education, health and water sectors now rely entirely upon the generic MC/PM performance indicators used for the Local Government Development Grants (LGDGs) in order to assess "sectoral" performance, while the agriculture sector uses a sector-specific PM indicators. All assessments, however, take place as a single exercise and are using similar MCs.

In terms of grant mechanisms, the education-capital sector grant has now effectively been merged into the overall LGDG, while capital grants for the other sectors (health, water and agriculture) continue to be made as sector conditional grants.

Although there are still separate national-level steering committees for the water and agriculture-sector grants, GoT intends to fully streamline and unify the grant-allocation process for all sectors.

Although these first experiences are positive, more work may be needed to fine tune such approaches.

Uganda is also considering extending the positive lessons learned from performance-based non-sectoral development grants to all other recurrent and development grants in the country, including the sector grants. On a pilot basis, the Philippines has also recently introduced a sector-specific PBGS in the health sector, and is considering the same in the agriculture sector[63] (see box 4 overleaf).

63 The Health Sector Programme even combines generic and more sector-specific indicators.

Box 4: Mindanao Rural Development Project (MRDP 2) – the Philippines (Original Proposal – Not Fully Implemented)

MRDP2: One of the design components in the proposal for the MRDP2 is the Rural Infrastructure (RI) Component, which includes a) rehabilitation and construction of strategically selected sections of roads and bridges, which will help enhance agricultural and fisheries productivity and access to markets; and b) construction and rehabilitation of devolved communal irrigation systems; and c) construction of potable water systems. The project will replicate good and sustainable O&M models, based on LGU-community partnerships. MRDP II will test a performance-based grant scheme that will provide additional grants to LGUs based on achievement of agreed revenue targets, which are adjusted against the previous revenue-collection pattern in each of the LGUs.

Although the project proposal has only one explicit performance indicator – improvements in own-source revenue of the LGUs (a positive scoring provides an increase in the grants from 50% to 70% of the project costs under the RI component) – there are a number of other performance requirements. The LGUs have to i) factor in operational and maintenance costs, ii) ensure that subproject billboards are set up from the start until the end of construction; iii) use mass media to provide information about project opportunities; iv) use indigenous fora such as *barangay* meetings; v) impose sanctions for wrongdoing; vi) make the results of regular audit reports on the project available to the public; vii) involve citizens actively in the procurement process; viii) arrange equity funding; and ix) ensure that all Statements of Income and Expenditure are duly signed by the local office for Auditing. Furthermore, each LGU is expected to prepare an action plan of local fiscal reforms to be undertaken in coordination with the Ministry of Finance and the implementing agency. The Ministry of Finance and the implementing agency will review the performance of the LGUs to determine whether they have met their revenue targets. In order to get an additional 20 percentage points of their grants to arrive at the maximum 70% central government funding of the project costs, the LGUs would have to demonstrate the following increases:

Average of previous five years' growth rate: Target growth-rate indicators	
Less than or equal to 10%:	5%
More than 10% or less than/equal to 25%:	10%
More than 25% or less than/equal to 50%:	15%
More than 50%:	20%

This means that LGUs which have made substantial improvements in their own-source revenue collection over the previous five years would need to sustain their fiscal efforts to benefit from the 20% top-up grants. LGUs that have been less successful in the past could access top-up grants by making more modest improvements in own-source revenue.

It should be noted that the information in this box was a proposal for the project design. It is still (2008) being discussed in relation to the overall funding system (cost-sharing arrangements between central government and LGUs) and should still be treated as a proposal not yet implemented.

Source: WB, Project Appraisal Document: "Mindanao Rural Development Project Phase 2, March 2007"

Most of the PBGSs have applied *generic* institutional performance measures, covering areas such as planning, financial management, fiscal capacity/tax effort, expenditure prioritisation (reward for poverty focus in expenditure allocation), transparency and accountability. The Ugandan example (in Annex 2.1.) provides a good illustration of these types of generic measures.

Some countries have limited the use of funds to real "capital" investments (Uganda, Ghana, Nepal, the Solomon Islands, Bhutan – with some exemptions – and, in the future, the Philippines) whereas others (Tanzania and Kenya) have included a more general definition of eligible expenditures as "development" spending, which covers all development-oriented expenditure, not necessarily of a capital nature alone.

Many countries (e.g. Uganda, Tanzania, East Timor, the Solomon Islands, Nepal, Ghana, Bhutan and, in the future, the Philippines) allow LGs to spend a certain maximum percentage of their non-sectoral capital/development grants (typically between 5% and 10%) on investment servicing costs. These are costs related to planning, appraisal, monitoring and follow-up of the investments. Most countries have clear LG investment menus (eligible expenditures) with positive and/or negative lists. The future system in Nepal will require districts to spend 2% of their PBGs on support to village councils, while 5% is allocated for investment servicing costs (including expenses related to planning, appraisal and M&E)[64].

There have also been discussions in various countries (e.g. in Uganda and Tanzania) on the option of linking not only the size of the transfers but also the degree of *flexibility* in the utilisation of funds (i.e. the level of autonomy) to the performance of LGs within key financial-management areas. Tanzania has recently introduced a system whereby the weakest LGs, which fail to comply with the MCs, are subject to more stringent supervision and control by the centre. These LGs will receive a relatively smaller share of the grants (25% of the calculated grants and 50% of the sector PBGS schemes) with less autonomy, but will then, hopefully, be able to access the full amount of their grants in the following fiscal years. The system attempts to balance minimisation of fiduciary risk with the political imperative of ensuring that **all** districts (irrespective of performance) access a minimum share of the funds available for development.

Size of the Grants

The size of grants is usually determined after careful review of LG absorptive capacities, the availability of funds, and a review of the minimum size of the grants needed to finance meaningful investments and provide sufficient incentives. However, in practice the decisive factor has often been the availability of funds (supply side), rather than a more "scientific" way of determining the expenditure needs of LGs versus their revenue potential (demand side)[65]. This means that most of the countries have been within the "ad hoc/programme specific" column in Table 1 (see section 2.6. above) with respect to grant classification.

The level of funding for non-sectoral capital development grants is usually USD 1–4 per capita per year. Of the 15 countries reviewed, 11 allocate USD 1–2 per capita per year in the PBGS. A few countries, like East Timor and the Solomon Islands, have a higher per capita

64 Note that specific grant guidelines for this are under elaboration (October 2009).

65 This is also a very comprehensive and time-consuming method, which may end up with highly unrealistic figures if not carefully conducted.

allocation (USD 3–4)[66]. The system introduced in 2008 in Bhutan is the "top-scorer," with about an annual allocation of USD 32 per capita for the lowest level of local government (*Gewogs*) and an even higher level for the *Dzongkhags* (of which 80% is earmarked to finance initiatives in the five-year development plan and the remaining 20% allocated on a discretionary basis to finance annual plans).

Although the performance-linked proportion of the total grants for development funding varies from 20% to 100%, it is generally recognised that the impact of a PBGS is higher if it constitutes a significant part of the total funds made available to LGs in order to provide sufficient incentives for improving overall performance. Although the grants need to have a minimum meaningful size to provide sufficient incentives to LGs to improve their performance, the impact has nonetheless been significant even when they have constituted a relatively modest share of the total development grants (e.g. 20% to 30% in Uganda). The main challenges for the incentive structure in some countries have been the existence of larger sector grants (as in Uganda), greater funding from various schemes supported by development partners (e.g. Tanzania) and ad-hoc allocations made outside of the allocation formula (e.g. Nepal, see below).

Allocation Criteria

International best practice for grant allocation formulae is also applicable for the basic allocation in the PBGS, prior to adjustment for performance.

All 15 countries use a *formula-based system* for the horizontal allocation of funds across LGs. Most countries use a small number of objective criteria in their allocation formulae, such as size of the population (by far the most common criterion used) and poverty indices, often applying the Human Development Index (HDI) or various types of poverty counts. A few countries (e.g. Nepal) include such factors as a cost index and size of the LG territory, which are assumed to have a bearing on expenditure needs. None of the countries has applied real calculated figures on LG fiscal potential[67], although poverty data are often used as proxies for this (e.g. Tanzania, Nepal, Uganda and the Philippines). The countries have generally ensured that they do not counteract the performance areas being promoted in the identification of grant allocation criteria (e.g. the wish to mobilise revenues or to improve financial-management capacity).

The availability of sound and accurate data on LG expenditure needs and fiscal capacity is a real issue in all countries; as a result, proxies are often used. This underlines the need for better and more geographically disaggregated statistics, which would, for example, allow the UN-based poverty indices to be extended down to the LG levels. The exact formula to be applied has been subject to intense debate in some countries, especially concerning the relationship between the weight of the "equal share" criterion (which does not factor in the expenditure needs of each LG but provides the same amount per LG) versus the population criterion[68].

In some of the countries, the large amount of funding that LGs can access over and above formula-based allocations has been a major challenge to the overall effectiveness of the PBGS. Such funds can come from a variety of sources: development programmes (sometimes funded by DPs), social funds, constituency-development funds, ad-hoc allocations and

66 The system in Nepal is also in this group if the grants to Village Development Committees (future PGBS) are considered.

67 This is a tremendous challenge due to the lack of data in most developing countries.

68 E.g. in Ghana, where the formula was changed as representatives of the GoG decided that larger districts were getting disproportionately large shares of the overall grant pool under a formula based largely on population size.

the like. In Nepal, in particular, this problem seems to be growing more serious and risks undermining the PBGS incentive structure (see below).

Box 5: Allocations in Nepal

The PBGS grant system was rolled out to all DDCs in Nepal from FY 2008/09 with a GoN contribution of 379.5 million NRs and ADB contributions of 635.5 million NRs. However, during the course of the FY, additional funds became available from GoN budget lines, and these were allocated to various DDCs based on specific requests and political initiatives/considerations. These funds nearly doubled the amount available for capital investments from the GoN, but were not consistent with the allocation formula nor with PBGS principles as a whole. Such funds are estimated to have totalled 200–300 million NRs – and this applies only to discretionary capital funds, as other ad hoc funds were also allocated for sector-specific initiatives. This leads to problems in terms of planning, budgeting and project implementation – but also threatens to compromise the effectiveness of incentives PBGSs are meant to create.

(Based on field work and interviews with the Financial Comptroller General's Office, September 2009).

Extra-budgetary funds and/or funds allocated over and above the transparent allocation formulae create problems not only for the leverage exercised by any PBGS incentives, but also for the overall efficiency of intergovernmental fiscal transfer systems, particularly in areas such as poverty targeting and predictability.

Capacity-Building Support

All 15 countries have a kind of CB support integrated into the design of their PBGSs. Five of the countries (Uganda, Tanzania, Ghana, Mali and Pakistan) have a specific *capacity-building grant scheme* included in the system, combining supply- and demand-driven dimensions to CB support and allowing LGs to spend funds on their own CB priorities (see box 6 below for the Ugandan case). Five other countries (the Solomon Islands, Nepal, Bangladesh, Philippines and Bhutan) plan to do the same in the near future.

Box 6: CB Support to LGs in Uganda Related to the PBGS

LGDP-I included – as one of the first schemes of its kind – a genuine CB grant allocation to LGs. LGs could use these grants within areas identified by themselves for the purpose of building capacity and enhancing performance. The grants were intended to enable LGs to respond to weaknesses identified by annual assessments. The mid-term review (conducted in 2001) of the CB grant system found that it was useful and important, but that it could be made more effective by introducing a number of improvements, notably by providing greater autonomy to LGs within a better-defined CB menu and by creating and facilitating a market for "capacity building" with demand by LGs and supply by accredited CB service providers. The improvements were incorporated in the design of LGDP-II and implemented from 2003 onward. Improvements included, *inter alia*:

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- new and clearer allocation criteria for CB grants to LGs, notably with greater LG autonomy within a better-defined menu;
- providing LGs with assistance in establishing HRD units and responsibilities as part of their core administration;
- providing support for the development of LG CB plans;
- developing a clear set of guidelines for the utilisation of CB grants, specifying maximum levels of expenditure for equipment and longer-term courses, with a clear set of sanctions if these guidelines were not complied with;
- establishing better reporting systems and monitoring arrangements;
- providing stronger incentives for LGs to use their CB grants efficiently;
- developing standard training course materials of high quality, covering most generic areas from PFM to HIV/AIDS;
- ensuring greater coordination of CB activities amongst all stakeholders;
- establishing an LG national committee for CB coordination with representatives from ministries and DPs, led by the Ministry of Local Government;
- establishing a list of accredited CB service providers to ensure adequate quality on the supply side; the list is supposed to be updated regularly;
- encouraging the use of local CB service providers but setting clear standards for training and CB activities.

The system, although not without its challenges, has been assessed as a great success – see Nelson, World Bank Institute (2006).

Many of these measures have been introduced in other countries, based on lessons learned and country-specific piloting schemes.

There has been a general move away from mandatory and supply-driven CB for LGs to a more demand-driven modality. With the gradual introduction of CB grants in various countries, LGs themselves can analyse the results from annual performance assessments, identify capacity gaps, and then finance appropriate CB activities. However, even in countries where a CB grant has been introduced, a significant supply driven/central government-managed element of CB support to LGs has remained to supplement the CB grants. This supply-driven component covers core areas of mandatory skills (such as training in new budget and procurement guidelines, induction of newly elected politicians, etc.). One of the challenges has been to establish a balance between demand- and supply-driven CB support, and to establish systems which are adjusted to local needs, but also take into account the often weak capacity of LGs to plan and handle discretionary CB support.

Examples and Number of Minimum Conditions (MCs)

In all the countries, clear minimum access conditions for grants are applied. The number of MCs varies between three and 30. Most of the countries (11) apply five to 10 MCs, but some (such as Indonesia, Pakistan and the Solomon Islands) use or have used more than 15 access conditions. In the case of Solomon Islands, the number of MCs was reduced in 2009 from 17 to eight, with a simultaneous introduction of 64 PMs for the future assessments. The MCs are basic safeguards to ensure absorptive capacity and proper management of funds. Six countries rely exclusively on minimum conditions (i.e. no qualitative performance measures and gradual adjustments of the grants – only on/off triggers). Some of the countries, such as East Timor

and Bhutan, are planning to introduce performance measures as well and to move beyond the basic MC system after the first testing of the MCs. Other countries (such as Uganda, Tanzania, the pilot in Bangladesh, Nepal and, from 2009, the Solomon Islands) apply both MCs and PMs. In these countries the *size* of the development grant is adjusted upward or downward, depending on the performance of the LGs within key areas (typically by around 20% from the base-line allocation). Mali has a special system with drawing rights for LGs, the size of which takes into account performance in areas such as governance and local fiscal efforts.

Some of the countries, such as Nepal, the Solomon Islands and Sierra Leone[69] initially applied only minimum conditions for eligibility and, during subsequent phases, introduced more-qualitative and complex performance measures. Hence, there is a clear tendency to further develop and fine-tune performance-based systems once they are in place, and to move toward second- and third-generation systems.

Some of the most typical MCs are:

- development plan approved by the LG council on time
- core LG staff positions and decision-making committees in place (e.g. staffing of an internal audit unit)
- final accounts produced on time
- cash books and bank reconciliations kept/made and up to date
- no adverse audit report or all serious audit queries settled
- procurement entity in place

The box below shows the MCs used in the Solomon Islands in the first year (2008) of implementation of the new PBGS.

Box 7: Examples of MCs in the Solomon Islands (2008)

- Memorandum of Understanding signed between the province and the Ministry
- Core staff positions filled and proper procedures for handling of staff
- Staff participation in core training relevant for the new grant system
- Detailed work-plan and budget approved on time (if submitted late, provinces will get a second chance, but then the province will lose one quarterly release)
- Active participation in the current work of updating provincial accounts (teams of accountants/auditors support the provinces in the field with three to four days in each province)
- Cash books are up to date
- Bank reconciliations are up to date (max. one week of delay)
- Provincial Financial Management Ordinance is updated and approved by the province, following the new standard guidelines
- Provinces have taken serious steps to address irregularities in the most recent audit reports
- Co-funding obligation met – 10% (to ensure ownership and efficiency)
- Contact person for the PCDF identified

In addition to these MCs, there are a number of reporting triggers for the release of funds and a clear menu of permissible uses for the grants. These conditions have been updated for the 2009 assessment, based on experience from the first assessment, and combined with 64 new performance measures.

Source: Operational Manual for the Provincial Capacity Development Fund (PCDF), 2008.

69 E.g. Tanzania and Bangladesh. The development of a PBGS is also being considered in other countries, e.g. the Philippines and China.

In Nepal, the MCs have been updated several times since the piloting of the system in 2004/05. The box below shows the most recent MCs applied in the assessment of the District Development Committees (DDCs).

Box 8: Examples of MCs in Nepal (Assessment Manual of June 2008)

Below is a list of the 13 MCs applied in the recent assessment with budget implications for FY 2008/09. In addition to these MCs, 57 Performance Measures are also being applied.

- Approved plan and budget according to legal framework
- Annual budget ceilings and planning guidelines provided to municipalities and VDCs (other tiers of government)
- DDC has publicity informed municipalities, VDCs and relevant stakeholders (citizens) about approved budgets and programmes
- Annual progress reviews of previous year conducted according to legal framework
- DDC has submitted its report on use of funds as per grant guidelines
- Accounts from previous FY but one completed and submitted for final audit
- DDC has prepared annual statement of income and expenditures of the district development fund and financial statement for previous FY
- DDC has released the budget or grant from the District Development Fund to VDCs and Municipalities, sectors and other organisations as per approved work-plan and budget
- Internal audit section established in accordance with legal framework
- Due and timely responses have been given to comments made and issues raised in the Office of the Auditors' General Report within the deadlines specified in the legal framework
- DDC has updated documentation on irregularities (cumulative records of unsettled irregularities documented and updated as per regulations)
- DDC has ensured that final audit of the VDCs is conducted in the previous year but one
- Information and record centre established and information/records kept as per regulations

(Shortened version of the specified MCs in the Manual for Assessment of Minimum Conditions and Performance Measures (MC and PMs) for the DDCs in Nepal, June 2008, Ministry of Local Development – Local Bodies' Fiscal Commission, Government of Nepal. The Manual is undergoing a slight revision as of October 2009).

Focus Area, Examples and Number of PMs

Nine of the 15 countries are using or plan to use detailed, qualitative PMs with an associated scoring system for assessing LG performance. The number of PMs varies from seven to 121. As mentioned earlier, several countries are moving from a system based solely on MCs to one with both MCs and PMs. A combination of the two tools will be a common feature of future PBGSs.

Most countries use indicators related to generic/institutional and cross-sectoral performance, such as planning, budgeting, PFM and good governance. A few countries (e.g. Uganda and Tanzania) began with a non-sectoral PBGS, and then went on to include sector-specific **generic** indicators, to enable buy-in from sectoral line ministries to join the non-sectoral grant system. The Philippines has applied a combination of generic and sector-specific performance indicators in the Health Sector[70].

The types of indicators used are remarkably similar, although with some country-specific peculiarities. Some of the most commonly applied *performance measures* are:

- participatory planning process
- quality of planning and links with budget
- prioritisation of expenditure allocations for core service areas and poor/ disadvantaged people
- fulfilled budget targets
- accountability measures such as public disclosure of plans, budgets, accounts, project progress and audit reports, execution of social audits and application of citizen charters
- revenue mobilisation initiatives (e.g. strategy, plan and development in own source revenues)

There has been a tendency to add more indicators over time and to progressively refine the level of detail in the assessment manuals and the scoring system. The example overleaf (see box 9) from Tanzania illustrates some of the common principles used in several countries. Although the number of indicators, scoring system etc. varies across countries, PM assessment methods are usually based on some common principles, *inter alia*:

- a minimum and maximum score which determines the rewards and sanctions;
- promotion of balanced scoring, such that LGs cannot simply focus on just a few performance areas to get a high score/reward;
- a number of indicators grouped within core performance areas;
- clear overview of the scoring system and defined scores for each indicator;
- scores within a range, e.g. between 0–100 (although some countries use relative scores);
- system for rewards and sanctions in cases with strong and poor performance respectively;
- indicators focusing on the core areas of generic performance, typically in areas where LGs have weak performance;
- quantifiable indicators.

70 Similar schemes have been planned in the Agriculture Sector where revenue mobilization will be a key measure (as per information received in 2008).

Box 9: PM Areas in Tanzania and the Scoring System (2008)

Functional area	Total score	Minimum to avoid penalty	Minimum score to receive performance bonus
A. Financial management	25	12	18
B. Fiscal capacity	25	7	12
C. Development planning	27	12	22
D. Transparency and accountability	15	6	12
E. Interaction with LLG	10	4	7
F. HR development	13	5	9
G. Procurement	14	6	10
H. Project implementation	26	10	18
I. Council functional process	5	2	3

The table shows the system as it was in September 2008. There were 41 PMs grouped into nine functional areas. In order to get a reward, the LGs need to have a good performance in all nine composite areas, whilst very poor performance in one area can lead to a sanction which is defined as a 20% reduction in the stipulated grant.

This system was changed in 2009 to incorporate both discretionary (multi-sectoral) grants and sectoral grants. The budgetary consequences of scoring have also changed from +/-20 % to a 100% entitlement for very good performers, 80% for good, 50% for poor and 25% for failed, except for sectoral funding where the minimum (entitlement) is 50%. The new system allows some funds to go to all districts, with all districts (irrespective of their performance) accessing a minimum entitlement. However, if a district fails, it will be placed under stricter supervision and control by the Prime Minister's Office – Regional Administration and Local Government (PMO-RALG).

Adjustment of Grant Size

In PBGSs which combine the use of MCs and PMs, compliance with the former determines LG access to the grants. The assessment of PMs, on the other hand, operates so as to modulate the actual size of the grants – which are adjusted upward or downward from the formula-derived amount as a function of LG performance.

The table below shows examples of various scoring systems and the impact of scores on the size of grant allocation:

Table 6: Examples of Systems of Adjustment of the Size of the Grants

Features	Uganda (2008)	Ghana (2009)	Nepal (2009)	Philippines (proposed in 2008)
Number of PMs	121	60	57	To be defined, probably about 40
Scoring	The maximum score in each composite area (e.g. planning) is 10. A score of 7 is required to get a reward (this score has to be achieved in all performance areas); a minimum score of 5 (in each performance area) is needed to receive the basic allocation; and if the score is below 5 in any one of the areas, then sanctions are applied	Relative score.[71] All LGs are measured against the performance of other LGs on a scale from 0–100.	Scoring between 0–100. The total score is decisive, but with minimum requirements within each performance area (LGs do not need to score highly in all performance areas to be rewarded). Various performance areas are weighted differently for scoring purposes.	To be defined. Will probably be relative scoring within a scale from 0–100
Minimum level of funding	In order to receive the basic level, all MCs need to be complied with. NB: in FY 2008/09, a few exceptions to this overall rule were made, as the assessment manual contained some MCs that were not supported by sufficient prior guidance and awareness-raising. According to information received, this will be rectified in the future. In addition to the development grant, all LGs receive CB grants if they comply with a few conditions.	In order to receive the basic level, all MCs need to be complied with. However, there have been some discussions as to whether a minimum level of funding should be allocated even in cases of non-compliance. In 2009, it was agreed to increase the CB component (allocated to all districts) to 20% of total funds for the PBGS to ensure increased future access to the development grants.	Pilot: All MCs have to be complied with to get full access to the grants. LGs receive a minimum allocation (between 1.5 million and 2.5 million rupees) even if they do not comply with MCs, as the PBGS is the only discretionary capital grant scheme. This minimum entitlement has been increased to between 2.5 million and 3.5 million in FY 2009/10; equal to about 29% of the GoN's contribution to the PBGS. DDCs which did not comply with the MCs in FY 2008/09 received a small amount for CB support (as compensation). From FY 2009/10 a genuine CB grant to all DDCs will be introduced, and this system of small-scale "compensation" will cease.	All MCs will need to be complied with. In addition to the capital grant it is expected that LGs will receive a CB grant where access conditions will be minimal (e.g. a CB plan and reports from previous use).
Reward/ sanction system	Basic allocation adjusted upward and downward by 20% against a fixed scoring system. The system ensures that a minimum score is attained in each composite area. Only LGs which have complied with the MCs get access to the grants.	40% of PB grants are divided using the performance measures applying the relative score earned by each LG compared to the total score for all[72]. Only LGs which have complied with the MCs get access to capital grants.	Top score is 100. > 79 points: 30% increase, 66–79: 25% increase, 51–65: 20% increase, 36–50: Static/basic allocation < 36: 20% reduction There is a minimum performance level in each composite area. If LGs score below this level (in any composite area), they will be sanctioned.	The performance criterion is part of the other grant allocation criteria, such as size of population, poverty level etc. (integrated in the basic allocation formulae). The performance criterion will have a weight of 50%. It will focus on relative performance of the local governments.

Continues...

71 This system of relative scoring is also introduced in Solomon Islands from 2009.

72 However contrary to the original design, the current allocation based on performance does not factor in the number of inhabitants (nor the basic allocation level) as in other countries.

Continued

Features	Uganda (2008)	Ghana (2009)	Nepal (2009)	Philippines (proposed in 2008)
Comments	Predictable, but static. Ensures balanced performance.	Focus on stronger competition, but less predictable for each LG More predictable for CG budgeting purposes. Does not ensure balanced performance, but this is to some extent handled by the MCs. The formula as it is applied does not provide equally strong incentives to the larger LGs as the scoring results are not weighted by population size or the results of the basic allocation (as is the case in many other countries).	Ensures balanced performance, but also a holistic view on overall performance. The provision of grants to LGs, which do not comply with the MCs, somewhat reduces the fiduciary safeguards.	It is less predictable for the LGs, but ensures strong competition and continuous incentives to improve. Promotes stronger control over the quality of the assessment. It is more predictable for CG budgeting purposes. Does not ensure balanced performance, but this is handled in the MCs, which will cover most core areas.

The District Development Facility Steering Committee has discussed whether there should be a minimum level of allocation to each LG even if the LG is not complying with all the MCs. However, there is already the District Assemblies Common Fund (DACF), which allocates significant grants to LGs and which is not performance-based. DACF grants can thus be seen as serving the purpose of making a minimum level of fiscal resources available to districts. According to information received in February 2009, it has been decided to increase the CB component of the grants to 20% in the first FY, i.e. 80 % is left for the two other components. In the original design the CB component was 10%.

Most PBGSs ensure a balanced performance through their scoring system, in the sense that a minimum score is required for all indicators (and compensation for the lost access to the grants is not applied). Several countries (five) use a total score/calibration ranging from 0 to 100. Some countries (Uganda, Tanzania, Nepal and Bangladesh) use a fixed scoring system, whereby LGs know beforehand that if they obtain a specific score – e.g. 80 points – they will get a specified amount of funds (see the table above). In these systems, the scoring method is made in such a way that LGs cannot strategically focus on a few performance areas while neglecting others, in order to qualify for an increased allocation, but need to perform relatively well in all (or most) areas. In any case, it is often deemed important that the adjustment of performance is weighted against the basic allocation (e.g. the case in Uganda, Tanzania, Nepal and the future Philippine system), so that larger LGs will have the same performance incentives as smaller ones and to ensure that the basic formula is not distorted[73].

A few countries (e.g. Ghana, which bases 40% of allocations on this), SOI (from 2009, 20% of total grants) and, in the future, the Philippines (50% of total grants) use *relative performance*, in the sense that those with the most points (e.g. the top 25%) get most of the bonuses, and the performance of each LG depends on the scores of other LGs. The argument for this is that it puts constant pressure on the LGs to improve their performance, ensures a

73 Similar discussions arise when it comes to the introduction of other "indexes" in allocation formulas, e.g. Human Development or Poverty indexes, which also need a certain weighting to avoid distortions.

higher level of competition between LGs, and introduces some sense of mutual control against misuse and "over-counting" in the scoring system. Although it is more predictable for central-government budgeting purposes, the relative scoring system is less predictable and transparent from the LG perspective. Some of the LGs may also feel that they are not rewarded (or may even be sanctioned) despite the fact that they have improved from one year to another.

Occasionally, systems have been piloted whereby LGs are rewarded for their own improvements over time (relative to a "baseline" year 1), without reference to the performance of others or to any absolute measure. This was, for example, done during the first few years of PBGS implementation in Uganda. However, there were a number of problems associated with this way of measuring LG performance:

1. It was complicated to measure, as data from several years was required but was often unavailable;
2. It was seen as unfair, since LGs which were poor performers (in absolute terms) could still be rewarded, whilst better-performing LGs (in absolute terms) could be sanctioned, thus creating a sense of "double standards". If the laws, regulations, systems and procedures are equal for every LG – which they are – the performance of all should be measured against the same objective yardstick.

Given the problems associated with using improvements over time as a way of assessing LG performance, all assessment systems in the 15 reviewed countries are based on either performance in relation to a fixed set of standards or performance in relation to that of other LGs. It is important to note that any scoring results from the assessments should ideally be weighted against the original allocation formula (adjustment of the basic allocation) and should not distort this formula, ensuring that all LGs have equally strong incentives to improve performance.

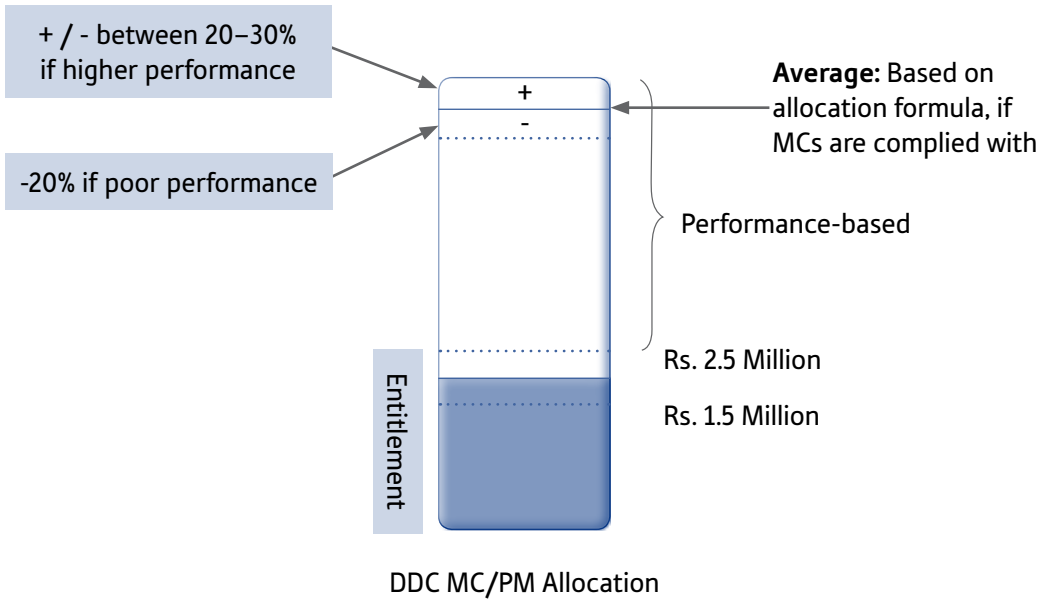
Some countries have introduced, or are in the process of introducing, a system whereby LGs will receive a minimum level of grants even if they do not comply with the MCs. This is typically the case where the PBGSs cover **all** the development grants and can be justified by the need to (i) ensure that some LGs are not completely deprived of all funding through failure to comply with MCs; and (ii) make sure that the consequences of LG non-compliance are "politically" acceptable[74]. This is the case for the system that is about to be introduced in Nepal (see Figure 8 below). The issue here is whether the LGs should be allocated this minimum amount if they are unable to prove that they can safeguard the funds, and whether there are sufficient countermeasures in place to mitigate against the risks of waste.

There has also been debate about the impact of the PBGS on poorer (not to be confused with worse-performing) LG jurisdictions. Part of the UK monitoring system is structured so that poorer LGs "play with a handicap" and thus have their assessment scores weighted by a higher coefficient than other LGs[75]. This has not yet been applied in PBGSs, for fear that doing so might overly complicate the system and because there is no unequivocal evidence that some types of LG perform worse than others, However, the design of second- and third-generation PBGSs could consider such options – although it is important to note that there are other means of supporting poor LGs, such as greater backstopping support, strengthened monitoring and more intense CB support.

74 Where non-compliance may result in complete denial of grants, acute political pressure to make exceptions could eventually erode the overall integrity of the system. Ensuring a minimum entitlement (however bad LG performance) can deflect some of this potentially disruptive political pressure.

75 Where poor LGs generally perform worse than others on a particular indicator, their score for that indicator might be topped up by a factor. A score of 20, for example, might be multiplied by 1.2, yielding a final score of 24, or a topping-up of 20%

Figure 8: MC/PM System and Minimum Entitlement in the Future System in Nepal (districts)



Source: Technical Note on Input to the Strategy for Topping-Up of Capital Grants to Local Bodies – the "Expanded Block Grants" (EBG) in Nepal, July 2008 by Jesper Steffensen and Bandhu Ranjab (as per 2008, see below). In 2009, the entitlement was increased to between NRs 2.5 million and NRs 3.5 million.

Box 10: Nepal

Development-grant allocations to districts in Nepal's recently proposed PBGS ensure that all DDCs will access a minimum entitlement whether or not they comply with MCs. In mountainous and hilly areas, where costs are higher, each DDC was initially entitled (in FY 2008/09) to a minimum of NRs 2.5 million; in the low-lying floodplains of the Terai, where costs are lower, each was entitled to a minimum of NRs 1.5 million. Provided DDCs comply with the MCs, they will receive a larger, formula-based grant adjusted against performance (as measured by PMs). For FY 2009/10 the basic entitlements were raised to between NRs 2.5 million and NRs 3.5 million, as part of a general increase in PBGS funds, and currently constitute about 29% of the GoN's contribution. (Funding from development partners is fully performance-based and not subject to entitlements.)

Source: Based on mission information from K.L. Devkota, Fiscal Decentralisation and Public Management Specialist in the Local Governance and Community Development Programme/Ministry of Local Development.

There has been a tendency in most countries to refine these systems over time and to incorporate lessons learned from piloting. As mentioned in Box 9, Tanzania in 2009 changed its PBGS so that all districts get a minimum entitlement (25% of the potential full amount) even if they do not comply with MCs, but they are placed under stricter supervision by the ministry in charge of LGs. Other countries, such as Ghana, have increased levels of CB support to ensure that all districts access substantial funding. In these initiatives, it has been important to ensure that strong incentives to improve performance have been maintained.

Release of Funds

Most countries have some basic requirements/triggers for releases, such as timely reporting on the most recent release (or the most recent but one) and adherence to conditions stipulated in the relevant operational manuals (e.g. requirements that the LGs adhere to the menu of eligible investments). If LGs do not comply with such triggers during the year, the flow of funds will immediately cease.

Counterpart Contributions From LGs

Eight of the 15 countries require LG counterpart contributions (matching funds), often in the range of 5% to 10% of the total grants. The objective of co-funding varies, but in most countries it is meant to ensure ownership, accountability and long-term sustainability, while encouraging LGs to mobilise own-source revenues and contribute to their own development. Some countries have also strengthened incentives for LG own-source revenue mobilisation (fiscal effort) in either the MCs and/or in the PMs – another option to promote local-revenue mobilisation. However, several factors, such as the limited taxes assigned to LGs and/or taxing authority, political influence/interference in taxation, weak capacity in LG tax administration, and unwillingness to improve local tax regimes, have limited the impact of such incentives in a number of countries (see Chapter 4)[76].

Assessment System and Procedures

The quality of the assessment process is crucial for the impact of PBGSs on LG performance. The method of assessment varies across the countries. Six countries use external consultants (contracting out), often combined with a robust system of quality assurance and endorsements from various authorities/committees. Four countries use committees, or combined teams managed by the responsible ministry. Six countries use internal government systems, sometimes with some level of quality assurance. Annex 3 provides further details on the advantages and disadvantages of various options.

Most countries use a system which includes field visits (on-the-spot). Only a few countries (e.g. Kenya and some pilots in Pakistan) rely entirely on desk reviews and the submission of LG reports to the central government/project offices – a system which has also been practised in Indonesia, but with regular audits of the results through field visits to the LGs.

Some countries (Uganda, Tanzania and Nepal) have designed refined systems of quality assurance (e.g. sample checks and control of the assessments), appeals processes and grace periods, but the extent to which these are actually applied varies. This is sometimes problematic, as these procedures may not be sufficiently formalised or well-known and may lead to severe delays in some countries (e.g. apparently in Uganda, where grace periods can last for three to five months, leading to delayed results, reduced transparency and doubt about performance at the time of actual assessment).

In some countries, the results of the assessments have been subject to political or administrative pressures – such as demands for reassessment of non-performing LGs, reluctance to publish results, and so forth. Ensuring and maintaining the quality and integrity of the assessment process has been one of the key challenges in PBGSs (see Chapter 4).

Thirteen countries have developed detailed assessment manuals or operational guidelines, while two have relied on simple guidelines. The most sophisticated manuals are those used in

76 See also OECD/DAC (2004) for a discussion of this problem.

Uganda, Tanzania, Ghana, Bangladesh (pilot case) and Nepal. These manuals provide a detailed description of the method for assessment, indicators, scoring, sources of information, appeal and grace periods, formats for reporting, assessment methods, etc. Most countries prepare the assessments well in advance, with preparations including training of the assessment teams and awareness-raising. Procedures for the announcement of assessments, revision of manuals and so forth vary across countries. The Tanzanian experience serves as an example of the practice applied in a number of countries (see Box 11 below).

Box 11: The Assessment of LG Performance in Tanzania Under the Local Government Capacity Development Grant (LGCDG) System (as per September 2008)

Since 2004/05, districts in Tanzania have been assessed on an annual basis by contracted private companies/consultants divided into a number of assessment teams. Each team consists of four members: two contracted consultants and two others provided by the responsible Ministry (the Prime Minister's Office – Regional Administration and Local Government) from a pool of trained resource persons. These resource persons may be from various ministries, LGs, NGOs and other institutions. An assessment takes three days in each district, and the Assessment Manual defines the process, indicators, scoring system and method. There is a formal appeal option built into the assessment, assessment teams are trained, and there is a degree of quality assurance. Assessments are announced in advance and results are published. A Steering Committee for the grant scheme finally endorses the results. The costs of the assessment constitute about 1% of the total value of the grants.

A recent evaluation of the assessment system concluded that the assessments are carried out with a high level of integrity, objectivity and quality, particularly with respect to assessment of the MCs. LGs were well-prepared for and appreciated the assessment exercise. Despite some differences in the interpretation of the results, arising from the fact that some of the indicators are not sufficiently clear and/or cover areas not fully under LG control, the assessment teams were reported to be objective, autonomous and fair. The system of rewards and sanctions has started to have an impact – especially in terms of elected officials becoming more rigorous and demanding with regard to the performance of LG staff. The overall evaluation was generally very positive, as the assessment process is achieving its objectives.

However, the assessment process leaves room for improvement in a number of areas:

- The timing of the assessments is not entirely consistent with the LG budgeting process;
- Decisions on the results from appeals have not always been clear, and the process needs further formalisation and clarity;
- Disclosure of information about and dissemination of results has been weak;
- Citizens are insufficiently involved in the process, are insufficiently aware of assessment results, and thus do not do enough to hold their LGs accountable;
- There has been insufficient internalisation of assessment results;
- There is a need for improvement in the clarity of some of the indicators, as well as ensuring that all areas measured are under the full responsibility of the districts.

The report recommended a number of specific improvements in these areas in order to further strengthen the initial encouraging results.

Source: See "*Independent Evaluation of Annual Assessments of Local Government Authorities (LGAs) under the Local Government Capital Development Grant (LGCDG) System, Evaluation Report*", April 2008 – Prime Minister's Office – Regional Administration and Local Government (PMO- RALG 2008).

Where external assessment teams are involved on an annual basis with detailed field studies and reviews, the cost of assessments turns out to be in the range of 1% to 3% of the total grants in most places[77]. In Nepal the annual costs (about USD 100,000) are lower, even if the assessments are contracted out, and constitute only around 0.6% of the value of performance-based capital grants to the DDCs. This is considered minimal given with the potential benefits of the system and compared with the cost of existing multiple assessments, audits, etc.

Despite this, there are discussions in several countries about the cost of assessments and the possibility of "internalising" or "mainstreaming" them into regular government functions. Uganda, for example, has moved from an assessment process coordinated by consultants to one where the ministry takes direct responsibility for conducting LG assessments, with some quality assurance (QA) from externally recruited persons. The crux of the matter is, of course, the independence and integrity of these quality surveyors (who have a function similar to financial auditors, see Chapter 4). There is debate about the quality and objectivity of the assessment processes in several countries, and about ways and means to ensure sufficient quality and credibility. This has been a contentious issue in Nepal, where officials have agreed to establish a system whereby 10 of the 75 district assessments will undergo an annual quality-assurance "audit" with related systems for the reconciliation of results, and endorsements of final decisions by an Intergovernmental Supervision Committee with representatives from Local Bodies, auditors and development partners. There will also be a system for quality assurance of assessment results at the lower levels of government – the Village Development Committees.

The tendency to mainstream and internalise the PBGS assessment process in various countries raises issues about (i) the roles of the assessment teams; (ii) how to ensure neutrality, objectivity, integrity, sufficient time and capacity for the assessors; and (iii) whether assessments are properly core government functions or should be contracted out, as are many training and auditing tasks. The discussion to some extent resembles the debate over the value of internal versus external audit. Chapter 4 includes further discussion of this critical design issue and Annex 3 provides more detailed background information.

Funding of the PBGS

The number of DPs supporting PBGS approaches has increased over time in many countries. However, two countries (Kenya and East Timor) now use funding solely from governmental sources (although part of this may, of course, be indirectly sourced by general budget support to the countries in question). In Uganda, DPs provided significant financial support to the PBGS grant facility until 2007, after which the government provided full funding with its own budgetary resources[78]. From FY 2008/09, however, a DP basket-funding arrangement provides top-ups to the grants (adding about 10% to the development grants). Most other countries have combined funding from government and DPs. In some cases the government's contribution is 30% to 50% or higher (e.g. Ghana, Bangladesh, Bhutan and the Solomon Islands), but support from DPs in other countries (Tanzania, Laos, Pakistan and Indonesia) constitutes the lion's share of PBGS funding. Based on encouraging results, many programmes have been extended, but it remains to be seen whether subsequent phases will

77 This is true even if the costs are not related to the size of the grants, but rather to the number of LGs to be assessed, the complexity of the system and the geographical challenges.

78 DPs continued to support some related activities such as the annual assessments, development of guidelines, etc. through a basket-fund arrangement.

involve a larger government contribution, particularly in cases where support from DPs is moving from project/programme support to various forms of budget support.

There has already been (or there is planned) an increase in the government contribution in several countries (e.g. Ghana, Bangladesh and Nepal). The box below provides an example of a co-funding arrangement between government and the DPs.

Box 12: Ghana – Support to the District Development Facility (DDF) – (as of 2008)

Ghana was amongst the first developing countries to introduce (in 1994) a system of genuinely non-sectoral, discretionary, formula-based development grants – the District Assemblies Common Fund (DACF). However, various rules/regulations and weaknesses in the DACF system and its procedures limit the possibilities for making this grant system performance-based, at least in the short term. At the same time, and until recently, DP support to LGs has been fragmented, poorly coordinated and based largely on the funding of area-based programmes. Altogether, this pattern of financing LGs has provided them with very few incentives to improve their performance in core areas.

To rectify this, the Government of Ghana (GoG) and its development partners, following a series of intensive and detailed studies of LG financing and grants, have decided to establish a PBGS, the District Development Facility (DDF). The DDF is jointly funded by the government and the DPs – with GoG providing about USD 10.5 million a year (sourced from the DACF) and DPs providing about USD 14.5 million in 2008[79], with commitments to increase their contribution over time. A letter of Intent has been signed by the contributing DPs and GoG regarding levels of funding, fund-flow arrangements and modalities for planning, budgeting, reporting and accounting for the funds.

The first assessment of the districts was completed in June 2008 by out-sourced consultancy teams, and the funds are expected to flow in 2009.

As of September 2008 the name of the fund has been changed to "Facility" and additional DP funding has been mobilised.

Links to the Budget System and Cycle

The assessments in most countries are conducted so as to fit into the budget cycles of the central and local governments. Assessments typically examine the past fiscal year's performance (Year N-1) and its potential impact on the coming fiscal year (Year N +1). However, there are delays in many countries (e.g. Ghana, Uganda, Tanzania, the Solomon Islands and Nepal), often attributed to "teething problems". Whatever the cause, delays are problematic in terms of LG planning and budgeting, predictability and transparency. In many places, therefore, governments and programmes have tried hard to improve on the timing.

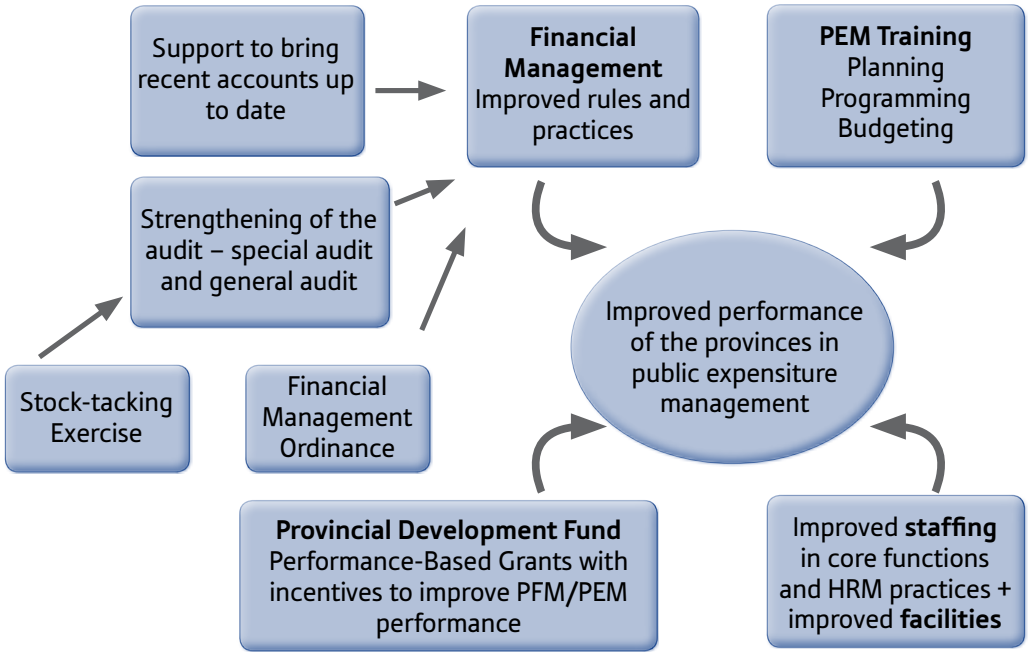
Support to Systemic Reforms

In 13 of the 15 examined countries, PBGSs include an element of support to the wider decentralisation reform process (e.g. support for drafting improved budget and procurement guidelines, support for reform of the overall intergovernmental fiscal framework, refining PFM procedures, annual reviews of decentralisation, support for policy development and

79 Figures as of September 2008 and some changes have taken place since design.

coordination, etc.). In the remaining two countries (the Philippines and Laos), the system is intended to underpin reforms in the overall grant system. Grant systems have been a good vehicle for the promotion of other decentralisation reforms (see Chapter 4). The Solomon Islands is a good example. There, the PBGS, named the Provincial Capacity Development Fund (PCDF), is part of a larger capacity-development effort that impacts the entire public financial management cycle (see Figure 9 below). The system has had a significant impact on the PFM performance of the provinces, just two years after its introduction[80].

Figure 9: The Solomon Islands: the PBGS as Part of a Larger PEM/PFM Reform



Source: Programme Document of the Provincial Government Strengthening Programme (PGSP) in the Solomon Islands.

Coordination of Government and DPs in Support of the System

PBGSs have had a positive impact on overall coordination between governments and DPs, spearheading coherent joint funding arrangements and a movement toward budget support in most countries (e.g. Uganda, Mali, Tanzania, Bangladesh, Nepal, Bhutan and the Solomon Islands). In other countries (e.g. the Philippines), where the systems are planned, this is one of the intended objectives.

In 12 of the 15 countries, the PBGSs are funded (or will be) by more than one development partner. The grant system has often been the first area of collaboration and use of basket-funding arrangements. This has subsequently spilled over into other areas, such as capacity building and coordination of other systemic reforms.

80 Annual Assessments of the provincial governments' performance.

There has been an increasing tendency toward budget support in some countries. This is best exemplified by Uganda, where PBGS funding has moved from project support to programme support financed by five development partners, and then to a system where the grants are funded entirely by the Government of Uganda (and indirectly and partly financed by general budget Support). This has been complemented by joint basket-funding arrangements in related areas (such as training, development of guidelines, CB support, etc.) through annual support to a Local Government Sector Investment Plan (LGSIP) comprising a SWAp-like arrangement with a sector strategy, a longer-term comprehensive investment plan (2006–2016), annual work-plans/budgets and annual reviews. Since FY 2008/09, the DPs, through the joint support arrangement (LGSIP), contribute part of their basket funds to the topping-up of the PBGS – the local development grant scheme.

The figure below shows the case of Bhutan with the newly designed on-budget funding arrangements (DP funding will be routed through the government's Treasury). Similar approaches have been adopted or are under development in other countries (e.g. in Nepal, see figure 11).

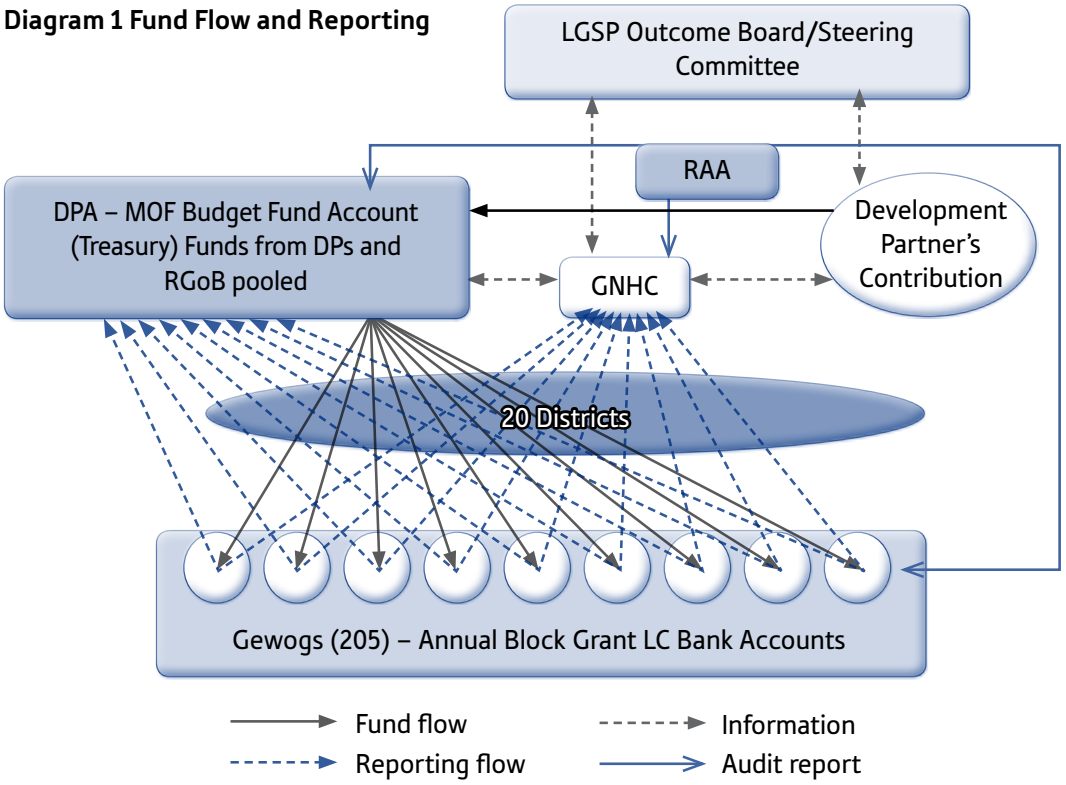
In Bhutan, the DPs (initially UNCDF and Danida) will contribute to the annual capital grant facility to Gewogs by transferring funds through the Gross National Happiness Commission (GNHC) to the Budget Fund Account (BFA) of the Royal Government of Bhutan (RGoB), maintained by the Ministry of Finance. The funds are then to be disbursed by the Ministry of Finance directly to the Gewogs in a timely and predictable manner. The total contribution from the DPs to the annual block-grant facility is expected to be a minimum of USD 1.1 million annually over four years, starting in FY 2009/10. DP funds are expected to constitute roughly 10% of the total funding pool available for Gewogs, with 90% coming from RGoB[81]. The funding from the DPs and the RGoB will be combined and transferred to the Gewogs as one sum, not in parallel transfers. From 2010, it is expected that Danida will provide additional funds (USD 1.9 million to 2 million per year) to the PBGS from its Sustainable Environment Support Programme.

The actual size of the transfers to each Gewog will depend on the allocation formula and compliance with the defined minimum access conditions.

81 If the Government of Bhutan's allocation to the Dzhongkhag level is considered, the DP contribution will be less than 5% of the total funds for capital investments.

Figure 10: Funding Flow and Coordination in Bhutan – Local Governance Support Programme (LGSP) – 2008

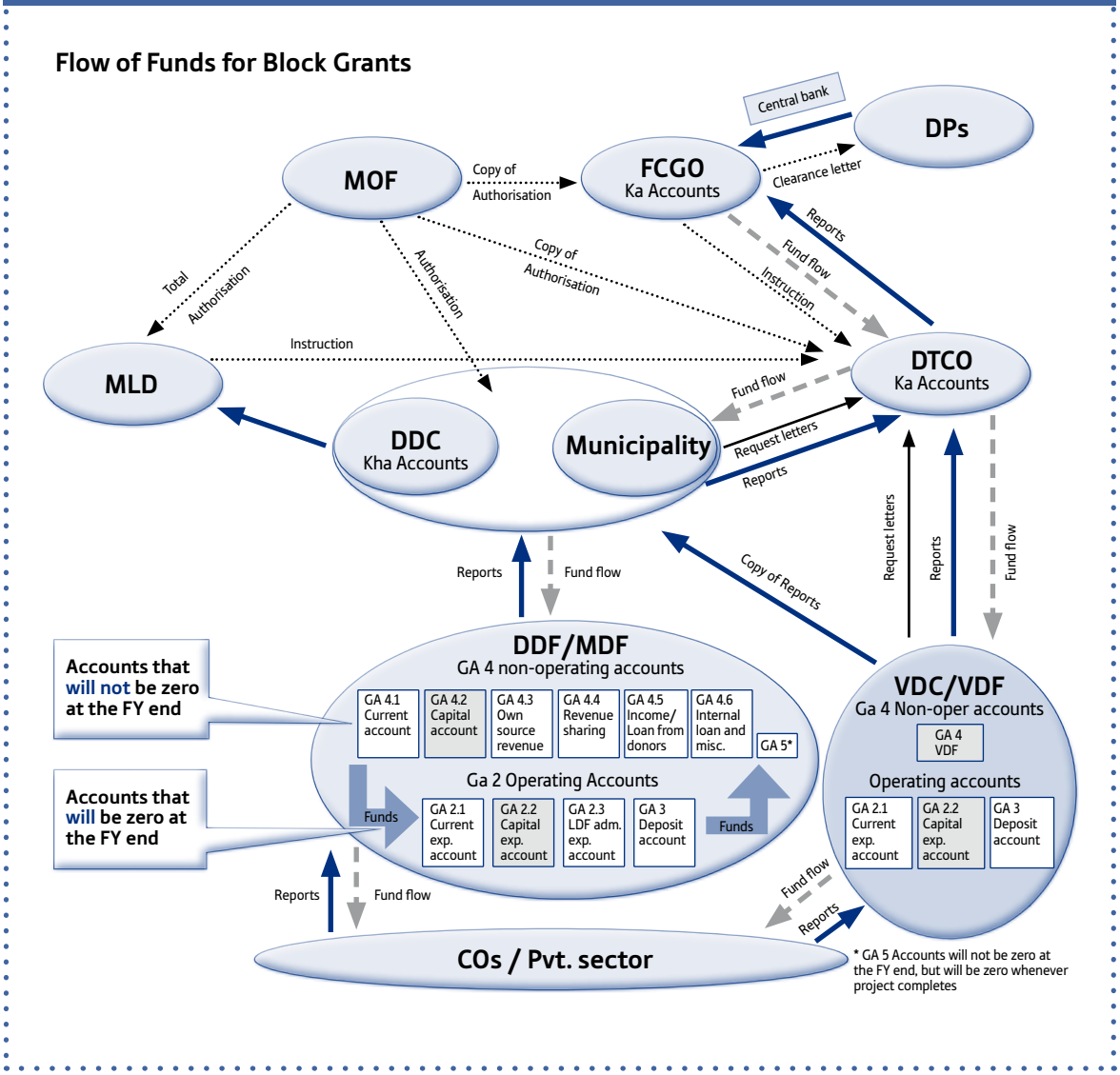
Diagram 1 Fund Flow and Reporting



Source: Royal Government of Bhutan: *"Local Governance Support Programme – Joint Programme Document"*, May 2008.

In Nepal, a Joint Financing Agreement has recently been signed (September 2009) between a number of development partners (ADB, Danida, Norad) and the government, regulating the funding of the future PBGS. Other DPs are expected to sign the JFA soon. Other DPs – UNCDF, UNDP and others – are supporting the system through targeted CB and technical assistance within the framework of the joint Local Governance and Community Development Programme (LGCDP). For FY 2009/10, this will mean that the funding from the government for the DDC part of the PBGS will be NRS 770 million, and from the DPs NRS 855 million. For the VDCs, the government will contribute NRs 6.26 billion for capital grants (entitlement) and the DPs NRs 1.2 billion, which will be allocated to VDCs based on compliance with a number of minimum conditions. The funding flow is shown below, but will be adjusted over time to ensure a direct flow of funds from the Treasury (DTCO) to the VDCs when sufficient capacity has been built up.

Figure 11: Flow of Funds in the LGCDP in Nepal – Performance-Based Grants



Source: Technical Note on Input to the Strategy for Topping-Up of Capital Grants to Local Bodies – the "Expanded Block Grants" (EBG) in Nepal, July 2008 by Jesper Steffensen and Bandhu Ranjab, based on information from the FCGO (as of 2008, see below). CO: Community organisations, FCGO: Financial Comptroller General's Office; DDF: District Development Fund; DTCO: District Treasurer Controller Office, MLD: Ministry of Local Development, MoF: Ministry of Finance; VDF: Village Development Fund, Pvt: Private. GA and KA = various types of accounts.

In Tanzania and Uganda, the initial design of the PBGS led to a quick scaling up of support to a comprehensive and coherent country-wide system, bringing together a number of DPs that previously used fragmented, area-based approaches for providing support to districts.

4. Lessons Learned – Achievements and Challenges

4.1 Lessons learned – Introduction

Within a relatively short period of time, performance-based funding has provided LGs with remarkably strong incentives to comply with statutory requirements and to improve their performance in core functional areas. Most systems have only recently been introduced and will require time before their full impact is evident. Nonetheless, the key lesson learned from the piloting, replication and roll-out of PBGSs in a range of African and Asian countries has been that these systems have a high potential for promoting performance and strengthening the capacity of LGs in key areas.

In the various countries, the PBGSs notably address the pressing need to develop systems and incentives to strengthen accountability, especially with regard to interactions and control in the relationships between LG councillors, LG administration and citizens. PBGSs have had a significant impact on local PFM and accountability performance, as documented in formal evaluation reports, informal consultancy reports, studies and interviews[82]. Although a larger scientific cross-country quantitative impact evaluation has yet to be undertaken, there is sufficient evidence to suggest that the PBGSs so far implemented have generated promising results.

However, there are also a number of challenges and constraints in the design and implementation of PBGSs which need to be addressed in any country if the approach is to deliver on its full potential. Many of these are related to institutional weaknesses and gaps in PBGS implementation arrangements.

Below is an overview of some of the core achievements (4.2) and challenges (4.3).

4.2 Achievements and Benefits

Impact on General Institutional and Administrative Performance

PBGSs appear to have been most successful in the areas of improved legal compliance, performance in LG core administrative functions (such as meeting culture and documentation), planning and PFM and other areas of good governance[83]. Where reviews, evaluations, value-for-money audits and beneficiary studies have been conducted, and documented in the large number of synthesis reports of annual LG performance assessments (e.g. in Uganda, Tanzania, Nepal, the Solomon Islands and Bangladesh), it is clear that PBGSs have had a significant impact.

82 The experiences in this section are documented in various reviews, e.g. in: 1) Shotton Roger, ed. (1999); 2) Steffensen, Land & Ssewankambo (2002); 3) Ministry of Finance, Uganda (2001); 4) Olaa (2003); 5) Shotton, ed. (2004); 6) Steffensen & Tidemand (August 2004); 7) Annual LATF Reports from the Ministry of Local Government, Republic of Kenya;. 8) Shotton & Winter, eds. (2006); 9) K2 (2005); 10) Gardener et al. (2003, B); 11) Stanley et al. (2006); 12) (BGD/97/CO1), 2003; 13) Tidemand, Steffensen, Pyndt et al. (December 2003: Volume II); 14) PMO-RALG (April 2008); 15) DEGE Consult, NCG et al (February 2008); 16) Nelson (2006), 17 UBOS, (2007), 18) MoLG (2007) and 19) the World Bank (2008) and Steffensen & Chapagain (2010). The statement is also based on reviews of numerous national assessment reports from the various countries and interviews with key stakeholders.

83 See the footnote above and the annual synthesis reports from assessments in Uganda, Tanzania and Nepal.

Despite the difficult situation in Nepal during the insurgency, annual assessments in the 20 pilot District Development Committees (DDCs) covered by the Decentralized Financing and Development Programme (DFDP) show that DDCs improved their planning, budgeting and financial management performance significantly between 2004 and 2006[84]. During the expanded pilot assessment of 55 districts in 2007, only 28 were able to demonstrate compliance with all the MCs. Of these, 18 were DDCs covered by DFDP. One year later, in 2008, 47 districts were able to comply. In 2009, 67 of the 75 districts passed the MCs and will gain full access to their performance-based capital grants. The assessment indicated that there had been significant improvements in DDC performance in all areas of PFM[85].

When the system was rolled out in Uganda, as well as in other countries, there were numerous problems associated with local government performance, *inter alia*:

- inadequate legal compliance;
- very weak PFM systems (many districts did not produce annual plans/budgets and accounts, documentation and accountability were very unsatisfactory; internal audit functions were not established or effective; the management culture was poor, with limited meetings, consultations and coordination; and there was very little attention paid to cross-cutting issues such as gender, environment and HIV/AIDS);
- The traditional CB support was akin to "spoon feeding", with a high level of control and central management, whereas the PBGS approach reviewed the LGs as "adults", which had to be held accountable and seen as responsible, but also provided with sufficient support.

Prior to the introduction of the PBGS in Uganda, CB and other programmes aimed at strengthening LG performance appear to have had little impact on core PFM areas. LG capacity building was largely uncoordinated, poorly targeted, and appeared to have had surprisingly limited impact[86]. As an example, when the system was introduced nation-wide in 2000/01 (through LGDP I) only 25% of LGs produced final accounts. In 2007, when the programme ended, all districts produced accounts, 97% of them on time[87]. The box below looks at the impact of the Ugandan PBGS based on a review of the annual assessments up to the end of 2007.

Box 13: Experience from Uganda – Impact of the PBGS on PFM

In the areas of *budgeting and financial management*, the performance of LGs has improved significantly over the past 10 years, particularly in the period from 1999–2002, although there are still challenges in procurement, cash management and commitment control[88]. Budgeting has become more realistic, though with room for improvement[89]. Nearly all LGs are now able to submit final accounts on time, audit performance has improved, internal audit units and LG accounts committees have been established, and the capacity at all LG tiers in financial management greatly improved from 2000 to 2007.

- Status as of 2007:
- 97% of districts prepared final draft accounts on time and submitted them to OAG

Continues...

84 See LDTA (June 2007).

85 Presentation from MLD, Mr. K.L. Devkota, slides of September 2009.

86 E.g. after many years of substantial levels of donor support to Rakai District, the District was unable to comply with the MCs in the first annual assessment. See Nelson (2006).

87 See Nelson (2006) and Ministry of Local Government: Synthesis Reports 2004, 2005, 2006, 2007.

88 See World Bank (2003), p 56 and Steffensen et al, (2001). Williamson et al (2005):

89 MoLG, (2007): "Technical and Value for Money Audit of LGDP Supported Districts, Final Synthesis Report", 2007, p. 35.

Continued

- All districts but one have functioning internal audit units in place
- All districts but three have CB plans in place
- 95% of the LGs meet co-funding obligations
- Quality of the development plans was improved as the number of rewards to LGs increased from 51 in 2005 to 74 in 2007
- 93% of districts had top scores on accountability procedures
- 85% of districts had top scores on budget-allocation performance, i.e. they spent most of the development grants on core poverty-alleviation areas and very limited amounts on administration
- 97% of districts earned rewards in procurement
- 96% of districts earned rewards in gender mainstreaming
- 95% of districts earned rewards in council and committee operations
- A comprehensive beneficiary survey[90] showed that 63% of citizens thought LG performance had improved as a result of capacity building, that 75% of the citizens are pleased with the implementation of the LGDP, and that there has been an increasing level of participation in investment priorities over the past three to four years. Nine out of 10 LGs were satisfied with the use of the LGDP.

Trends:

- In 2006, 81% and 78% of districts and municipalities, respectively, met the minimum conditions (in terms of good quality plan, financial management as per statutory requirements, compliance with public procurement laws and ability to provide 10% co-funding) up from 59% and 69%, respectively, in 2003.
- In planning, the percentage of higher local governments (HLGs) which received a reward after national assessments increased from 9% in 2002 to 98% in 2006 (with relatively stable indicators for review over time)[91];
- Overall compliance with the legal framework increased from 29% in 2003 to 59% in 2006.
- The proportion of LGs with integrated CB plans increased from 39% in 2002 to 98% in 2006.
- There has been an improved degree of legal compliance. During the first year of the LGPD-I in 2000 only 12 out of 39 districts could comply with the MCs. In 2004, 42 HLGs out of 74 higher levels of LG (including urban authorities) could comply.
- The rewards in the area of legal compliance have increased from **2005**: 25, **2006**: 42 and **2007**: 55 districts out of 80 districts.

Source: *Annual synthesis reports from MoLG 2002, 2003, 2004, 2005, 2006 and 2007 and UBOS (2007)* and the World Bank Project Completion reports (2004 and 2008). The findings rely on a high level of objectivity in the national assessment. Although the assessment tool has been relatively stable in terms of indicators used, there is anecdotal evidence that some assessments of district performance could have benefited from stronger quality control. However, this is not expected to throw doubt on the major trends in the results. In 2007 the assessment manual was slightly modified to change one of the core MCs (now with a specific date for presenting the budget to the councils and new requirements linking budgets and plans with the budget framework paper) without prior notice to the districts. This led to a large number of districts (35 in 2008, compared to two on this indicator in 2007) failing to comply with the MCs. The Ministry therefore gave the districts a waiver for this MC in 2008 (MoLG, 2008), and the results cannot therefore be compared with 2007. Similar changes were introduced in the assessment conducted in 2008, published in 2009 (new requirements on cash-flow statements and changes in the duration of the development plan were introduced), and the results are therefore hard to compare with previous ones. Due to the introduction of new formulations of conditions (without prior notification of the LGs), the Ministry has made a number of ad-hoc waivers, and prolonged the grace period (up to four months), making the entire system less transparent.

90 See e.g. UBOS (2007, which is based on 1,485 households
UBOS, op. cit. (2007)

91 World Bank (2008): Implementation Completion and Results Report for the Second Local Development Project, June 10, 2008

The table below shows the development of performance in core PFM areas as documented in annual assessments conducted under the LGDP from 2002 to 2007. There are signs in recent assessments that this improvement of performance has not continued as expected and that some of the conditions required for an effective PBGS are no longer in place, such as an environment conducive to decentralisation reforms (LG taxes have been abolished, districts have been fragmented, with more than 20 new districts being established in the space of a few years), diminished robustness in the annual assessments of the MCs, and reduced levels of support to the implementation of the PBGS[92]. The overall intergovernmental fiscal framework in Uganda now appears to be much less conducive to improvements in LG performance than it was in the past, indicating the importance of not neglecting the overall environment for fiscal decentralisation[93].

Table 7: Trends in Ugandan LG Performance, from Annual Assessments

Timing of Assessment	July 2002	March 2004	March 2005	February 2006	January 2007
Number of HLGs in compliance with all MCs	21 out of 74 (28%)	42 of 74	47 of 74	56 of 74	76 of 97 (78%)
Rewards from performance measures	9 of 74	16 of 74	34 of 74	18 of 74	33 of 90
Overall sanction from performance measures due to poor performance	52 of 74 (70%)	22 of 74	14 of 74	40 of 74	26 of 81 (32 %)
No of HLGs which did not pass all MCs in Planning	37 of 74	14 of 74	15 of 74	7 of 74	9 of 97
Rolled development plans	66 of 74	71 of 74	73 of 74	74 of 74	97 of 97
Draft Final accounts not produced on time	2 of 74	8 of 74	5 of 74	1 of 74	4 of 97
Co-funding provided from HLGs (capacity in place)	28 of 74 HLGs met the MCs	58 of 74	64 of 74	65 of 74	90 of 97
CB plans developed	35 of 74		70 of 74	72 of 74	94 of 97
Comments from the assessment synthesis reports	Noted improvements from 2000/01 for all LGs in PFM	Noted improvements	Remarkable improvements over the years	Great improvement in the MCs but decline in the PMs. Problems were particularly within revenue mobilisation	The number of LGs passing the MCs has increased. Observed performance gaps in some of the HLGs requiring more backstopping support.

Source: Based on a review of the synthesis reports from the national assessments. Although there have been some relatively minor changes in the assessment manual, the overall consensus is that it is still possible to compare LG performance over time. The requirements in the MCs have been somewhat strengthened over time. (1) Assessment was carried out in 80 districts, including all the new ones.
HLG = Higher level of local governments
MCs = Minimum Conditions
PMs = Performance Measures

92 See e.g. Tidemand, Steffensen and Ssewankambo (2007) for a review of some of the overall framework conditions in the case of Uganda.

93 See Brook, Brumby, Mayes and Steffensen (2008) annexes on fiscal transfers.

Although factors other than the PBGS may have helped, the quantitative evidence from Uganda is backed up by the two mid-term reviews (MTRs) of LGDP-I[94] and LGDP-II, a number of value-for-money audits[95], and beneficiary assessments[96]. All reviews have concluded that the impact of the PBGS on LG performance has been significant, particularly from 2000–2005. The 2001 MTR[97] concluded that.

"The programme is highly and widely appreciated... the LGDP system has great potential for strengthening LGs and it has already had a significant impact on the LG institutional capacity, administration performance, legal compliance and accountability. The performance assessment and incentive system has been accepted and is appreciated by all levels of LGs and played an important role in areas such as improved planning and more involvement of all levels of LGs in priority making and implementation, better linkage to the citizens improved financial management, especially accounting, improved links, interaction and corporation between staff and politicians, improved ownership pf investments and increased involvement of private sectors".

These findings were confirmed in the 2005 MTR, which also concluded that:

"In summary, LGDP II has contributed significantly to increased service delivery. The project strategy has been successful and still seems to be relevant to continuing the decentralisation process in Uganda"[98]

The impact of the Ugandan PBGS on PFM improvements is also clearly documented in various field reviews and comparative studies[99]. However, as mentioned above, it has been a challenge to sustain and deepen these improvements in the context of a reform environment that has become less conducive to decentralization and where hands-on technical assistance to the PBGS has been scaled back[100].

Although the PBGS has been up and running for only a few years in *Tanzania*, similar results are documented in a recent review of the system there. In Tanzania, the introduction of the PBGS in 2004/05 took place in the light of a number of reviews showing that the previous methods of fund allocation and capacity building were inefficient[101]. Box 14 below summarises some of the outcomes of the PBGS in Tanzania.

94 Three independent review teams of LGDP-I came up with the same results: that the PBGS had a positive impact and that the programme was achieving its objectives.

95 MoLG (2007).

96 UBOS (2007)

97 Steffensen et al, (2002), Volume 1, p. Xii.

98 K2 (2005). Note that the strategy was to link the development grants with performance assessments and capacity-building grants.

99 See Steffensen, Tidemand & Ssewankambo et al (2004), Tidemand, Steffensen, Ssewankambo, Land et al (2007), MoLG (2007 and UBOS (2007).

100 The LGDP ended in 2007 and was succeeded by various types of CB support, although with less "hands-on" support to the implementation of the PBGS.

101 Numerous studies in recent years have highlighted problems with supply-driven CB support without proper linkages to funding flows, incentives and local needs. See, for example, evaluations of district support programmes in Tanzania, exemplified by: 1) ETC-EA, 2004 and 2) PO-RALG/RNE (2004) which documented that the CB support provided by donors in various district support programmes in Tanzania could have been more efficiently used had there been better integration with government systems and procedures, stronger linkages to incentives and investments, and if a more demand-driven approach had been pursued.

Box 14: Experience in Tanzania

The experience of the PBGS in Tanzania has shown:

- significant and consistent improvement in the number of LGAs complying with the MCs (from 53% in 2004 to 91% in 2007/08), i.e. increased adherence to policies and guidelines (see below)
- improvement in financial management as measured by (among other things) improvements in audit outcomes. Only four LGA audit reports expressed an adverse opinion in 2004/05, compared with 28 in 2002/03 and 20 in 2003/04
- all LGAs have approved Medium Term Expenditure Frameworks (MTEF), Development Plans and budgets by the time of the assessment, i.e. improved planning and participation
- increased adherence to procurement procedures and guidelines
- improved council processes – Finance and Planning Committees meetings and discussions of relevant issues

Results/Year	LGs Assessed	Qualified – LGs complying with the MCs
2004/05	47	25
2005/06	66	41
2006/07	121	84
2007/08	121	110
2009/10	132	129

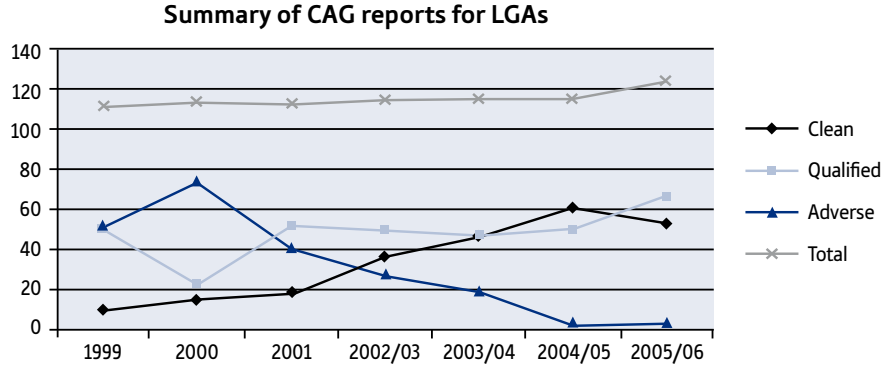
The following quotes from the assessment characterise the results:

- *"The assessment has put pressure on us. We have as a result improved record keeping, adhere to the procurement thresholds, the PMU has been constituted and trained, which was not the case before – Supplies Officer Kahama District Council"*
- *"The Assessment has improved transparency and accountability. The financial reports are now communicated – Legal Officer Tabora MC"*

Source: DEGE Consult, NCG et all: "Midterm Review of the Local Government Support Project (LGSP), Component 1&3", Final Report, (Tanzania), February 20, 2008 and the Prime Minister's Office – Regional Administration and Local Government: Synthesis Report FY 2009/10 – Annual Assessment of MC and PMs under the LGDG system for FY 2009/10 – National Synthesis Report, May 2009.

As graphically illustrated below, the outcomes of LG audits reports have also improved in Tanzania.

Figure 12: Audit Opinions for Local Government Authorities in Tanzania



Another review of the annual assessment system in Tanzania, carried out only a few years after the introduction of the PBGS, concluded that the system has improved council processes and strengthened interactions between councillors and staff in many places, by helping to stimulate council oversight of the performance of LG staff and promoting a stronger focus on performance by all concerned[102]. These improvements have continued, and the recent assessment for FY 2009/10 shows very impressive results within all areas of PFM and governance, and nearly 100% compliance with the MCs[103].

Similar PBGS outcomes are reported in other countries, such as Nepal, Mali, Bangladesh and the Solomon Islands.

In *Nepal*, the piloting of a PBGS since 2004 has generated very encouraging results, documented in the Final Review Report (2006), evaluations and the national assessments[104], in a large number of consultancy reports, PFM reviews, and in the latest assessment manual of the Ministry of Local Development (2008). The MC/PM indicators in Nepal, as in many other countries, are largely based on the statutory requirements of LGs. The PBGS has encouraged LGs to improve on compliance with these. It has also helped LGs to enhance efficiency, accountability and service-delivery capacity, and to better honour citizens' rights. The results of PM assessments in Nepal show that varying levels of fiscal endowment among LGs and varying levels of urbanization do not have a bearing on improvements in district performance. On the contrary, it has been more of a question of getting the incentives right. The PM assessments show that wealthier and fiscally better-off districts like Kaski, Rupandehi, Kailali and Dhanusha have performed below par in some years, while poorer districts, and even districts in the most conflict-prone areas, have sometimes managed very well. An analysis of the results since the start of the PBGS clearly shows that MCs and PMs are focused on management efficiency, transparency and accountability of DDCs – and that responding to such incentives is not dependent on the availability of revenues. Regular assessments of MCs and PMs and the allocation of grants based on those assessments have put pressure on DDCs to improve internal documentation, enhance management efficiency and strengthen monitoring of development projects. DDCs have become more aware of the importance of collecting and updating documents (minutes, receipts, files, etc.) required for the assessments. The majority of DDCs have started to organize internal staff meetings and to delegate responsibilities to each section to ensure compliance with assessment requirements. The system has encouraged a narrowing of the gap between senior and junior staff and promoted better cooperation across the sections within DDCs. Furthermore, the system has led directly to the establishment of internal audit functions in the districts and thus to a greater degree of financial accountability[105]. Finally, the PBGS has put pressure on the central government to ensure close monitoring of and feedback to LGs, to improve systems and procedures and to organise CB support. These findings are supported by the final evaluation of the PBGS (as piloted by DFDP), which concluded that:

"An effective fiscal transfer system has been established and is operational under the DFDP. There is a consistent accounting system across districts and internal auditors are in place. Use of block grant funding as an instrument to raise DDC performance, through Minimum Conditions & Performance Measures (MC/PM), has been effective. The block grant formulation does not apply to the VDC at this time. Though DFDP grant amount constitutes

102 PMO-RALG, 2008 (2008).

103 Prime Minister's Office (2009).

104 Stanley et al (2006), (Parajuli & Sharma, 2006); synthesis reports – national assessments (2005, 2006, 2007) and Assessment Manual, 2008.

105 See above and Ministry of Local Development, LBFC: Manual for Assessment of Minimum Conditions and Performance Measures for DDCs in Nepal, 2008

a relatively small share of District funding, the processes and procedures have been efficient, effective and instrumental in policy considerations for replication of the DFDP process nationwide, especially the MC/PM." (Stanley et all, Final Evaluation of the DFDP, 2006)

These findings are echoed in an unofficial internal review of Nepal's PFM performance, which concluded that:

"The experience of UNCDF's Decentralised Finance and Development Programme (DFDP) suggests that improvements in local government financial management and accountability are more likely to occur when a system of performance based incentives and penalties is used."[106]

A field review of three DDCs in September 2009 confirmed that the system was highly appreciated by all stakeholders at the local level – by politicians as well as officials from the administration. In Palpa District, for example, local politicians said: *"... we did not comply last year, but this year we managed to get our act together and strengthened PFM, including basic record keeping, and passed the test.*[107]. The district is now among the best-performing DDCs, earning 83 points out of a possible 100 and complying with all the MCs in FY 2008/09. In the previous fiscal year, the district's score was only 57. Similar findings were recorded in the review in June 2010, where field visits confirmed that the assessments are well appreciated and have a strong impact on the internal performance of DDCs and VDCs as well as the link between the administration and local politicians. [108]

In Bangladesh, the MTR[109] concluded that support from the project as well as the incentives provided by performance assessments and performance-based funding appear to improve union parishad (UP) performance, even in politically sensitive areas such as revenue collection (UP revenue mobilisation had increased by 42% in two years). UP accountability and transparency had increased considerably due to direct transfers of performance-based grants. Other benefits included (i) the regular opening of LG offices to the public; (ii) participatory planning, budgeting and implementation arrangements; (iii) higher levels of accountability; and (iv) greater efficiency in resource allocation reflected in lower unit costs (Gardener, 2003, p. 34).

Simply being aware that a system of PBGS will be introduced, with strong incentives to improve LG performance, has had an impact in countries such as the Solomon Islands. Until very recently in the Solomon Islands, for example, most provinces had a very poor track record and:

- had not produced final accounts for decades;
- had not submitted reports for use of funds and grants transferred from the central government;
- had not updated their books of accounts;
- had not made any bank reconciliations;
- had not provided any kind of information to citizens and/or central government on performance of the provinces;
- were poorly and under-staffed;
- were generally unaware of the provisions of the Provincial Financial Management Ordinance (FMO);
- lacked clear management arrangements for accounting tasks;
- suffered from a lack of confidence and low morale amongst their treasury staff.

106 FRA Stocktaking exercise, Draft, DFID, p. 10.

107 Steffensen and Devkota (2009).

108 Steffensen and Chapagain (2010)

109 Gardener, 2003 (B).

In addition to these major weaknesses, there was insufficient supervision by the Ministry of Provincial Government and Regional Development (MPGRD) to ensure that the FMO in full was being complied with, and there was a good deal of political interference in administrative and financial decision-making[110].

The Solomon Islands' new PBGS, the Provincial Capacity Development Fund (PCDF), under which provinces have clear MCs for access to grants (combined with a strengthening in audit functions and CB support), has provided significant incentives for improvement. The results have been encouraging: Seven of the nine provinces were able to comply with the demanding MCs defined in the PCDF operational manual (see Annex 2) and all nine complied in the 2009 assessment. Provinces have worked with auditors and external accountants to clear up financial-management backlogs, have updated financial-management ordinances (regulations) as per central requirements, and have drafted annual plans and more detailed work-plans to an extent never seen before – mostly initiatives taken prior to the flow of funds but prompted by the conditions clearly communicated by the new programme. The assessments compared to the baseline show a significant improvement in all areas of planning and PFM.

As described in Annexes 2.1 through 2.3, other countries have experienced similar improvements, although the point of departure has usually been different than the one in the Solomon Islands, which conducted a big clean-up exercise prior to the first assessment. In Ghana, some LGs which did not comply with the MCs in the first DDF assessment have committed themselves to doing everything possible to improve their performance and to ensure compliance in the next round of assessments[111].

The impact has been particularly positive when the PBGS has been combined with a high level of transparency, information sharing, public disclosure of assessment results, open discussions and involvement of all stakeholders in design, implementation with a highly credible external assessment (see Section 4.2), and clear procedures for decision-making.

Impact on Accountability and Transparency

In most of the countries where PBGSs have operated for some years, they have helped create an environment conducive to dialogue on the performance of LGs, promoted healthy competition among LGs, stimulated discussions on ways to improve LG performance, and served as a tool for improved dialogue between citizens and LGs on how best to address local challenges (see Annexes 2.1–2.3)[112].

A range of requirements and incentives embedded in PBGSs contribute toward achieving a positive impact on accountability and transparency. Examples of these requirements and incentives include:

- providing information to citizens on issues of importance for local development in the initial stage of the programme (e.g. Kenya);
- involving citizens in planning and budgeting processes (e.g. Sierra Leone);
- publishing financial information on transfers, budgets, accounts, audit reports, etc. (e.g. Pakistan and Uganda);
- establishing coordination and decision-making bodies, project-implementation committees, etc., with involvement of citizens (e.g. Bangladesh and Nepal);

110 PFMIP Provincial Financial Stock Take Report, 2007. An estimated 14% of the funds were accounted for.

111 Joint GoG-DP assessment, March 2008.

112 See e.g. Steffensen, Land & Ssewankambo (2002). There has also been anecdotal evidence that, in some cases, poor performance in the annual assessment has impacted on the LG election results (e.g. in Uganda).

- ensuring that LG meetings are open to the public (e.g. budget meetings in Bangladesh and Uganda);
- involving citizens and citizen groups in project implementation and monitoring/ follow-up (Bangladesh, Nepal and Uganda);
- rewarding innovative instruments such as social audit, establishment of resource/ information centres, citizens' charters, user surveys and scorecards and "one-stop shops" (e.g. Nepal);
- promoting involvement of women and disadvantaged groups in decision-making (e.g. Nepal and Bangladesh);
- promoting a focus on cross-cutting issues, such as environment and HIV/AIDS (e.g. Tanzania and Uganda);
- promoting the capacity of citizens (and representative groups) and the private sector to interact with LGs (Uganda and, in the future, Nepal).

These are all initiatives which have promoted downward accountability and transparency. Where reviews have been conducted, they have generally been positive[113]. However, despite evidence from numerous reviews, field reports and the like, the impact is often hard to quantify, attribute and isolate. Nevertheless, in Nepal, it is generally accepted that the PBGS has promoted the introduction of social audits, information centres for citizens, citizen charters and participatory planning processes[114]. In Bangladesh PBGS piloting has improved transparency, sharing of information and the establishment of planning and implementation committees of great importance for involving citizens in development projects[115]. In Uganda a larger beneficiary survey found that two-thirds of the communities believed that the PBGS has had a significant impact on the LG performance, and there was a strong belief that the LGDP had strengthened the involvement of citizens in LG matters[116].

PBGSs have also improved upward accountability (i.e. the relationship between CG and LG) as they have provided an objective basis for dialogue and helped identify areas of LG functioning and activity that require support from the centre (e.g. the Solomon Islands and East Timor). Horizontal accountability patterns have also been influenced in some countries, as LG politicians have become more aware of the need to improve performance and to ensure that an efficient LG administration is in place. In Tanzania, for example, the dialogue between elected politicians and LG staff has become more focused and target-oriented. The following quote from a recent review in Tanzania illustrates this well:

"Accountability of the use of LGA resources has improved significantly during the period of the LGSP/LGCDG (PBGS) implementation ... the incentives provided by the Annual Assessments where LGAs strive to meet minimum conditions to access to the grants, are considered to have been prime movers for these improvements.... The Annual Assessment system provides a common framework for monitoring LGA performance and capacities and gives LGAs incentives to adhere to rules and regulations as well as good governance."[117]

Finally, PBGSs are often combined with other innovative initiatives, such as the establishment of local project implementation committees to ensure operations and maintenance of the investments, various means for improved citizen participation, and involvement of the private sector in the production of services. However, more can be done to maximize the impact in terms of ensuring that indicators target specific needs for improvements in LG

113 See e.g. UBOS (2007)

114 Stanley (2006) op. cit. and annual assessment reports.

115 Garderner et all (2003, B).

116 UBOS (2007), p. 46.

117 Dege, NCG et al (2008), p. ii.

performance, that assessments are conducted transparently and that results are better disseminated (see section 4.2).

Incentives to Improve LG Revenue Mobilisation

Setting the right incentives for LGs to collect taxes (and other own-source revenues) has been a major challenge[118]. This has been the case in East Africa – in countries such as Uganda, where (i) there have been large increases in the size of intergovernmental transfers in recent years[119]; (ii) the legal framework for LG tax assignments is often inappropriate; (iii) there is frequent political interference in LG tax collection; and (iii) taxes are being used as political tools in election campaigns. To address these issues, PBGSs in some countries have focused on the critical linkages between LG own-source revenue mobilisation and grant allocations, and they can be designed to incentivise the mobilisation of local revenue sources, enhancing sustainability. Although this can have an impact, experience shows that this initiative alone cannot ensure that local revenue potential is realised if the legal and political environment is not conducive.

To encourage own-source revenue mobilization, PBGSs have typically included three main measures:

1. LG co-funding obligations (5% to10%);
2. minimum conditions/and or performance measures to boost the LG revenue mobilization, e.g. indicators of increases in revenue mobilised and/or process indicators, such as the development of a revenue enhancement strategy/plan;
3. CB support to improve LG revenues.

In *Kenya*, for example, LGs are rewarded for preparing revenue-enhancement plans and debt-recovery strategies[120]. The focus on revenue enhancement and debt recovery, combined with adjustments to and improvements in tax legislation, seem to have generated some positive lessons. In *Uganda*, it has been deemed necessary to strengthen the tax-effort incentives embedded in the PBGS to halt the downward trend in LG revenue mobilisation. Thus, one particular MC – "no decrease in LG own-source revenues" – was put into place as a condition for access to development grants, but was later changed to a softer measure – " three-year local-government revenue enhancement plans" – due to changes in LG tax assignments that included abolition of a major LG tax (the graduated tax). In several other countries, tax effort is a performance measure intended to provide incentives for LGs to focus on own-source revenues and thus ensure sustainability and LG absorptive capacity.

Transfer systems with tax-effort criteria and performance measures for tax collection have provided some positive results in few countries, but the potential has not been fully realised. Decisions to abolish the most important local taxes in several countries and political interference in local tax collection have been more important factors and threaten the entire decentralisation process. It is therefore important that any incentives built into the PBGS are combined with reform measures to ensure a more conducive environment for LG taxation, and with considerations on how to ensure a poverty-sensitive and efficient framework for LG taxation. This requires well-planned reforms, an enabling legal framework

118 See Prud´Homme (2003) for a technical discussion of the issue.

119 Steffensen & Tidemand (2004) and Tidemand, Steffensen, Ssewankambo and Land (2007).

120 The ways in which large increases in the size of transfers to LGs act as a disincentive to own-source revenue mobilisation are discussed by Prud'Homme (2003) and have been documented in various studies undertaken in Uganda and Tanzania, e.g. Steffensen & Tidemand (2004).

for local taxation, capacity building of politicians and staff (especially tax collectors), and – last but not least – strong "moral" support from the highest political level.

Several countries (e.g. Uganda, Tanzania, Ghana and Nepal) have introduced guidelines, best practices and training sessions in LG revenue mobilisation, often as part of the entire PBGS support.

However, it is important to note that increased revenue mobilisation is not an objective *per se*. Tools and incentives should be introduced only when there is a large, untapped revenue mobilisation potential at the local level which can be utilised in a fair, efficient and poverty-sensitive manner to improve sustainability, participation and ownership in local activities. As mentioned in Section 2, Box 1, in some OECD countries, grant incentives are used to reduce the appetite of LG politicians for mobilising taxes – the political environment is clearly different in some of these countries.

Cross-Cutting Issues – Gender, Social Inclusion and Environment

Many countries have successfully experimented with the promotion of gender, social inclusion and a greater focus on disadvantaged groups in PBGSs. Indicators used in Uganda, Nepal and Bangladesh have ensured that LGs pay more attention to disadvantaged groups in all phases, from planning to project execution. Examples of good practices that have had an impact are:

- Gender issues and considerations are integrated into plans and budgets (Uganda and Tanzania);
- Indicators on a number of proposals are generated by women (e.g. Bangladesh);
- Projects target disadvantaged groups (e.g. Nepal);
- There are user committees and project implementation arrangements with strong representation of women (Bangladesh);
- Gender mainstreaming in human-resource management (Ghana, just started).

The environment is another important area often targeted by PBGS indicators. Robust indicators on the environment (e.g. integrated into the performance areas of planning and budgeting) have improved the quality of plans (e.g. in Uganda). The incentives provided by the indicators are often combined with environmental safeguards such as requirements on environmental screening, use of checklists, and standard formats. The PBGS in Nepal includes a comprehensive environmental screening tool to be applied by districts in appraising investments.

Impact on Capacity Building and Internal Learning

A PBGS – if properly designed and correctly implemented – can improve CB support in terms of the assessment of needs and targeting. It can also lead to the more effective utilisation of capacity-building support, moving toward a more demand-driven system, by providing LG with greater responsibilities for their own performance and stronger incentives to improve, resulting in more focus on performance and internal leaning. Some of the benefits of the PBGS approach have been:

- It links the needs assessment with the CB support;
- It provides stronger incentives to improve performance and to use CB resources efficiently;
- It combines support to systemic reforms – e.g. the regulatory framework – with organisational and institutional reforms;

- It focuses on improving the supply side (systems of provision of CB support) as well as identifying the demand side (LGs' need for CB support);
- It targets CB support to local needs;
- It ensures stronger local ownership of capacity development[121].

Although the capacity-building support provided by PBGSs has been greatly appreciated in all countries, the efficiency with which it has been used varies, depending on PBGS design, implementation and monitoring/oversight, amongst other factors. However, compared to previous systems of mandatory, standardized and supply-driven CB support, the PBGS approach to CB has yielded encouraging results in many countries. Where this approach has functioned best, it can strengthen LG incentives to utilise CB resources more efficiently and provide tangible results, particularly in areas such as financial management (planning, budgeting, procurement, etc.). Demand-driven CB and CB grants have enabled LGs (in countries like Uganda and Tanzania) to address individual weaknesses and gaps[122]. But such innovations have also underlined the need for strong support from the centre to ensure a national coordination framework for capacity building – including support for the development of training materials, quality assurance of trainers and the development of HR and personnel management functions in LGs. Reviews have shown that CB works best when there is adequate oversight and when it is fully linked to the assessment of LG performance[123]. In Uganda, linkages between the assessments and CB leave room for improvements: the CB unit in the Ministry of Local Government, for example, has not been sufficiently linked up with the inspection unit in charge of the assessments[124].

Experience has shown that CB should not be treated as peripheral to and "dis-connected"[125] from the investment operations (development grants), but as an important and integral component of the entire PBGS, linked directly with improvements in the main functions and capacities of LGs to fulfil their mandates and objectives. Ghana, which has recently adopted a PBGS approach, has put considerable emphasis on this linkage, with assessment results supposed to be used explicitly to develop both supply- and demand-driven CB plans for LGs. The same is expected to take place in Nepal, Bangladesh and the Philippines.

The CB components of PBGSs typically account for 10% to 20% of total funding. This investment is important not only for enhanced LG capacities but also as a matter of fairness, enabling weaker LGs to climb up the performance ladder and compete on equal terms with better-performing LGs. In several countries there has been debate as to whether CB support should focus on LGs that score poorly in annual performance assessments or whether it should be provided to all LGs. But to avoid negative incentives, to ensure that all have equal opportunities to improve, to ensure fairness and due to practical arrangements, most countries have decided to provide all LGs with access to CB resources, even those that have not complied with minimum conditions. In countries where CB grants have been provided to LGs, the allocation criteria have not included the actual performance of LGs. In addition, the CB grant systems have not allocated larger CB grants to poorer-performing LGs, in order to avoid perverse incentives: CB grants are greatly appreciated amongst staff, as they assist in institutional as well as *personal* development. If poorer-performing LGs were to receive larger CB grants, this might lead to strategic behaviour to get access to these (and thus

121 A recent review by the World Bank Institute documents these benefits in the Ugandan PBGS. See Nelson (June 2007).

122 See e.g. UBOS (2007) pp. 45–46

123 This, in itself, underlines the need for assessments to be (seen as) evidence-based, objective and accurate.

124 ETC-EA and Mentor (2006)

125 Land, Ssewankambo et al, (2004); World Bank/OED (2005) documents the weak focus on capacity building in most WB projects and the problem that CB support is often treated as an "add-on" to programme operations.

be perceived as a "reward" for poorer-performing LGs). Furthermore, CB is a permanent process, and no one can say they have no need for improvement.

Most countries that apply PBGs are in favour of a move toward including CB grants. However, only a few have introduced them so far, as they typically require LGs i) to use the assessment results to identify their priorities needs, ii) to draw up CB plans as a consequence, iii) to procure CB service providers, and iv) to monitor and ensure quality of the CB rendered and avoid misuse of funds. This, in itself, is a capacity issue. CB grants are therefore usually introduced with a combination of strong support to LG Human Resource units, supply-side coordination (Uganda) and demand-side assistance (e.g. in Ghana, where assessment teams assist LGs in identification of CB needs). However, where general capacity is low (e.g. where there are no HR functions in the LGs) more "guidance" and hands-on support is needed. Under such circumstances, it is also important to carefully design a menu for CB grants and to implement the system with adequate support, supervision and control[126]. Where capacity-building grants have been provided to LGs, they have often been combined with centrally managed "backstopping" support to enable LGs to improve their performance and respond to incentives. The requirements for LGs to get access to their CB grants have typically been much less stringent than those applicable for accessing the development grants – so as to ensure that as many LGs as possible can strengthen their performance (through capacity building) and thus qualify for entry into the PBGS development grant system.

One key question concerns the delivery CB services to the lowest level of LG – which, in many countries, consists of more than a thousand small units. To reach these, a regional "in-house" approach has been applied and tested in several countries in order to avoid the high costs of using specialised CB service providers. In this situation, staff and officials from higher-level LGs (regions or districts) or regionally based training institutions may take the lead. The use of trained and experienced practitioners as trainers for LGs has considerable potential. LG staff and councillors may actually prefer (and benefit greatly from) discussions of practical issues – and this is where experienced LG staff, as trainers, have advantages[127].

PBGS assessments have been very useful in identifying and benchmarking the stronger and weaker areas of LG performance. Synthesis reports, summarising assessment results in countries like Ghana, Tanzania, Uganda and Nepal, show the relative performance in various areas, types of LG, geographical areas, trends in performance over time, and other patterns. Thus, in the recent assessment in Ghana, for example, it was possible to identify four thematic areas where performance was particularly weak, namely i) the relationship between higher levels of local governments and substructures (worst); ii) fiscal capacity; iii) management and organisation; and iv) human-resource management. On the other hand, the performance of LGs was better in other areas, such as procurement[128]. This kind of information also enables the central government to intervene in areas where there is persistently poor performance.

To sum up: A PBGS can provide a valuable framework for the coordination of overall capacity building support for LGs, as it is based on standardised assessments (previously many LGs underwent several types of CB needs assessments), common standards, materials, systems for monitoring, and so forth. In many countries, effective coordination of local-government CB has emerged or is emerging as a positive by-product of the PBGS.

126 Pyndt & Steffensen (2005).

127 It is also a common practice in many European countries – see Pyndt & Steffensen (2005).

128 See MLGRD, (2009).

Impact on the Overall Reform Process and Coordination

As documented in an OECD review of decentralisation, government-DP and DP-DP coordination is crucial for effective support in the field of decentralisation and local capacity building[129]. Experience has underlined the need for coordination, especially in the design of joint programmes, such as those which provide LGs with development grants and/or capacity building[130].

However, achieving effective coordination is a challenge in most countries. Donor support in the field of decentralisation has often been moving in various directions, creating so-called "islands of development" without sufficient linkages to the overall country-development process. Frequently, coordination has been far from optimal –due partly to capacity shortages in key ministries, and partly to the often large number of DPs, each with its own modalities for donor support, not always synchronized, and with some DPs needing to show that their isolated inputs have provided tangible results. There are numerous examples of DPs funding area- based/LG programmes which are not integrated into the overall decentralisation process, which operate systems and procedures (for planning, budgeting, accounting, etc.) that are parallel to those used by central and local governments, and which are implemented in a policy and information vacuum[131]. This is, of course, a problem in all sectors – but is accentuated in the field of decentralisation, which is not a typical sector with a clearly defined set of stakeholders and objectives (and is thus infrequently the object of a SWAp).

DPs have often concentrated on a few LGs, sometimes disingenuously justified as "piloting", leaving all others without support. This has created severe inequality, a focus on supply-driven CB support (which may be insensitive to real needs) without linkages to incentives to improve performance, lack of institutionalisation and use of government systems, procedures and modalities (e.g. for transfer of funds to LGs), and programmes with contradictory objectives and undermining incentives[132]. These problems have resulted in very high transaction costs and inefficiency[133].

PBGSs have had a positive impact on coordination and coherence. Performance-based grant systems have proved useful starting points for this, with coordination then spilling over into other areas. In all countries, where PBGSs have been introduced, they have had or are expected to have a strong impact on the overall coordination of support for decentralisation reforms (see Annexes 2.1–2.3). They have often provided the traction needed for DPs to merge their support, to establish joint basket-funding arrangements and joint steering arrangements (with common plans, budgets, coordination and decision-making bodies, as well as M&E systems). The successful piloting of smaller PBGSs, the increasing focus on performance in many areas (see Chapter 1), the general push to mainstream and harmonise support as a follow-up on the Paris Declaration, and the possibility of "safeguarding" funds and introducing a gradual response (whereby funding is linked to performance), are amongst the reasons for this drive toward joint funding under the PBGSs[134].

In 12 of the 15 countries involved in this review, more than one DP supports or will support the grant system; and in two of the other countries (Kenya and East Timor), the systems are

129 OECD (2004)

130 OECD (2004: pages 22–24).

131 Shotton, ed., (1999: 77); OECD (2004); Dege & NCG (2006), Steffensen and Tidemand (2004) and ETC- EA (2004).

132 See e.g. 1) Tidemand, Steffensen, Pyndt et al. (PWC), December 2003: Vols 1–2; 2) Land, Ssewankambo et al. (2004 A & B); and 3) Steffensen, & Ssewankambo (November 2001).

133 IDD, Mokoro, NCG et al (2006), Annex 6.

134 Based on interviews with various development-partner representatives.

now fully funded by government budgets. In two of the countries – Bhutan and Uganda – more than 90% of the funds come from government budgets. A clear example of the move toward enhanced coordination of support for decentralisation is Tanzania. Only five years ago, Tanzania was characterised by a multitude of area-based programmes focusing on a few districts. Today, following a rapid process of harmonization and agreement between the government and the DPs, a large group of DPs now channels its support through a basket-funding arrangement (embedded in the government budget system). Another example is Uganda, where the PBGS-supported programme (LGDP) included significant support for formulation of a decentralisation strategy, the sector-investment plan, joint annual reviews of decentralisation and strengthening of DP-GoU relations in the decentralisation process[135]. A recent evaluation of this support shows that it has had a markedly positive impact on the DP-DP and DP-government coordination of the entire support to decentralisation[136]. In other countries new government-DP programmes (like LGCDP in Nepal and LGSP/LIC in Bangladesh) are building on previous experience in piloting PBGSs and leading to improvements in the coordination of and support to decentralisation reforms.

Some countries hope to move from the existing modality of programme support with basket-funding arrangements, toward budget support with "notionally earmarked" funding for decentralisation reform programmes – and there is little doubt that PBGSs have had an important role to play in this area[137].

Impact on Service Delivery

While it is relatively straightforward to document the impact of PBGS approaches on inputs and processes such as PFM and governance, it is harder to demonstrate their impact on service delivery. Many of PBGSs have been operational for only a few years. In addition, given that the funding of infrastructure and services is often channelled through a variety of mechanisms, it is not easy to isolate the impact that might be attributable to a PBGS (rather than other modalities). However, the evidence from various studies, beneficiary surveys and audits of PBGSs is generally promising[138].

Costs and Efficiency

Provided that the right incentives are in place, largely discretionary funding[139] for LGs has encouraged participation and the identification of local priorities, as well as strengthened the focus on investments in key poverty-alleviation areas such as feeder roads, education, health, water and sanitation.

The PBGSs have also led to an increase in the level of investments in small-scale infrastructure and service delivery, i.e. they have supported a move toward genuine devolution and local self-determination. An example of this is Uganda. From 2000–2007, some 8,204 and 12,790 projects, respectively, were completed using the local development grant under the two phases of LGDP. Most of these were in the education, roads and drainage, health and water/sanitation sectors. LGs have spent less than 3% of total discretionary development funds on administration, but around 40% on roads/drainage, about 23% on education, about 14% on water/sanitation and roughly 14% on health over the life of the two PBGSs (LGDP-I and LGDP-II). Tables 8.1 and 8.2 below provide detailed data on these LG investments and show that

135 Steffensen, 2009

136 Steffensen, 2009

137 See e.g. IDD, Mokoro, NCG et al, 2006, Annex 6. .

138 Gardener et all (2003), UBOS (2007), World Bank (2004), World Bank (2008), Dege, NCG et al (2007) and Steffensen (2009).

139 I.e. without any earmarking for specific sectors.

local governments, when provided with the right incentives, focus on the core service-delivery areas. The LGDP supported the piloting and establishment of a new performance-based grant system, which provided funding for investment in infrastructure in core LG service delivery areas in an increasingly cost-effective manner over time and relative to other grants. It has been one of the more important vehicles for promoting local planning and infrastructure delivery. The LGDP also provided a framework for donor financing of local investments, and donors moved away from area-based funding to the provision of sector-budget support via LGDP. LGDP contributed to the expansion of local infrastructure and service-delivery facilities. The system has been highly appreciated by all – from community groups, to officials at the LG and CG levels[140] – and has been incorporated into GoU funding arrangements under the MTEF.

Table 8.1: Uganda - Use of Funds Under LGDP-I (2000-2003)

Sector	No. of projects	% of total sample projects	Actual costs	% of total sample project costs	Average costs (UGSH per project)
Administration	117	1%	3,236,321,529	5%	27,660,868
Education	2,525	31%	14,715,183,740	23%	5,827,796
Health	832	10%	8,441,966,949	13%	10,146,595
Production	809	10%	3,150,550,664	5%	3,894,377
Roads and Drainage	2,081	25%	24,359,287,209	39%	11,705,568
Solid Waste	99	1%	696,371,107	1%	7,034,052
Water and Sanitation	1,741	21%	8,565,436,093	14%	4,919,837
Total	8,204	100%	63,165,177,290	100%	7,699,307

Source: World Bank Project Completion Report, 2004, p. 25. 1 USD = approx. 1900 UGSH.

Table 8.2: Uganda – Use of Funds Under LGDP-II (2003-2007)

Sector	No. of projects	% total sample projects	Actual costs	% of total sample project costs	Average costs (UGSH per project)
Administration	256	2%	3,291,919,431	3%	12,859,000
Education	3,445	27%	22,219,348,464	23%	6,449,738
Health	1,248	10%	13,892,024,525	15%	11,131,430
Production	1,593	12%	6,185,279,079	6%	3,882,787
Roads and Drainage	3,338	26%	37,155,051,192	39%	11,130,932
Solid Waste	140	1%	801,245,495	1%	5,723,182
Water and Sanitation	1,543	12%	7,688,782,046	8%	4,983,008
Sanitation	1,227	10%	4,308,919,316	5%	3,511,752
Total	12,790	100%	95,542,569,547	100%	7,470,099

Source: World Bank Project Completion Report, 2008, p. 24. 1 USD = approx. 1,900 UGSH.

A recent study concludes that there were two major positive effects on service delivery from the improvements in sector outputs delivered by LGDP[141]:

140 UBOS, 2007.

141 Steffensen, 2009

First, support from LGDP has had a direct impact on the expansion of service delivery at the LG level in sectors such as health, education, water and roads. This has improved the coverage of citizen needs for infrastructure and service facilities, and improved access to schools, health units and water points. LGDP contributed 36% of development transfers to local governments between 2000/01 and 2006/07. The majority of projects were satisfactorily implemented[142], and they were implemented with better value for money than were projects funded through other development grants. The value-for-money audits have clearly proved that the investments financed through the LGDP/PBGS modality are more cost-efficient than similar investments using more "traditional" grant instruments[143]. Only 7% of the LGDP projects were rated as poor value-for-money, and the vast majority were implemented with a high level of satisfaction[144].

Second, the contributions to improvements in institutional capacity have had effects not just on the Local Development Grant, which represented 5% to 10% of LG revenues, but also on the efficiency and effectiveness of all LG expenditures. This, in turn, has had a positive effect on local service delivery overall. Various reviews have documented a clear correlation between the enhanced capacity of the LGs in core generic areas such as planning, accounting and governance, and the actual efficiency of service delivery. Focusing on incentives to improve in areas such as PFM was thus seen as very appropriate[145].

The fact that central government has taken over the funding of the local development and capacity building grants means that these positive effects are likely to continue. However, the positive effects the LGDP has had on service-delivery outcomes could have been greater if more progress had been made to maximise spill-over effects to other sectors, through the application of LGDP procedures in other sectors. If more focus had been placed on the overall framework for financing local governments (including the implementation of the Fiscal Decentralisation Strategy in the country), and harmonising processes across sectors, the approaches spearheaded by LGDP could have had a greater positive effect on service-delivery quality as well[146].

In *other countries*, where LGs have been allowed to set their own priorities under the "guidance" of strong incentives, investment outcomes have been very similar to those in Uganda[147]. Table 9 below provides the sector-wise breakdown of PBGS-funded investments in Tanzania, which is clearly in line with the intended focus.

Table 9: Tanzania: Use of Funds Under LGSP-PBGS

Projects	Quantity – Number of projects	Amount (Tshs)	Budget Share
Education	N/A	37,593,327,792	43%
Health	N/A	10,670,244,784	12%
Water	N/A	7,041,824,863	8%
Roads	N/A	11,299,339,426	13%
Agriculture	N/A	3,604,769,069	4%
Others	N/A	17,580,504,175	20%
Total	**4,619**	**87,790,010,190**	**100%**

Source: Dege, NCG, et al, Midterm Review of the LGSP, Final Report page 39, February 2008.

142 See note 62.

143 World Bank, Project Completion Report, 2004, page 7, 12, 22.

144 World Bank, Project Completion Report, LGDP II, 2008, p. 6.

145 World Bank, Project Completion Report, 2004, pages. 7, 12 and 22.

146 Steffensen, Draft Report: Sector Budget Support in Practice, Second Draft, March 2009.

147 E.g. Bangladesh and Nepal.

A recent study of decentralisation in East Africa concluded that:

"*Performance Based Grant Systems have shown that if proper incentives are in place for LGs to improve performance, tight earmarking of development grants and central government micro-control, prior approval of plans and budgets etc. to address national priorities, may not be required, as LGs have proved to spend the discretionary development grants within the core national priority areas, but with increased flexibility and thereby expected efficiency gains".* [148]

Although there are only a few comprehensive surveys of unit costs and the efficiency of PBGS investments compared with other funding arrangements[149], there is anecdotal evidence and a number of studies which suggest that PBGS-funded projects[150] are often less costly due to a greater focus on LG performance, greater levels of LG ownership, better targeting of the investments to meet local priorities and greater participation of citizens in all project phases.

A thorough value-for-money survey in Uganda has shown that the unit costs for investments supported by the PBGSs were generally lower than the non-PBGS schemes (when the quality was approximately the same)[151]. Similar findings apply to Bangladesh and Nepal (see below).

Table 10: Cost Effectiveness Between LGDP-I and Non-LGDP-I Investments in Education

Classroom	Source of Financing	No. Districts	No. of classrooms	Actual total costs UGSH	Average costs UGSH	Index
Standard	LGDP	9	169	840,455,878	4,973,112	100%
Standard	Non-LGDP	13	2,6727	16,304,533,940	6,206,522	125%
Desks						
Standard	LGDP	13	40,971	1,990,576,445	48,585	100%
Standard	Non-LGDP	13	47,382	2,767,590,000	58,410	120%

Recent independent reviews of the Sirajganj model in Bangladesh have shown that – despite a generally unfavourable policy environment – LGs (union parishads) can be participatory, transparent and downwardly accountable if funds are provided with the right incentives, some procedural changes are made, and a grassroots-based participatory planning and monitoring system is adopted[152]. Reviews noted that (i) UPs can efficiently handle direct grants with participation of the community; (ii) direct grant projects are more durable and of higher quality; (iii) the effectiveness and efficiency of direct grants to UPs depends upon the extent and quality of participation and social monitoring of the project beneficiaries; and (iv) because of the technical assistance provided by the project, UPs tended to become more open, transparent and accountable under the grant system (see the box overleaf).

148 Dege/NCG/ETC-EA/Mentor, February 2007.

149 This is also often hard to determine as many projects are co-funded through various sources.

150 Steffensen (2002); MoLG (2007, B); Gardener 2003 (A) and (B) and Stanley et al (2006)

151 World Bank (2004), p. 12. The costs of the PBGS investments in e.g. Education – Classrooms – were 25 % lower than projects funded by traditional funding schemes.

152 Source: Government of the People's Republic of Bangladesh and UNCDF/UNDP: Local Governance Support Project – Learning and Innovation Component (LGSP-LIC), Final Document, 2007, p. 7–10.

Box 15: Bangladesh – Experience From the SLGDP Pilot of PBGS

According to reviews, the key benefits associated with the SLGDP pilot in Bangladesh can be attributed to its main innovatory processes:

a) Devolved performance-linked funding
b) Participatory planning
c) Infrastructure and service delivery
d) Enhanced accountability
e) Improved measures for central government oversight of UPs
f) Innovative procedures for enhancing women's participation

The following benefits of the devolved funding mechanism piloted by SLGDP – a performance-linked grant disbursed directly to UPs – have been documented:

- Greater budgetary certainty in the allocation of annual development grants as compared to routine ADP "block grants".
- Improved timing of grant disbursements, allowing UPs to engage in more rational planning and budgeting and more efficient fund utilization.
- Incentives for enhanced UP performance reflected in several basic indicators, including own-revenue assessment and collection, which increased over 200% in one year in a number of UPs within the pilot.

An impact study based on a sample comparison of culverts revealed the following benefits of the SLGDP's devolved funding and participatory planning innovations in relation to scheme implementation and operation:

- A substantial increase in the efficiency of infrastructure delivery: 10% to 15% lower cost estimates for SLGDP schemes relative to others implemented by Upazila functionaries on the basis of a standard schedule of costs; improved supervision of schemes during implementation resulting in greater adherence to established engineering/service standards; and 40% more value for money relative to similar non-SLGDP schemes.
- Twenty percent value addition to many SLGDP schemes through direct community contributions (cash or kind) as a result of increased community involvement in scheme identification, implementation and operation.
- Twenty percent to 80% lower maintenance and repair costs through greater durability of assets and other means of enhanced scheme sustainability.

Use of Block Grants by Union Parishads Participating in SLGDP

Under SLGDP, block grants are allocated for discretionary use by UPs to fund schemes identified and prioritized by the local planning process – provided that they fall within UPs' legal mandate. The sector breakdown of the 854 schemes funded in 2005 was as follows:

- Roads, paths, culverts & bridges 51%
- School facilities 15%
- Water supplies & sanitation 22%
- Market infrastructure & electricity 5%
- Skills training 7%

Sources: 1) Gardener, GHK (2003); 2) Government of the People's Republic of Bangladesh and UNCDF/UNDP: Local Governance Support Project – Learning and Innovation Component (LGSP-LIC), Final Document, p. 7–10, and GHK (2004).

Various evaluations from Nepal[153] also support the hypothesis that PBGS funding is an efficient way of providing resources to finance local infrastructure. Through a focus on good governance issues, procedures and systems for enhanced sustainability by promoting participatory processes, the involvement and establishment of user committees and high mobilization of co-funding, PBGS-funded projects in Nepal have tended to be more cost-efficient and sustainable. Research has shown that DFDP/PBGS-funded projects incur lower unit cost than investments financed in other ways, as described below:

Box 16: DFDP in Nepal

An independent review of the experience from DFDP in Nepal – a PBGS pilot covering 20 districts – concluded that:

"Thus, the DFDP projects tend to be genuinely needed by the users' community and local bodies own them. As a result, users and the local bodies tend to continue to maintain them even after the close of the external assistance"..... "From this perspective, the DFDP funded projects tend to be more sustainable compared to others."..." Both the DFDP and CSP have made provisions of signboard, project book, social audit, and Nepali cost estimates. These activities contribute to the promotion of transparency and accountability. High level of awareness found in the community about the DFDP projects testifies this. Unlike this, other implementing institutions such as KIRDARC and GON (Government of Nepal) line agencies do not follow any special mechanism for maintaining transparency. As a result, level of awareness is also low. This suggests that DFDP and CSP (community support programme) projects are more transparent compared to other projects. From the perspective of the external funding, DFDP projects are cost effective compared to projects implemented by other institutions. This is because, with about half of the total cost contributed by DFDP, and the other half of the resources are mobilized locally for achieving the targeted output. Further, in specific case also a DFDP project tends to be cost effective compared to others. DFDP requires that its infrastructure projects need to have operation and maintenance plans and provision for financing them prior to construction of the said infrastructure. DFDP followed decentralized planning process and transparency in project execution has contributed in enhancing community ownership toward the infrastructure developed. This has contributed toward efficient operation and timely maintenance of the infrastructure, which in turn has contributed in achieving overall sustainability of the project"

Source: Parajuli & Sharma (July 2006)

Despite this positive (albeit only anecdotal) evidence, this is clearly an area in need of further research and follow-up.

Sustainability of Investments in PBGS

As mentioned earlier, PBGSs have typically been applied to funding for capital investments aimed at improving levels of and increased efficiency in LG spending on infrastructure and service delivery. However, meeting the operational/maintenance costs of such local investments has been a great challenge in most developing countries, especially in cases where LG own-source revenues have declined.

153 See GHK (2004); Stanley et al. (2006) and Parajuli & Sharma (July 2006).

The PBGS approach has tried to address this challenge in the grant design in various ways, including:

i. In the determination of the size of the grants, ensuring they are commensurate with the LG tax and other revenue sources needed to cover O&M costs;
ii. Reviewing the absorptive capacity of LGs. This will depend on the vertical (how funds are allocated between tiers of LGs) and horizontal (how funds are allocated across the LGs within an LG tier) allocation criteria;
iii. Increasing the incentives in the MC/PM system for LGs to mobilise own- source revenues (Uganda, Tanzania, Kenya Nepal and Bangladesh). Such incentives range from awarding scores for increases in revenues from one year to another (Philippines), to awarding scores for "softer" instruments such as the drawing up of revenue-enhancement plans, debt-recovery plans, and the like (as in Kenya);
iv. Support from the central government to improve LG planning and budgeting procedures, including budgeting for maintenance (all countries); and
v. Through development of incentives for improved LG planning, budgeting and project implementation, rewarding LGs which take into account O&M issues e.g. in terms of explicitly planning and budgeting for O&M (e.g. Uganda, Tanzania and Nepal) and actual allocation of resources for O&M (e.g. Nepal);
vi. Through CB support in areas such as planning and budgeting to ensure that there is a stronger focus on sustainability.

A number of countries also allow LGs to spend a share of their grants on preparation, appraisal and monitoring of infrastructure projects (so-called investment servicing costs), with a focus on ensuring that user committees and project implementation/follow-up committees are in place for each scheme.

However, meeting O&M costs is an issue which remains to be fully addressed. Indeed, it may require more serious reforms of the overall framework for LG own- source revenues (such as adjustment of revenue assignments, strengthening of tax administration and the policy environment for taxation). In addition, further work needs to be done in many places on consolidating linkages between capital investments and recurrent budget.

4.3 Limitations and Challenges in the PBGS

Although PBGSs have had a positive impact on many areas, they face limitations and challenges that must be taken into account during their design and implementation.

Limitations in the Overall Focus of the PBGS – From Inputs to Outcomes

Ideally, it should be possible to tie the funding of LGs to their success in improving service delivery and in reducing poverty. Most systems influence this in a largely indirect manner, by providing incentives for improvements in the ways that LGs work and function. They also do so directly, by improving governance practices (e.g. enhanced participation, citizen involvement, etc.), often seen in themselves as important elements of poverty reduction[154]. But the fact remains that the PBGS model used to date does not directly link LG funding to service-delivery and poverty-reduction outcomes.

154 This section draws on Shotton & Winter (2006: 74).

However, it is often **neither** practical **nor** useful to attempt to institute direct links between measures of such outcomes/impacts and annual PBGS funding. Several reasons underlie this, *inter alia*:

- The *high costs* and complexity of undertaking regular annual surveys of outcome/impact indicators in every LG area and the wish to ensure that the assessments are kept simple and manageable;
- The *attribution problem* that would have to be addressed, since LGs can often legitimately claim that such outcomes derive partly from factors outside of their control and which may depend on the service-delivery performance of line ministries – it is nearly impossible to distinguish between these factors[155]. It may not, for example, be fair to sanction LGs for a low enrolment rate in schools (output) if the education sector is not fully devolved to LGs or for a low literacy rate (outcome) as factors other than LG activities/performance have an impact on this (typically the poverty level, distance to service facilities and economic potential of an area and/or historical/cultural reasons);
- The wish to ensure a high level of flexibility in the use of funds. As PBGSs are often applied to non-sectoral block grants, neighbouring LGs may use funds for quite a different mix of service expenditures[156], greatly complicating the comparison of the performance outcomes. It may also indirectly defeat the purpose, if outcome indicators are focusing on a few sectors (non-balanced), or it may be very hard to balance across the sectors in terms of scoring weights[157]. Giving all sectors equal weight would also be wrong, as all sectors should not have the same share of investments. Giving some sectors a higher weight could lead to bias toward these sectors, even in local areas where there is no need for this, e.g. agriculture interventions in urban areas.

The last point, especially, is the reason why non-sectoral block-grant funding within PBGSs has been more closely tied to performance measured against *process* indicators and *institutional* outputs (such as participatory planning and budgeting processes, revenue mobilisation and transparency and good governance in administration). This type of performance underlies all service delivery, is more easily measured, and can act as a proxy for performance outcomes (see Figure 4 in Section 2.6)[158].

For sectoral grants, the problems associated with sector-specific output indicators are somewhat reduced. Nonetheless, care must be exercised in ensuring that such indicators (i) measure what is wholly attributable to LG actions; (ii) are poverty sensitive; (iii) are not too complex and time-consuming to collect; and (iv) are fair. However, even in this area there are major challenges in defining specific and feasible indicators – an indicator such as the unit cost of classroom construction may be influenced by conditions in the environment, logistical conditions, economic and historical factors. It is perhaps a gradual process whereby the core processes – such as planning, PFM, interactions with citizens – are fixed as the first step in measuring progress toward effective decentralisation, and then gradually moving toward more output-based systems, particularly for sector funding schemes.

155 E.g. LGs in the Philippines have complained that the M&E system established should make it clearer which indicators relate to areas under their control (often more input-, process- and output-related) and which relate to areas outside of their control (often more outcome- and impact-related indicators).

156 This is actually also promoted by one of the objectives behind decentralisation, which is to ensure a close link between targeting of investments and local needs.

157 This has, for example, been a problem in the previous draft assessment manual for municipalities in Nepal. The proposed system would (as it was tested) provide incentives to municipalities to focus on a limited number of sectors, which may not necessarily be the most important ones for poverty reduction and addressing local needs.

158 One of the important findings in a value-for-money-audit in Uganda was that there was a direct link (correlation) between the LGs which have improved performance in institutional areas such as PFM and in their efficiency and effectiveness in service delivery, World Bank (2004), pp 7, 12 and 27.

Framework Conditions – LG Control and Attribution

A number of basic conditions should preferably be in place prior to introduction of a PBGS.

Peace, stability and poverty levels

LG reforms in general, but PBGS approaches in particular, are most efficiently implemented in contexts of peace and stability. PBGSs require a minimum LG capacity to respond to incentives, improve performance and reap the benefits of the system. Assessment teams also must be able to do their work. Extreme poverty levels and very weak capacity may also hinder introduction of PBGSs, but robust capacity-building support, especially for weaker LGs, can often (but not always) resolve this problem[159]. In cases where LGs are barely functioning, alternative means of service delivery may have to be implemented in the short term, whilst LG systems, procedures and genuine grant systems are developed[160]. Except for these extreme cases, experience has shown that even the poorest LGs can compete with better-off LGs in terms of institutional and organisational performance (e.g. in Nepal, Tanzania and Ghana). Indeed, in Ghana it was a big surprise that some rural districts could comply with the minimum conditions in the first assessments, whereas some very developed urban centres faced significant compliance problems.

As another pre-requisite, the assessment teams must also be able to operate in all LGs and to move freely[161]. Where conflict is geographically circumscribed, this may imply using a cautious step-by-step approach, gradually phasing in assessments and the overall approach to different parts of the country.

Staff and control of HR

Ideally, LGs should be in control of front-line service delivery and other staff in order to make them fully accountable for their performance (see figure 1). This will ensure that LGs can respond to the requirements in the system in an efficient and timely manner. It is harder to make service-delivery staff (e.g. health workers) accountable and control their performance if they refer to line ministries at the central level of government. However, experience (from Tanzania and Nepal) has shown that this condition need not be entirely fulfilled for the PBGS to work, as there are often other ways of influencing the performance of line department staff (e.g. through publication of the results of assessments in the local areas where staff actually live, review of the results by line ministries at the centre, influencing staff career patterns, etc.). Furthermore, many line department staff may wish to attract additional funds for their operations and may therefore respond to the incentives offered through a PBGS. However, where service-delivery personnel are only weakly accountable to LGs, the incentives provided by PBGSs may not be fully effective in improving performance.

Expenditure assignments

An unclear division of expenditure assignments between tiers of government will impact negatively on the PBGS, as well as on other grant systems, since it is hard to make LGs accountable for their performance in areas where responsibilities are not clearly defined. This is often compensated for by embedding a specific investment menu in PBGS design, but ideally work should be undertaken in many places to improve on the clarity with which

159 It has, for example, been difficult for some of the LGs in the northern part of Uganda to improve their performance due to armed conflict and severe insecurity.

160 For example, in some districts in the northern part of Uganda during the insurgency or in Sudan, where LGs were functioning in some, but not all, areas (see NCG assessment in 2005 for the World Bank).

161 In Uganda and Nepal some assessments have been incomplete (or delayed) in some years due to insurgency in certain districts.

expenditures are assigned. Similar problems arise in areas where there is no clear legal framework in core generic areas of planning, budgeting and financial management.

Revenue assignments and support to local revenue mobilisation

An appropriate system of LG revenue assignments is also important for the success of the PBGS, particularly to ensure that sufficient funds are available to cover operations and maintenance costs associated with capital investments. Some countries have introduced incentives for LGs to increase their own-source revenues, but at the same time have constrained their options for doing so by circumscribing LG revenue assignments (e.g. abolition of core LG taxes). Furthermore, there has often been political interference and a lack of central government administrative support to LGs in the field of local-revenue mobilisation. This has created severe problems in areas such as co-funding, the funding of O&M costs, etc., and impacted negatively on the sustainability of the entire LG funding system. A review of the political economy prior to launching of a PBGS should therefore be part of any design.

Limitation on the Size of Grants and Other Systems

The PBGSs are often introduced alongside other LG funding channels – and in some cases the various systems undermine each other. There are cases where LGs have been deprived of funding from the PBGS due to poor performance, but where other, more easily accessible funding flows have more than compensated for this. In Tanzania, for example, the central government initially continued to allocate non-PBGS funds to non-performing districts at levels which may have reduced the impact of the PBGS[162]. In cases where there are other sources of funding available to LGs, it may be necessary to ensure that PB grants are sufficiently large (relative to other grants) that they continue to provide incentives for improved LG performance. There has been a temptation in some countries to "compensate" non-performing LGs with various sources, e.g. new capacity-building funds. However, this is a risky road to take, as LGs may perceive such CB funds as very valuable for individuals, distorting the institutional incentives to improve performance. More hands-on support and supervision of the poorer-performing LGs would be a more sustainable alternative.

The development of fragmented, multiple, highly conditional and earmarked systems of sector-specific (or categorical) transfers could undermine incentives provided by PBGSs if the right balance is not achieved, i.e. if the funds allocated are too small to provide incentives and/or too small for meaningful planning, budgeting, project implementation to take place. The co-existence of off-budget funding flows, such as social funds, is a special concern since these alternative funding systems are particularly prone to undermining PBGS incentives[163]. As mentioned earlier, a recent review of the system in Nepal noted that these "extra" funds (which by-passed the MC/PM system) were of a significant size (nearly as large as the entire capital grant scheme), causing significant problems for planning and accounting and potentially undermining the entire incentive system[164]. When such funds by-pass the official LG system, but nonetheless finance mandatory LG functions/services, they can seriously compromise the importance of LG service delivery and – because citizens can count on other sources of funding – dilute the value of incentives (and pressure) to improve performance. These issues often hinge on political will from the government to

162 This was contrary to the GoT´s strategy of mainstreaming the PBGS into the overall IGFT system.

163 E.g. In 2002, NUSAF in Uganda provided funds to LGs to the tune of 3–4 USD per capita, compared to the PBGS (LGDP) scheme with an average of 1 USD in rural districts.

164 Steffensen and Devkota (2009).

make the overall system efficient, and can be partly addressed through better coordination among DPs rather than leaving each agency to support different systems and funding mechanisms.

Budget Cycle

In principle, PBGSs should be aligned with the central and LG budget cycle. However, they often are not, due to delays in the implementation of programmes, delays in performance assessments and a dearth of sufficient and timely data. In the worst-case scenario, weaknesses in PBGS implementation may themselves be factors behind the poor performance of LGs (e.g. poor and delayed planning, budgeting and implementation) if the indicative budget figures are announced too late by central government[165] or if funds are not allocated to LGs on time. This is often a problem in the initial years of PBGS implementation, when assessments are carried out for allocations in the current fiscal year, or when funds are transferred in the last months of a fiscal year. Fortunately, experience shows that such bottlenecks are usually resolved over time. In some cases, it may be necessary to postpone introduction of the system so that it can fit into the budget cycle from year one, and is thus better prepared at the local as well as central-government levels.

Stable Flow of Funds

In order to provide strong incentives, it is important that the PBGS ensures a stable and reliable flow of funds. As with other grant systems in developing countries, flows are not always reliable, creating implementation problems and pressures to relax assessments. Governments may run into funding gaps or liquidity problems, and DPs, in some cases, have been unable to make proper forecasts or honour long-term commitments. Such problems may lead to poor or rushed planning processes at the local level, delays in project implementation, inefficient spending and bottlenecks (given that delayed disbursements are often back to the central government at the end of the fiscal year).

Management Issues, Delays and Administrative Bottlenecks

Experience gained from PBGS piloting and implementation shows that there are numerous design and operational challenges, particularly in terms of:

i. identifying specific indicators for LG performance;
ii. designing institutional arrangements;
iii. ensuring adequate communication of the objectives behind the system;
iv. involving all key stakeholders in grant implementation;
v. ensuring a highly credible assessment process with firm decisions on the outcomes of the assessments;
vi. deciding on possibilities for QA of the assessment and options for redress;
vii. reporting and monitoring systems, etc.

These challenges, however, can be overcome with proper design and a careful strategy for roll-out, coupled with support to enhance the administrative capacity of core agencies. Although the administrative and transaction costs are somewhat higher than those of

165 In Tanzania, for example, there has been a tendency to wait for publication of final audit reports as indicators for LG performance, but this has delayed the announcement of indicative budget-allocation figures to LGs. In Ghana, this has been avoided by using results from earlier years, even if these do not fully reflect up-to-date data.

simpler grant schemes, they are outweighed by the significant benefits associated with PBGS approaches. Reviews in various countries (e.g. Tanzania and Uganda) have indicated that a more targeted focus on strengthening the institutional capacity of core institutions in charge of the system would have made the PBGS even more successful[166].

The major bottlenecks associated with PBGS implementation have often been:

i. incapacity among core ministries to support LGs and sometimes an under-estimation of what is needed to ensure effective and timely implementation;
ii. weaknesses in M&E systems (including reporting for the use of grants);
iii. insufficient capacity to organise and conduct timely assessments;
iv. procurement problems, especially with respect to contracting consultants to carry out the assessments and provide CB services;
v. lack of political will or capacity to maintain integrity in the system, and a tendency to make exemptions where tough decisions have to be made;
vi. insufficient information about assessment results and inadequate awareness raising/ communication initiatives.

The introduction of a PBGS may also run the risk of adding yet another M&E system, in addition to the existing ones, without thinking through possible linkages and cost implications. It is therefore important – to the extent possible – to use the information already available and to use PBGS assessment data to enrich other kinds of monitoring systems, ideally in an integrated manner.

To find the right balance between the wish to mainstream activities rapidly into existing structures and ensure government ownership on the one hand, and to ensure efficient, highly professional and timely implementation of the PBGS on the other hand, has been a major challenge in most countries. Stand-alone and costly project-management units have been difficult to mainstream. But the introduction of systems without sufficient project support (staff and facilities) to ensure effective management (sometimes due to a reluctance of countries to use external technical assistance and an exaggerated commitment to strengthen local ownership) has led to delays and problems in implementation.

Quality of the Assessment

Experience shows that the credibility of LG assessments is vital to the system's success. An impartial, *external,* highly professional and multi-disciplinary assessment is essential given that results impact directly on the transfer of fiscal resources to the LGs[167]. Because the poorest-performing LGs are likely to contest the legitimacy and results of the assessment process, it is important that the system is characterised by high levels of integrity and neutrality. Involvement of LG practitioners in the assessment (as team members)[168] may be a sensible option, as their participation ensures local knowledge, legitimacy and internal cross-LG learning. Participatory self-assessments may supplement the external assessment process, improving dialogue between LGs and their constituencies, but cannot be used as a stand-alone arrangement for deciding on grant allocations – external/neutral/third-party involvement in the assessments is absolutely crucial (see Annex 3 for further discussion of the various forms of assessments). Avoiding collusion between LGs and assessment teams

166 See Dege, NCG et al (2008). Similar issues have arisen in Bangladesh.

167 Documented from personal experience in Nepal, Bangladesh, Uganda, Tanzania and the Solomon Islands, and in discussions held during preparation of the LGDP-II in Uganda, the LGSP in Tanzania and the LGCDP in Nepal.

168 E.g. in Uganda and Tanzania, selected, highly qualified district staff participate in the assessment of other districts.

is a major challenge, and various tools have been applied in various countries – such as publication of results, quality assurance, selection of indicators which can easily be verified – but to reduce the risks to zero is typically not possible.

Nepal has recently adopted a quality-assurance strategy whereby a number of district (DDC) assessments will undergo review by another independent team of contracted consultants. A similar process will be applied to VDC assessments. The system will enable a reconciliation of assessment results, rely on final endorsements by a multi-stakeholder committee and ensure communication and dissemination of the results. Poor or biased assessments will be sanctioned, and teams which may have manipulated results will not be used in future assessments. Assessment teams and QA teams (which check the quality of the original assessment results) are to be contracted by the Local Bodies' Fiscal Commission, and the final endorsement committee will include representatives from all core agencies in this area, i.e. Ministry of Local Development, Ministry of Finance, National Planning Commission, Office of the Auditor General, Associations of Local Bodies and DP representatives.

In the Solomon Islands a similar type of committee – the Provincial Fiscal Grant Coordination Committee (PFGCC) – has worked well over the past year or so, and results are reporting to it and scrutinized. The committee includes representatives of core ministries, provincial governments and contributing DPs.

Institutional versus Individual Focus

The PBGS focuses on the institutional performance of LGs as corporate bodies. However, the performance of individuals is of equal importance. Establishing a clear link between these levels is likely to be a major challenge in many places. Only one country (Nepal) has introduced a direct linkage between annual PBGS assessments and personal remuneration, and the impact of this will be interesting to evaluate[169]. PBGSs, if they are to maximise their impact, should be supplemented by HR management reforms, pay reforms and other incentives, as well as the proper use of various management tools. There is a need for further studies and a better understanding of these important linkages.

Shift in Accountability

PBGSs are designed on the premise that financial/institutional incentives (rewards and/or sanctions) have an impact on performance, and that there is a minimum level of LG accountability – either downward (vis-à-vis the citizens) and/or upward (vis-à-vis the funding agencies) – for the instrument to improve upon. There is always a risk that rigid conditionalities will induce a shift away from local accountability toward focusing entirely on upward accountability and compliance with the central government's reporting requirements and targets, "ticking off requirements one by one". However, if properly designed, a PBGS can incorporate incentives for improved *downward accountability* – by measuring LG performance in terms of public disclosure of information (e.g. transfer figures, plans, budgets, accounts and audit reports), use of notice boards, use of social audits and support for establishment of user committees/project implementation units that involve citizens and promote development of the "demand side". This can provide LGs with incentives to open up for dialogue and may, over time, enhance citizen participation and downward accountability. The experience with citizen involvement in the LGDP and its refined performance measures on good governance, linked to the size of the transfers

169 Each well-performing district gets an amount – NRs 100,000 to NRs 150,000, depending on the score in the annual performance assessment – to be shared between district officials upon approval by the DDC (decision-making body of the district). The NRs 8 million set aside for this constitutes about 0.5% of the total allocations under the PBGS for DDCs in Nepal.

in Uganda, has been positive in this respect – but this is clearly an area in need of further studies and greater attention.

Central governments and DPs may consider moving away from the use of tight ex-ante controls over local government and toward playing a role of guidance and mentoring – ensuring an enabling environment for LGs, proper supervision and ex-post sanctioning, as well as providing LGs with real incentives to improve service delivery and governance. In severe cases, where LGs persistently fail to perform (assessment after assessment), a more hands-on approach (such as strong central backstopping support, monitoring and control) may be needed, in addition to the incentives and CB grants provided by the PBGS. In Tanzania, such a system **has** been introduced from 2009 whereby poorly performing LGs will be subject to more-intensive central-government supervision.

Political Will and Pressure to Ensure Implementation

All reform processes require political will and backing if they are to succeed – even more so when it comes to PBGSs, if only because tough decisions must be made and LG failure to perform can entail real sanctions. When LGs are sanctioned for poor performance they almost invariably pressure central government to have such decisions reversed. This has certainly been the case in the some of the countries that have piloted PBGSs.

Sometimes this pressure can lead to delays in the publishing of assessment results, back-peddling, demands for re-assessment and a weakening of minimum conditions. Examples include:

- the Solomon Islands, where representatives of the government insisted that some of the poorer-performing provinces be re-assessed and given a second chance/grace period;
- in Ghana, where there were initial concerns that many districts did not comply with the first assessment. However, it was eventually agreed that all LGs involved would receive a increased share of CB grant support to enable more districts to improve their performance and pass the "test" in the coming years[170];
- in Tanzania, where during the first years of PBGS implementation the government allocated non-PBGS resources to LGs which did not comply with the MCs;
- in Nepal, where the government (in 2005) was initially reluctant to publish the results of the assessment process. These results are now published widely, as this has proved to have a great impact on performance;
- In Nepal, where LGs which did not comply with the MCs in FY 2008/09 were "compensated" outside of the planned "design" with new CB funds. This was done to avoid criticism from non-compliant DDCs. In addition, the "entitlement" component has increased to 29% of the GoN's capital grants without a corresponding increase in the intensity with which non-compliant DDCs are supervised, mentored or monitored, despite the fact that they represent high fiduciary risks. Although the CB grants were of a relatively modest size compared to the development grants, they still risk undermining the incentives provided by the PBGS. From FY 2009/10, a genuine system of CB grants to all DDCs will be launched and the "compensation" system will be brought to end;
- In Uganda, where LGs were exempted from some of the results of the MCs in 2008 after their assessments[171]. These MCs were deemed too demanding and/or seen as having

170 There were also meetings with relevant members of Parliament to ensure a strong buy-in prior to introduction of the system, particularly those sitting on the committees responsible for LG issues.

171 Alternatively, the Manual could have been updated prior to the assessment to eliminate these problems.

been introduced without sufficient preparation, worsened by lack of timely information from the central government about budget ceilings for the coming FY. LGs have also been given a longer-than-normal grace period, leading to delays and less transparency in the overall system of assessment. In Uganda, there has also been a tendency to prolong grace periods, providing LGs with more time after assessments to prove compliance with the MCs. This creates a greater risk of data manipulation and less transparency in the entire process.

However, it is important that senior government officials and others take a firm stand on this and that politicians understand, appreciate and support the system, even in cases where tough decisions must be made. Moreover, experience from various countries shows that LGs which are sanctioned in one year may be amongst the best performers the following year, as they respond to incentives and tighten up management. Deviations from the "rules of the game", exemptions and special "considerations" for some LGs can seriously compromise the integrity of the best-designed PBGS. Exemptions are hard to control, establish unfortunate precedents, and may lead to slippage in the entire PBGS. Fortunately, albeit with some occasional exceptions, most countries have been able to maintain PBGS discipline and stick to the rules.

That said, there are circumstances under which it may be necessary to relax certain principles. In countries where PBGS conditionalities are expected to apply to all or most development grants, the strict application of MC compliance requirements might deprive some LGs of all funds in a given year – and this may seem excessively punitive. One way of getting round this is to ensure that all LGs, irrespective of their compliance with MCs, can access a minimum level of funding (set well below what they would receive if compliant) combined with more support and stricter controls. Tanzania has introduced such an approach from 2009, and has combined an "entitlement" allocation (25% of the formula-based allocation) with more stringent supervision and control of the poorest-performing districts. As mentioned earlier, this option (the "entitlement" approach) has been introduced in Nepal, but without provisions for stricter supervision, more support or greater control. The need to introduce such a system will also depend on the coverage of the PBGS – if the PBGS modalities cover all development grants, the argument for some basic entitlement will be stronger.

Another way of dealing with this problem is to link *levels* of LG funding with *degrees* of compliance with MCs. Thus, to access a lower grant threshold, an LG would be required to comply with a sub-set of MCs – but to access a higher grant threshold, it would need to comply with a larger set. This would ensure a minimum level of safeguards and performance, regardless of how small grants to LG are. LGs that access only the lower thresholds receive targeted CB and other support, and be subject to greater guidance and control from the centre, until they graduate to higher grant thresholds[172]. However, it's important when ensuring minimum funding levels not to undermine incentives or promote unacceptably high levels of fiduciary risk. This requires following up on very poorly performing LGs to ensure that they do not remain at this level.

Limitations in the Design of Specific Indicators and the Scoring System

The design of performance indicators and the scoring system is a special "science", and there are several pitfalls. Some of the most common have been:

172 From 2009, districts in Tanzania are getting 25% as an entitlement for non-sectoral grants and 50% for sector-capital grants, subject to this system.

- over-ambitious and/or ambiguous indicators (not defined clearly enough);
- use of Indicators which measure areas of performance not under LG control;
- overlapping, even contradictory indicators;
- lack of sufficient balance in the various indicators, or systems where all types of performance are treated as equally important when they are not;
- inclusion of indicators covering areas for which central government has *not* issued guidelines, regulations and information to LGs on how to comply with them and/or where CB support is weak. A PBGS can be used to spearhead a focus on new areas (such as the promotion of gender budgeting or environmental safeguards), but this must be accompanied by government initiatives in the legal and regulatory framework, guidance and CB support to LGs, to enable them to respond to these incentives;
- design of MCs, which should have been PMs, contrary to the principle that MCs should be in place only to provide basic minimum safeguards. This has led to frustration in some countries that LGs are denied access to grants despite absorptive capacity;
- lack of communication and awareness-raising about the measures;
- insufficient involvement of stakeholders, particularly LGs, in system design;
- attempts by some stakeholders to make the system overly complicated, or the risk that if all stakeholders insist on certain core, well-argued indicators, the overall system will gradually become unmanageable and too complex;
- excessively frequent changes of the system (e.g. the assessment tool), leading to a lack of coordinated oversight and compromising awareness of current procedures[173]

These pitfalls can be avoided with investments in proper design, wide-ranging consultations and support for implementation and monitoring.

It is also important to follow up on the extent to which indicators have an anti-poverty bias (thus reducing general funding for the poorer areas, which may actually be most in need of resources), and if so to correct the indicators or ensure special support either in the measurement system or by increasing the importance of any CB. In some cases, it may also be necessary to start with a significant CB effort and central government backstopping support (e.g. in PFM) for some time prior to the launching of a PBGS. This was done in the Solomon Islands, where some of the provinces were 15 years behind in the preparation of final accounts and basic bookkeeping. In other cases, it may be necessary to provide stronger backstopping support (and supervision) to special areas in a country – areas without sufficient capacity or which face special challenges. In Ethiopia it has been deemed necessary to have a longer period of support for the development of the legal framework, basic organisation structures and CB support for urban authorities (from 2002 to 2008), prior to the launching of the PBGS – the Urban Local Government Development Project – in 2008/09.[174]

LG Structures Must Be Conducive to Performance Incentives

Overall LG structure influences the efficacy of most intergovernmental fiscal transfers, but the PBGS may be particularly vulnerable for non-conducive changes. In the past couple of years, the fragmentation of districts in Uganda has without doubt put the capacity of the entire LG system under strain, reduced the funding and HR available in each LG, and created confusion and up-start challenges that have impeded response to performance

173 In some countries, this has led to confusion among some of the core stakeholders about the prevailing version of the manual, and differences have been observed e.g. between the English version and the language applied in the country. Manuals have been up-dated without formal review and endorsement.

174 World Bank (2008, C)

incentives. Very small, and in some cases non-sustainable LGs, have also created challenges for some PBGSs, particularly when expanding the system to the lowest level of LG. There is a clear limit to the complexity of PBGS in environments with numerous, small LGs with few functions and little staff (see below).

Calibrating PBGSs to LG Structures

The design of a PBGS must be aligned with the overall structure of LG system. Assessment in countries with several thousand small LGs, such as union parishads (UPs) in Bangladesh and Village Development Committees in Nepal, is a major challenge and calls for simpler systems with few indicators and smaller review teams, although without sacrificing quality assurance. Fairly sophisticated PBGSs, with 40 + indicators, have been tested out in smaller UPs in Bangladesh. But this requires a substantial administrative set-up and strong institutional capacity – to manage assessments, compile results, process data and determine allocations. It also entails additional costs, due to diseconomies of scale. In Uganda, assessments of the roughly 1,000 sub-districts have been carried out by district-level staff trained and prepared for this, supplemented by quality assurance and a check (of a 40% sample) by national assessment teams comprising assessors from the central government and the private sector. A similar system is being introduced in Nepal, which will cover all 3,915 VDCs. Here, the DDCs will contract (using simplified procedures) the assessors to carry out simple VDC assessments (covering only eight MCs in the coming assessments) and the national assessment team will do a sample assessment of the quality of this. In any case, there should be a reasonable relationship between the amount of effort put into the system and the size of the funds allocated to each unit. Even if Gewogs in Bhutan are relatively small, for example. the capital grants per unit will be substantial (about USD 70,000 on average).

Second, systems of accountability vary from country to country (LGs in Tanzania are subject to oversight by elected politicians, while districts in Laos have no democratically elected LG councils of any kind). This again demands adjusting approaches to specific countries. In Laos, for example, there might be a greater focus on upward accountability, including supervision, control and follow-up on the results at the central government level, including HR management issues, career implications and the like.

Links to Other Grant Systems and Reform Initiatives

Until now, the PBGS approach has largely been limited to development transfer schemes – grants which are easier to adjust without implications for LG recurrent expenditures. However, there is room in some countries for a cautious roll-out of PBGS principles to recurrent expenditure grants by, for example, linking flexibility in the utilisation of such grants to LG capability and performance, or by granting greater discretionary powers over recurrent grants to the best-performing LGs, thereby catalysing good performance and linking LG autonomy with a commensurate level of actual risks for mismanagement.

Working exclusively on PBGS-related reforms, without paying sufficient attention to other areas of the LG reform agenda, may be short-sighted and risk weakening PBGS reforms themselves. This may be the case, for example, if LG own-source revenues are being undermined or if the legal framework (e.g. for expenditure assignments) is not conducive, or if LGs have little or no influence on HR management issues. It is therefore important to ensure that the PBGS is part of the overall decentralisation agenda.

Sustainability, Institutional Arrangements and Mainstreaming Activities

Transition and mainstreaming

To scale up a pilot PBGS and fully integrate it into the overall national intergovernmental fiscal transfer system has been, or will be, one of the greatest challenges in most countries. For this to succeed, a PBGS needs to be institutionally well-anchored in a central-government policy-making body (e.g. Ministry of Local Government, Finance Commission or Ministry of Finance). Mainstreaming, aligning and harmonising pilot PBGSs with the government's procedures for other grants has been a challenge in many places. It is important to note that mainstreaming does not mean that everything should be done in-house by the responsible ministry/agency, and it is sometimes confused with discussions over the pros and cons of in-house production versus contracting out. A system can be fully mainstreamed into government procedures, fully aligned and harmonised, and still rely on a great deal of out-sourcing of non-core government functions to the private sector, which may be in a better position to deliver certain services. This has been particularly the case for the assessment of LG performance, for which private sector/non-government entities have comparative advantages. In some countries, a misunderstood need to ensure mainstreaming – whereby government is immediately in charge of everything, expected to do it all without support staff, CB or TA, or hampered by cumbersome procurement systems and procedures – has led to compromises in the quality of performance assessments and/or other core elements of the PBGS.

PBGSs have often been piloted by programmes with well-equipped offices, specialist staff and well-padded budgets – and the incorporation of this into general government systems (ministries and LGs) is not an easy process. It requires a well-planned, phased approach. In the move toward budget support, it is important to ensure that sufficient administrative/technical support is provided, based on clear M&E systems, reviews and evaluations, to ensure that these more demanding systems for grant allocations are properly managed and periodically fine-tuned.

Sustainability of capital investments

As PBGSs typically aim to increase and improve capital investments, it is very important that systems and procedures are established and applied in order to ensure the use (operations) and upkeep (maintenance) of these investments. This requires:

i. an appropriately designed and carefully crafted system of LG finance, with sufficient LG revenue assignments;
ii. built-in incentives in the PBGS to encourage LGs to focus on O&M issues and expenditures;
iii. appropriate institutional arrangements for managing operations and maintenance (e.g. in the form of support for project- or user committees, training and capacity building etc.);
iv. a clear legal and administrative framework with specific agencies being held responsible for monitoring and evaluation, internal and external learning.

5. Design Issues – How to Proceed?

As mentioned in chapters 2–4, the design of a PBGS matters – and is usually a demanding task. Below is an overview of the most important issues that need addressing in the design of a PBGS, along with some guiding principles and recommendations for specific areas.

A PBGS design must typically address the following issues:

- Are the **basic conditions** in place for the system to function?
  - Review of the overall framework conditions: Is there a minimum level of peace and stability throughout the country? Are the objectives and overall configuration of the decentralisation reform process sufficiently conducive?
  - Clarification of the critical policy and strategic directions of the government as well as of its commitment to reform: Is there sufficient policy support for the ideas behind the system?
  - Review of legal framework (possible legal constraints), expenditure assignments, decision-making authority, control over human resources, socio-environmental frameworks, etc.: Is this framework sufficiently conducive and clear? How can the design support the filling of any gaps?
  - Review of the overall LG funding system, the composition and size of revenues: What levels of PBGS funding are feasible and how will this fit into the overall grant system?
  - Review of LG strengths and weaknesses: Where are the existing performance gaps, and what incentives exist for staff and institutions?
  - Review of existing capacity-building support and availability of suppliers (CB service providers – capacity and experience): Can the supply side respond to the increased demands generated by the CB component of the PBGS?
  - Review of existing M&E, inspection and audit systems and procedures: How will the PBGS assessment fit into these existing systems?

- Clarification of the **overall objectives** of the PBGS: Which core areas of LG performance should be targeted by the system, e.g. generic versus sector-specific performance, focus on inputs, processes, outputs, outcomes, impact and why?
- Definition of the **type of grants** – e.g. capital/development and capacity building grants: How can the various grant systems be mutually strengthening (or at least consistent with each other)?
- Identification of **target LGs** – definition of the vertical (which tiers of LGs and which types to be included) and the horizontal "universe" (number and types of LGs) to be eligible for the new grant schemes. Should the system be piloted or can it go for a full roll-out from the outset?

- **Design of the development/capital grant system**, including:
  - Determining the **size of the development/capital grants** and matching contributions from LGs. This in turn will depend on:
    - The availability of funds for the system (the supply side): How much can the government and DPs contribute and how to ensure longer-term predictability of these sources?
    - The demand side, particularly:
      - size of the per-capita allocation and allocation criteria;
      - the number of LGs to be targeted from Year 1;

        - stringency of minimum conditions for access (more stringent conditions will constraint use of funds);
        - investment needs of LGs and expenditure assignments;
        - unit costs of investments and minimum requirements for meaningful investments: What is a reasonable size of grant to ensure that planning processes are strengthened?
        - absorptive capacity of LGs;
        - level of funding needed to ensure sufficient incentives to enhance performance.
    - Definition of allocation criteria – vertical (across tiers of government) and horizontal (within each tier);
    - Definition of the investment menu (eligible expenditures)
        - Type of expenditures to be financed – positive and negative lists
    - Review and elaboration of support systems required in terms of planning, budgeting, procurement guidelines, environmental and socio-economic screening processes and frameworks;
    - Review of monitoring and reporting systems, and linkages to assessment systems;
    - Drafting of new grant guidelines or integration into existing guidelines.

- Design of the **capacity-building grant**
    - Review of the overall CB strategy and objectives in a country;
    - Review of core CB needs of LGs and weak areas to be targeted;
    - Review of target groups and beneficiaries (administration versus politicians). Is there a need to train private contractors?
    - Review and define system for delivery (the supply side):
        - Determine the availability of service providers and training materials
        - Decision on certification of providers and systems for informing LGs about them
        - Preparation of training materials, including decisions on the range of standard modules
        - Preparation of CB coordination arrangements
        - Systems for quality assurance of services provided
    - Determination of the average size per capita (set as share of capital grants or as separate calculations):
        - Review of existing support and costs of this
        - Review of the required size of the CB grant to ensure meaningful CB activities
        - Review the implications of this for the supply side – and of opportunities for service providers to respond to increased demand
    - Allocation criteria – vertical (across tiers of government) and horizontally (within each tier);
    - Management of the grants: Which tier of LG should receive the funds? How should they be handled? How should they be divided? In cases where there are several tiers of LG, can the upper tier handle the CB grants on behalf of the lower tier?
    - Definition of the CB investment menu: How can CB grants be used? For which expenditure items (training, workshops, equipment etc.)?
    - Monitoring and reporting systems;
    - Guidelines for management and use of the CB grants, eventually as part of overall grant guidelines.

- Design of the **minimum conditions, performance indicators, assessment system and process**, including assessment manual/guidelines.

The following **guiding** *design principles* may be applied in the selection of performance areas and indicators:

- Ensure that the system targets the **core grant objectives and the policy intentions** behind improved LG performance, e.g. in many countries, participatory planning and revenue mobilization are seen as core areas where improvements are most urgently required. Some areas are seen as more critical than others, and should be allocated a higher scoring weight. Identification of the indicators to be used for measuring LG performance and the specific scoring system are some of the key design issues;
- The system should be designed first and foremost to provide **incentives** to LGs to improve their performance, but also to identify **capacity-building gaps** and provide input to the overall M&E system of LGs;
- Address LG **functional weaknesses** as identified by various stakeholders during dialogue, consultations and field work;
- Use experience from **existing** M&E systems, previous testing and piloting of reward systems (if any) and from a range of other countries[175] which have introduced PBGSs with encouraging results;
- The system should support LG compliance with **statutory** requirements (government laws and regulations). Although this is a guiding principle, the performance measures may also be applied to areas outside of these statutory requirements, particularly areas related to good governance and transparency. It is important, however, that LGs receive support and guidance on how to improve performance in these areas (e.g. it would be unwise to assess very complex new requirements and systems if LGs have not been fully sensitized, trained and/or informed about what performance "means" in such cases);
- To the extent possible, ensure good coverage of the **existing assessment** indicators from other systems (the existing system, used by the various authorities – Ministry of Finance, Ministry of Local Government, Fiscal Commissions, etc.). This will facilitate alignment of the systems and any move toward the use of a single common assessment tool for LG performance;
- Use a combination of **minimum conditions (MCs)**, which are basic areas to safeguard proper utilisation of funds (designed as on-off triggers) and more qualitative **performance measures** (PMs) to evaluate variable performance and to promote good performance (used to adjust grant size). Systems may start with a few MCs and expand with experience;
- Ensure that **core areas** are well-targeted and avoid indicators of little importance. However, some "core-plus" indicators may be included to raise future awareness and to identify capacity-building gaps; these may assume increased importance over time;
- For multi-sectoral grants, start with the **core generic areas** of performance under LG control (attribution), such as financial management, participation, transparency, good governance and cross-cutting performance areas (like environmental protection); and avoid promoting a bias toward investments in specific service-delivery areas (e.g. health). For sector grants, systems may be combined using a tool with generic indicators from the multi-sectoral grant system and targeted, sector-specific indicators;
- The requirements in the minimum conditions and performance measures should be **realistic** and achievable, but still sufficiently demanding to promote improvements;

175 E.g. Bangladesh, Nepal, the Solomon Islands, Uganda, Tanzania, Kenya, Mali and Ghana.

- The **assessment system** may be designed so that it can be expanded to cover new areas e.g. specific sectors/service delivery areas (and sector grants) in subsequent phases, using generic indicators as the core basic framework, but adding sector-specific indicators. The system should keep a door open to refinement;
- The system should be based on a clear and **simple scoring system**. It is recognized that more-qualitative indicators require a greater degree of field testing/verification and control than simpler quantitative indicators;
- The system should supplement and utilize results from existing M&E and inspection systems, available audit reports and assessments, etc. However, it is important to ensure a strong system of data **validation** through field-work or on-the spot assessments. It should be noted that only very simple systems with straightforward indicators (such as compliance with budget deadlines) can be checked from the desk in the headquarters of the agencies in charge of PBGS assessments, whereas more qualitative indicators (such as levels of participation in development planning or functioning of LG committees) must be checked in the field by assessment teams.

The definition of MC/PM indicators and the way the scoring system is structured have an important bearing on the acceptance and credibility of the PBGS when applied at the local level. The main guiding principles for the final selection of appropriate indicators will typically be the need to achieve the core grant objectives, combined with practicality and *simplicity* in the selection of various options and the need to harmonise different assessment systems so as to avoid duplication and confusion. In any case, it is important that the indicators are clear, transparent, and cover key performance areas consistently, promoting the overall objectives of the transfer scheme.

Some of the overall *guiding principles for the selection of specific indicators* of performance and scoring system that should been considered in any discussions of MCs and PMs are:

Indicators

The indicators for performance (performance measures) should be:

- focused on what is under the **control of LGs**. This is typically **not** the case for many output and outcome indicators, particularly in areas where functions have not been fully devolved. Outcomes such as child mortality rates or literacy rates are influenced by factors beyond the control of LGs, such as a region's general economic status;
- SMART: **Specific**: clear about what, where, when and how the situation will be changed; **Measurable:** able to quantify the targets – indicators should measure, quantify and compare across LGs; **Achievable**: indicators should set performance targets that can be attained by LGs given their resources and likely capacities, but sufficiently demanding so as to ensure that LGs strive for better performance; **Realistic** and adjusted to the LG context; **Time-bound**: indicators should clearly include the time period in which they are expected to be achieved, prescribed in the general timing of the assessment.
- relevant to the performance of core LG mandates;
  - as few as possible;
  - as simple and easy to comprehend as possible;
  - promoting a balanced LG performance to avoid bias toward specific areas;
  - possible to collect and verify at reasonable cost;
  - mutually exclusive, non-overlapping and comprehensively covering the core areas to be measured;
  - designed such that scoring reflects the relative importance of each performance area and of each indicator to the objectives of the system;

- developed in close dialogue with LGs to achieve understanding, ownership, quality and support;
- the system should be sufficiently flexible to accommodate a progressive increase in the stringency of minimum conditions and performance measures;
- MCs and PMs should typically be different for various types of LGs, e.g. different for districts and villages (sub-districts).

Scoring system

- Once the indicators have been defined, the scoring system can be developed. The main consideration is whether all performance areas and indicators are equally important to grant objectives.
- Should the system be designed so as to compare an LG's performance with that of other LGs? This would encourage inter-LG competition but create uncertainty for LGs. Or should there be a fixed scoring system, where a given score triggers a certain degree of grant adjustment? [176]
- Should there be a **minimum grant allocated to all** LGs even if they do not comply with the MCs? In such cases, should this be coupled with greater control, monitoring, and backstopping support from the central government?
- **Triggers for release:** The design should also include a definition of the current triggers for disbursements in terms of reporting and accountability requirements, and the "rules of the game" that apply in cases where funds have been misused or mismanaged.

Assessment system

- Design of the **assessment process**: Issues to address here are guarantees for the neutrality, integrity, and quality of the assessments – the extent to which field work is required, preparations and training of teams, awareness-raising procedures, working methods and strategies for communication and dissemination of results, a system for quality assurance, procedures for final endorsements of results, and appeal options. The assessment should be **neutral,** of a high professional quality, and based on transparent systems with a strong element of QA. Assessment results should be publicly disclosed to ensure a high level of understanding, knowledge, mutual competition and the effectiveness of the incentive system. Some of the design issues to be aware of are i) team composition; ii) timing of the assessment; iii) quality assurance – how and who?; iv) appeal options – timing should be strict; v) communication and dissemination of results and guidance on the entire system.
- One of the first steps in this process is a review of the administrative capacity to manage the annual assessments and inclusion of support measures where there are gaps (see below).

Systems for flow of funds

- Most countries are in the process of ensuring that PBGS funds flow through the government treasury system, so as to avoid parallel systems with higher transaction costs. This may sometimes require support for strengthening treasury systems and procedures.

176 Ideally, the scoring in the assessment should be weighted with the results of the basic allocation formula in order to ensure strong incentives for all LGs.

Explore and define the links to other performance-monitoring systems

- The design must take into account existing systems for monitoring, evaluation, assessments and auditing, and establish proper linkages with these. Thus, PBGS assessments can to some extent make use of the indicators from audit reports, existing data on plans and budgets at the central level, various user surveys and other data. On the other hand, the PBGS assessments and their results can be used in many other areas (e.g. for identification of reform needs, for the development of guidelines, grant allocation criteria, DP support, etc.). However. in most cases spot checks will be required, as the situation is often very different in the field.

Institutional framework

- The institutional framework for managing and implementing a PBGS is of great importance in determining the success of the system. Various reviews (e.g. in Uganda, Tanzania, Nepal and Bangladesh) have shown how important it is at the central level to have a *strong, dedicated unit* which is responsible for the PBGS. This does not mean that the unit cannot do other things (e.g. be in charge of the overall intergovernmental fiscal transfer system), but it is important to clearly define responsibilities and share tasks, and to provide CB support if needed. This applies to both central and local agencies that are involved in PBGS management.

  Among the core tasks are:

  - Review of capacity in existing institutions to handle these tasks, particularly the PFM-related tasks (number of staff, skills, organisation and tasks)
  - Clear definition of the management functions and responsibilities in the PBGS;
  - Review of required support and design of future support framework;
  - Develop systems and procedures for the assessment of LG performance, CB support and accountability (e.g. reporting and M&E systems). Experience has shown that this is particularly important and challenging;
  - Ensure continued support for implementation arrangements over a longer time period (not only in the initial set-up of systems). Part of this is clear work plans, budgets and procurement plans for TA/CB support in the PBGS implementation.

6. Conclusions and Design Recommendations

This review of international experience to date has shown that PBGSs are valuable and innovative elements in overall reforms of intergovernmental fiscal relations, and that these systems have the potential to impact positively on the overall reform agenda in many countries. Although there is significant variation across PBGSs in areas such as the size of the grants, the number of MCs/PMs and processes of performance assessment, most of the common principles are applied in most countries.

Over a relatively short span of time and in several countries, the implementation of PBGS approaches has produced tangible and positive results, *inter alia*:

- better LG compliance with legal and statutory requirements;
- improved planning and public financial management at the local level;
- greater attention being paid to, and improved performance in, cross-cutting areas such as gender mainstreaming, environmental management, good governance and transparency;
- effectiveness as a source for efficient service delivery in cases where this has been assessed;
- ensured more focused LG capacity building;
- promoted consistent use of capital grants to finance investments in core poverty alleviation areas;
- fostered better coordination within government and between government and development partners.

The impact of PBGSs on efficiency of service delivery and on poverty alleviation is harder to document, but anecdotal evidence and some audits from several countries (such as Uganda, Tanzania, Bangladesh and Nepal) are encouraging. The incentives, provided they are properly designed, do appear to enhance LG performance, improve LG administrative capacity, better target LG investments toward core service-delivery areas, and improve sustainability and ownership in all phases of project implementation. And all such positive changes are more than likely to increase the chances of positive service-delivery and poverty-reduction outcomes[177].

Although the PBGS approach is not the only way to promote improvements in LG performance, it needs to be seen as an innovative and encouraging move away from earlier systems of central-government ex-ante, micro-management to a more targeted, ex-post and results-based framework[178].

If properly designed and implemented, PBGSs can contribute to the attainment of decentralisation objectives and help orient LGs toward delivering services more efficiently and becoming more accountable.

A PBGS can usefully complement other reform measures, and be supplemented by other tools for influencing LG performance, among them legal compliance control, conditional

177 As mentioned in Chapter 4, tests of this hypothesis have been carried out in value-for-money audits in e.g. Uganda under the LGDP. Various reviews in Nepal and Bangladesh also support these findings.

178 See Annex 4, which compares various instruments for dialogue and influence.

grants (input control), national minimum standards, audit, etc. (see Annex 4 for an overview of these tools). Compared with these other tools, however, a PBGS is systemic and not heavy-handed. Most importantly, it provides LGs with genuine discretion in decision-making, a high degree of operational autonomy and real options for addressing local needs – contrary to previous schemes which relied on strong control of the input side coupled with highly earmarked grants and/or support from projects. Experience has shown that if the right incentives are provided to LGs, sector-wise control and earmarking of funds can be relaxed without compromising national targets and priorities, while at the same time fostering good local governance.

However, the PBGS approach is not an all embracing panacea, and PBGS reforms need to be complemented and coordinated with other measures, such as structural reforms (e.g. size and shape of LGs and systems for accountability), HR reforms, pay reforms, improved individual incentives, holistic systems development, legal, expenditure and revenue assignment improvements, other fiscal and institutional reforms and PFM reforms.

To summarize, the PBGS as a tool is most useful and effective when the following prerequisites are in place:

Box 17: Prerequisites for Maximising the Impact of PBGSs:

- Strong policy support for performance incentives and the political will to cope with pressure from LGs that perform poorly;
- Based on solid analytical work, documentation of strengths and weaknesses of previous approaches;
- A well-prepared and robust design with significant involvement and buy-in from key stakeholders – core ministries, funding agencies, local governments and their associations;
- An LG framework conducive to a PBGS approach, particularly in terms of HR management (with LG staff being at least partly accountable to local political bodies or a strategy to encourage LG officials to pay attention to the results and respond to incentives), LG finance arrangements[179], the legal framework and the overall system of coordination of the decentralisation reform process. LGs need to have a certain level of autonomy to improve their performance;
- Adherence to design principles in developing MCs and PMs. Indicators should be under LG control, balanced, SMART, etc. and linked to intended changes in behaviour. Indicators should also be designed so as not to undermine the autonomy and discretion of LGs;
- Incentives and sanctions should be proportional with effort;
- LG performance assessments are highly credible, function as a "third neutral eye", and are associated with a robust system of quality assurance;
- Institutional arrangements and support to the CB institutions/core agencies involved in managing the system are well-conceived and correctly implemented;
- The mix of supply/demand-driven CB support to LGs is adjusted to the country-specific circumstances and the specific needs and development level of the LGs, which must have a certain level of autonomy in the use of CB support;
- PBGS operations, measures and outcomes are highly transparent and publicly disclosed, particularly with respect to results of regular LG performance assessments;

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- The support provided to LGs – both fiscal and non-fiscal – by government and DPs is stable, timely, long-term, predictable and well-coordinated;
- PBGS should complement, not substitute, other reforms.[180]

Although these pre-requisites impact on the success level of a given PBGS, and need to be carefully considered in the design and implementation, the PBGS can also seek to influence the environment and the overall reform agenda within which it is operated.

Experience from the introduction and operation of PBGSs in various countries has shown that a number of factors can compromise or limit their effectiveness. These factors can include:

- constraints in the overall system of decentralisation, e.g. lack of LG own-source revenues, limited control over staff, and other grant-allocation systems which may undermine the effectiveness of PBGS incentives;
- insufficient high-level support and political will to make and follow through with tough decisions ("stick to the rules of the game");
- capacity weaknesses in all tiers of government;
- insufficient credibility in the LG performance-assessment process;
- weak M&E of the results from the system, especially LG reporting on use of grants, processing and publication of results, limiting the possibilities to adjust systems;
- weak linkages between and insufficient coordination across various reform initiatives.

Many of these challenges can be addressed by rigorous design, a robust system of assessment, sustained and comprehensive support for PBGS implementation, the provision of adequate support to core implementing institutions and close dialogue with the top policy level to ensure sufficient political backing.

The key *recommendations* for design and implementation of PBGSs are summarized in the box below:

Box 18: Recommendations on PBGS – Design and Implementation

Design:

- Invest sufficient resources in proper design, as PBGSs are technically demanding and must avoid a number of pitfalls;
- Ensure effective linkages between the PBGS and other dimensions to the overall decentralisation reform process (the IGFT system, public-sector reforms, particularly in the field of human-resource development and management). PBGSs should not and cannot be a stand-alone initiative if they are to achieve their objectives;
- Ensure – from the outset – that all stakeholders understand the potential benefits, but also the challenges, associated with implementing a PBGS approach;
- Ensure that the indicators used in a PBGS are identified according to SMART principles, that they measure performance that can be genuinely attributed to LGs, are mutually exclusive and balanced, focus on key LG performance areas *and* PBGS objectives, and – as far as possible – are derived from statutory and regulatory frameworks;

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179 This is illustrated by the Ugandan case, where the system has been less conducive from 2006 onward. See Steffensen, 2009.

180 This point is also raised by K. Kaiser (2009), based on a review of PBGSs in some OECD countries and a few other places.

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- Ensure that, where it concerns capability rather than willingness, the LGs have autonomy and means to improve performance in the areas measured. The PBGS should be designed so as to improve capability as well encourage willingness to improve;
- Combine – if possible – fiscal and non-fiscal incentives;
- Start with a relatively simple system – focusing on critical LG performance areas – that can be adjusted and refined in the light of experience;
- It follows that the focus in the beginning should be on a few basic areas (such as quality in planning, budgeting, transparency, etc.) and then gradually move toward more sophisticated systems for monitoring how plans are implemented, budgets are followed and so forth – in other words, getting the basics right prior to moving on to other more sophisticated areas;
- Develop a clear performance-assessment manual and share it widely;
- Ensure clear and user-friendly guidance on the use of grants, fund flows, operations and maintenance, etc.
- Ensure a robust, neutral, highly professional, and highly credible assessment process that is aligned with the planning and budgeting cycle (i.e. on an annual basis if budgets are annual);
- Provide timely information about assessment objectives, procedures and indicators;
- Use a team approach for LG performance assessments, associated with an adequate degree of independent "voice". To avoid conflicts of interest, assessments should be de-linked from related tasks such as CB support;
- Ensure that there is external quality assurance of the assessment results;
- Clearly specify redress/appeal procedures in the formal operational manual and ensure that such procedures are used in a transparent, timely and rule-based manner;
- Unless assessment indicators are very simple, insist on field visits to all LGs as a requirement for all performance assessments;
- Ensure a formal system for complaints about assessment results, handled in a transparent manner, instead of informal ad-hoc arrangements;
- Ensure (and if necessary establish) effective coordinating bodies to endorse assessment outcomes and to oversee implementation of the system;
- Design a strategy for CB support, including clear guidelines, manuals and coordination arrangements;
- Include a communications strategy as a core element in the design;
- Given the innovative nature of PBGSs, establish sound M&E systems to track their results and outcomes, thus providing the basis upon which to adapt, adjust and fine-tune the processes, procedures and methods associated with PBGSs

Implementation:

- Seek to minimise "exceptions", exemptions and deviations from the general "rules of the game", as these tend to establish precedents, open opportunities for "fence-breaking" and compromise the integrity of the entire system;
- Ensure transparency and extensive communication in all phases of PBGS design and implementation (especially public disclosure of assessment results);
- Provide strong and continued support to core agencies responsible for PBGS implementation – TA/CB support should be coordinated and report to the lead ministry/established steering committee;

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- Ensure that the PBGS is institutionally well-anchored in central policy-making bodies;
- If pilots are being applied, these should be realistically and strategically designed so as to optimise opportunities for subsequent roll-out.
- Ensure gradual expansion of the multi-sectoral grants alongside the establishment of capacity of the LGs. The challenge, experienced in many countries where the discretionary grant is far less than the sector-specific grants, has to be addressed in a strategic manner by i) gradually increasing the size of the discretionary grant (and the performance-based incentives that apply to it); and/or ii) ensuring stronger linkages between the two types of grants and the performance incentives that apply to them;
- Periodically review and follow up on the implementation arrangements;
- Follow up and apply M&E information, address complaints and regularly adjust the schemes in a fully transparent way and in dialogue with all involved parties.

7. Annexes

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Annex 2.1: Country Table – Overview of Experiences PBGSs in Africa[181]

Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Grant/Program	The PBGS started as a pilot in 1997 (DDP) in a few LGs (four districts at first, with a fifth added in 1998). Eight annual national assessments have been conducted. Gradually expanded and scaled up through the Local Government Development Programme (LGDP I and LGDP II), now mostly GoU funding. Currently integrated in GoU's budget and covers all LGs in the country.	Local Authority Transfer Fund (LATF) started in 2000/2001, and covers all LGs.	Started in FY 2004/05 with 47 of the total 113 LGs. Covered all LGs during 2005. Currently includes 132 LGs. Local government capital development grant system (LGCDG). This is supported by the Local Government Support Project (LGSP) – Capital Development Grant and Capacity Building Programme and DP basket-funding arrangements. LGCDG system changed to LG Development Grant (LGDG) in 08/09. Sector grants are gradually being mainstreamed into the PBGS, starting with agriculture (2006), water (2007), education (2008) and health (2008). Education-sector grants have been blended into the discretionary LG development grants since 2009.	Started in 2008. District Development Facility (DDF) with assessments carried out in 2008 but allocations made only from August 2009	Started in 2004. Local Government Development Grants Program (established within a wider Institutional Reform and Capacity Building Project – IRCBP).	Started on pilot basis in 1999. The national agency for local government investments (ANICT) started in 2001. In addition to this national programme, a number of other programmes have provided inputs and tested the PBGS, e.g. the UNCDF-supported project in Timbuctu Region.
Piloting or nation-wide	Piloting initially supported by UNCDF/UNDP in a few LGs (four, then five, and later seven districts) 1997–2000, and gradually scaled up thereafter, becoming nation-wide from 2003 with support from both GoU and donors, covering the non-sectoral development grants. 2007: On-budget GoU funded and covering all LGs, i.e. 80 Districts, 18 municipalities & city corporations, 37 city divisions and 949 sub-counties. From FY 2008/09 a number of DPs, through a basket-fund arrangement, provided funds for "topping-up" of the local development grants (10% to 15% extra)	Nation-wide: Covers the government-funded non-sectoral (block) grant to LGs (the only major grant to LGs in Kenya).	Covers the entire country (mainland). It is supported by several DPs. There is a process for expanding the principles to other grants, using a combination of generic and more sector-specific indicators. Agriculture was the first sector to apply the MC/PM system, from 2006/07, and from 2007/08 water was included. From 2008/09 health and education have been included. All sectors use the same MCs, although agriculture uses some sector-specific indicators as PMs.	Covers the entire country, i.e. all Metropolitan, Municipal and District Assemblies (MMDAs).	Nation-wide from 2004. Gradually developed from a few MCs to a system with MCs and PMs.	Nation-wide. Influenced by early pilots (1999 onwards) like the UNCDF LDF project in Timbuctu, which covered three of the region's five districts. With the support from the government and many donors (EU France, etc.), the national fund covers all LGs – 701 communes, 49 *cercles* (districts); eight régions and Bamako District.

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181 As of October 2009.

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Type of capital grant and investment menu	Capital grant for capital investments with a provision for LGs to spend part of this for "investment servicing costs", i.e. preparation, planning and monitoring of projects (max. 15%). General recurrent costs cannot be financed. Furthermore, a negative list is applied with non-eligible expenditures. Non-sectoral grant, i.e. the funds may be used to finance capital investments within the broad menu of LG expenditure assignments. Incentives for LGs to focus on poverty-related investment areas. CB grant for HR development with clear investment menu and much less stringent access conditions.	Capital and recurrent costs. Incentives to focus on capital investments, service delivery and debt recovery; maximum ceilings placed on LG expenditures, salaries, etc. Non-sectoral grant.	Capital-development grant with provision for investment servicing and monitoring costs, i.e. planning, appraisal, M&E etc. (max. 15%). Started with the non-sectoral grant, but the CG has tried to influence spending toward secondary schools. Incentives to focus on poverty-sensitive areas and a negative list with non-eligible expenditure items. CB grant for HR development. Sector performance-based grants emerging, with allocations based on PBGS principles. In 2008, the assessment manual was changed to harmonize all minimum conditions and simplify performance measures. With the exception of agriculture grants, the core discretionary, water, health and education grants all use a common set of performance measures. All sectors use common MCs. Joint annual assessments for all sectors.	Capital-grant system for development/ capital expenditure. 10% allowed for maintenance (recurrent). Broad investment menu focusing on development/ capital investments, with a short negative list of investments (non-eligible expenditures) Non-sectoral grant. Capacity-building grant: 20% (initial design had an earmarking of 10% for HR development and institutional strengthening. This has been increased to 20%).	Development projects originating from community and included in the councils' development plans and financial budgets. Non-sectoral grants. Not restricted to capital; related recurrent expenses can also be funded. Both a negative list and an indicative list of acceptable projects provided in Programme Operations Manual. Some emphasis given to road projects.	LG block grants take the form of "drawing rights". Total funding pool allocated as follows: - communes (90%) - cercles (districts) and regions (10%). Non-sectoral grant. The type of eligible investment is linked to LG functional assignments ("competencies") as defined by the law (e.g. water, health, education; natural resources, sanitation).
Size of the grants	USD 1–2 per capita	Approx. USD 2 per capita, determined as 5% of income-tax revenues.	Multi-sectoral grant: Average USD 1.5 per capita. In 2008, the size of the grant was linked to a % of the government budget (minus CFS). For 2009/10, the percentage was set at 1.6% and is expected to rise to 2.0% from 2010/11. Sectors: Varies from USD 1–2. The size of the education, agriculture and health grant pools is determined annually through the budget process.	Average size USD 1.4 per capita (will be increased significantly over the coming years).	Total transfer, 2004–08 was USD 323,401 per LG. Specific-year averages are as follows: Per Capita allocations estimated at USD 0.11 (2004), USD 0.35 (2005), USD 0.30 (2006), and USD 0.40 $ (2007)	Approximately USD 1.5 per capita.

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Allocation criteria	Clear formula: For rural authorities (districts and sub-counties) the weighting of criteria is as follows i) 45% for population; ii) 40% for poverty count and iii) 15% for land area. For urban authorities, only one criterion used: 100% population. The basic formula is subject to adjustment depending on the performance of the LGs.	Clear formula: Basic lump sum, population, and urban weight (size of the urban population) + adjustment for performance.	Clear formula: i) Population: 70%; ii) area: 10 %; and iii) poverty: 20% (number of people below the poverty line). Allocations adjusted as a function of LG performance. Sector grant systems use their own sector-relevant formulas, e.g. agriculture: (i) number of villages (60%); (ii) rural population (20%); (iii) rainfall index (20%).	Total funding pool divided into three components: 1) Basic Grants (allocated on basis of compliance with MCs) = 40% of total funding pool with formula using three basic criteria: i) equal share 40%; (ii) population (50%); and iii) land area 10% 2) Performance Grants (allocated to LGs that qualify for a basic grant allocation on the basis of performance) = 40% of total funding pool. Formula that divides performance-grant funding pool among qualifying LGs on basis of their performance relative to all other LGs. 3) CB Grants (allocated to all LGs irrespective of MC compliance) = 20% of total funding pool. Sub-division of CB grant funding pool: i) 60% distributed among all LGs on an equal-share basis; ii) 40% retained by CG to finance supply-driven CB support, common training etc. (Discussions have taken place as to whether non-compliant LGs should be guaranteed a certain minimum allocation, but the share of the CB grants was increased from 10% to 20% instead)	Formula: Based on the size of the urban/ rural population and infrastructure damage index in education, health, roads and civil institutions. Performance grants are available and based on the score received in the assessment	Clear formula with five criteria: i) population size; ii) remoteness indices; iii) poverty indices (composite index); iv) local governance; and v) local tax mobilization rate.

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Capacity-building support and grants	Capacity-building grant to enable LGs to address performance gaps. Demand-driven use of grants according to local priorities, supplemented by central-government support. A clear CB grant menu. Strong element of both supply- and demand-driven CB support based on annual training needs assessments, using results from national assessments. Standard training courses with standard training modules. Accreditation of service providers. Support to establishment of HR units in HLGs.	Supply-driven and no CB grant. Not a strong component of the grant system.	Since 2006/07, there has been a combination of supply and demand-driven CB support. The programme includes a CB grant to all LGs to use according to local priorities, with a clear menu for utilization. Some of the sectors have specific CB windows. Central-government prequalification of CB service providers, but not fully adhered to by LGs. Significant support from the LG Reform Programme for the development of guidelines, training materials, etc., and supply-driven support within key areas. CB has been insufficiently linked to the assessment. CB grants from the core and sector windows are to be harmonized from 2009/10.	Combined supply-driven/ mandatory CB for all LGs (takes up 40% of the CB funding pool) managed by Local Government Service. 60% of CB funding pool is set aside for demand-driven capacity building CB in form of CB grants. The CB grant (managed by the LGs themselves) to be used to address individual LG capacity gaps as identified in performance assessments Standard training courses. Accreditation of service providers.	CB included in wider IRCBP reform activities but tied to LGDGP by monitoring of compliance with minimum conditions and adherence to programme governance requirements.	Supply-driven and no CB grant

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Examples of minimum access conditions (MCs)	Basic safeguards: – Three-year rolling development plan – Functional technical planning committee – Draft final accounts submitted on time – Linkage between the development plan, investment plan, budget and budget framework paper – Functional internal audit – Three-year LG revenue enhancement plan – CB plan – Co-funding and special account established	– Budget estimates submitted to the Ministry as stipulated in the budget guidelines, e.g. max 60% on personnel expenditure – Clearance letter from the statutory creditors (agreements on how to address the debt in a strategy) – Final accounts submitted – Debt-recovery plan – Revenue-enhancement plans – Citizen participation in preparation of the service-delivery plan	Basic safeguards: – Functioning political council – Development plan approved by council on time – Position of the council director, treasurer and internal auditor substantively filled – Final accounts submitted for audit on time – No adverse audit report – Bank reconciliation statements on time – No financial irregularities – Internal audit in place – Legally constituted tender board	Basic Safeguards: – Functional planning unit in place – LG plans formulated based on regulations – Annual statement of accounts submitted according to regulations – No adverse comments bordering on dishonesty in the audit report – Assembly meetings conducted – Procurement entities established and functional	▫ Financial management staff operating ▫ No substantial adverse comments in the Audit Report ▫ Development Plan prepared in a participatory manner ▫ A balanced budget that includes the proposed projects ▫ Annual statements of accounts prepared in accordance with Local Government Financial Regulations ▫ Adherence with transparency requirements specified in the Local Government Act	No MCs are applied and all LGs are considered eligible. However, drawing rights vary according to LG performance
Number of MCs	Eight MCs for HLGs; seven for lower levels.	Eight MCs (2004/05): three MCs complied with to access 60% of the allocation and compliance with five additional MCs to receive the remaining 40%.	Nine MCs	Six MCs.	Five MCs in 2004, increase to nine in 2008.	N/A (early UNCDF pilots used MCs but these were not scaled up in the national system)

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Types of performance measure (PM)	Generic focus on institutional improvement (e.g. planning, budgeting, financial management and good governance). Very comprehensive. Some cross-cutting sector indicators are included as well.	Generic and PFM-focused (more focused on MC). Delays in reporting/ submission of documents lead to reductions in grants.	Generic focus on institutional improvements (planning and budgeting cycle and good governance). Sector-specific indicators for sector grants but still focusing on generic performance such as planning and budgeting within a sector. From 2008/09 all four sectors except agriculture used the generic PMs – i.e. water, health and education use the same PMs as are used for the discretionary grants. Agriculture has a separate set of PMs focusing on processes in planning, procurement, etc.	Generic focus on institutional improvements: management and organisation, transparency and accountability, planning, HR development, relationship with sub-structures, financial management and auditing, fiscal capacity and procurement.	A number of thematic areas: management & organisation, transparency, openness, participation & accountability, planning systems, project implementation and M&E, HR management, financial management, fiscal capacity and LG revenue generation, procurement and contract mgt.	PMs are implicitly built into the allocation formula for "drawing rights", which takes into account local governance (regularity of council meetings, financial management reporting) and local fiscal effort (tax collection rates).
Examples of areas of performance measurement	21 performance areas such as: quality of the development plan and linkage between plans and budgets, operational and maintenance sustainability, tax effort/increase in own-revenue sources, poverty focus in expenditure allocation, good governance and transparency, gender and accountability, functioning of the councils and committees, functionality of sector departments, gender mainstreaming performance, environment focus and HIV/AIDs.	Submission of required documents (revenue enhancement plans, service delivery plans etc.) on time – delays will result in reduction in grants.	Status of the audit report (adverse, qualified and clean), development in own-source revenues, participatory planning procedures with integration of gender and environmental issues, public posting of list of approved projects and audited accounts, % of projects implemented against plans.	Executive meetings in council conducted; service delivery charter; publication of annual budget; trial balances; involvement of stakeholders in plan implementation; linkage between plan and budgets; staff appraisal systems; compliance with financial regulations; internal audit unit; growth in internal revenues; share of revenues used on development; operations and maintenance plan.	Correct recording and receipting of revenue. Functional Local Technical Planning Committee. Open competition for contracts above a set value. Timely submission of quarterly and annual financial statements.	Three main performance areas: 1) regularity of council sessions; 2) regularity of FM reporting; and 3) fiscal effort
Number of PMs	121 PMs for HLG (divided into 21 performance areas).	The conditions are generally formulated as MCs, which determine the size of the grants.	58 PMs divided into nine performance areas.	60 PMs divided into eight performance areas.	47 (2008).	Three PMs divided into two performance areas.

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Adjustment mechanism of the grants	MCs: Switch on/off for access to grants. PMs: Adjustment of the basic allocation grant by +20/0/-20% depending on the actual performance.	60% allocation on basis of meeting the MCs and additional 40% based on performance within key areas. Reduction in the grants is done on a pro rata basis if there are delays in reporting to the Ministry of Local Government.	MCs: In the beginning, on/off switch for access to grants. From 2008/09, all LGAs receive a minimum amount of CDG, but those failing to meet MCs will be under strict supervision from PMO-RALG/RS. The score is 0–100. PMs: Determine amount to be received. LGs that perform well will receive 100%, those classified as good will receive 80%, those classed as poor will receive 50%, and those who fail to meet MCs will receive 25% of the core discretionary development grants. For sectors they receive 50% if there is non-compliance with MCs.	Grant consists of three parts: 1) For MC compliance: 40% of the eligible allocation; 2) Performance part: 40 (based on the relative score of each LG that meets MCs); 3) 20% of funds are allocated to the CB grant. Score is 0–100.	PMs will be used to distribute performance-based component of available programme funds (about 5% in 2008).	Annual drawing rights are adjusted in the light of previous performance using a series of coefficients.
Counterpart/ matching funding by LGs.	10% in cash.	None, although strong indirect incentives for LG contributions toward development expenditures are embedded in the MCs.	5% in cash.	None. Incentives in the assessment tool to promote LG internal revenues	None.	None. Incentives to promote LG internal revenues

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Method of assessment	Previously: external annual assessment, including field work by teams of contracted private consultants and experts from LGs and CG (five people in each team). MoLG ensured that a resource pool of people was available to assist the consultants. From 2007: MoLG organises multidisciplinary teams of six people with representatives from CG, LGs and CBOs. MoLG in charge of the assessment with some QA from private consultants. Two-three days per LG. A level of QA is built into the design, with external consultants working alongside national assessment teams to check compliance with the assessment tool and procedures. Internal assessment by HLG of the performance of LLGs, with QA from the national assessment team (sample 40%). Orientation of the teams is conducted prior to assessment. Resource pool of experts is established. Results discussed in technical committee, and endorsed by the Permanent Secretaries of the MoLG.	Annual assessment of the conditions by the head-office/ Ministry of Local Government/ KLGRP (programme unit). "Desk Review"	External annual assessment in the field with teams of contracted private consultants and resource persons from LGs and CG (four people in each team – two consultants and two resource people from the CG/LGs) with QA. Three days per LG. First assessment carried out in 2004 and since then on an annual basis. Orientation of teams conducted prior to assessment. Steering committee (Permanent Secretaries from core ministries) approves the results. Some sectors have their own steering committee Costs: USD 0.9 million, between 0.5% and 1.8% of the grant size. Considering introduction of slight adjustments in the assessment process, moving toward a system with a Team Leader from the consultancy and three experts from the trained resource pool of experts from ministries/LGs/others.	External assessment – contracted out to private-sector (teams of four). The teams stay three days in each district. Prior training/ orientation and preparation of the teams, system for quality assurance, etc. Organised and QA by DDF secretariat in ministry responsible for LGs. As part of assessment the teams support identification of CB needs.	Annual assessment done by the Local Government Finance Department, Ministry of Finance.	Annual assessments by the key ministries responsible for performance areas, among them the Ministry of Finance for all local tax collection information and Ministry of LG for reporting and council meetings On the basis of previous analysis, the allocation decision is made by the board of the Agence National D'Investissement Des Collectivetes Territoriales (ANICT), which includes LG representatives, state representatives and donor representatives as (observers). Every year, the management of ANICT is audited by independent auditors.
Assessment manual	Yes: Very detailed with clear indicators and guidelines, formats for reporting. Changes to the manual are minimized to reduce confusion, although the manual has been up-dated several times.	Yes: Clear indicators described in the grant guidelines and documentation.	Yes: Includes guidelines and indicators. First assessment only had implications for the MCs. Second assessment covered both MCs and PMs. New assessment manual issued in 2008 is based on previous experience.	Yes: Detailed. Will be updated based on first assessment.	Yes: As part of the Programme Operations Manual.	Yes: ANICT Manual takes the form of a regulatory instrument.

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
General experience	– Although there are still problems in linking plans and budgets, there has been a significant improvement in performance in all areas of PFM and governance since PBGS introduction. – Strengthened legal compliance. – Documented significant positive impact in areas like planning, financial management, transparency, poverty focus of investments and accountability. – Introduced a healthy sense of competition across the LGs. – The lessons from the system may be applied to other grant schemes. – Strengthened local accountability and transparency. – Strengthened focus on cross-cutting areas such as gender, HIV/AIDs and environment, where LG performance has significantly improved. – Several reviews and assessments of the system have documented that is has been successfully addressing its objectives. – It has impacted positively on the coordination between development partners	– Major impact on financial-management performance – First time in many years that LGs have initiated participatory planning procedures, provided accounts and started addressing their debt problems. – Focus on revenue mobilisation and debt recovery improved.	– The need for such a system to provide discretionary funds and to strengthen incentives has been documented in various studies – PB grants spent according to rules and local priorities – Significant improvements documented in planning and budgeting performance – A recent MTR concluded that the design was sound and robust – Use of performance incentives has started to stimulate councilors to exert pressure on LGA staff to improve performance – Led to remarkable and tangible improvements in PFM performance and good governance – the incentives have contributed to these improvements (MTR) – No. of LGs which complied with MCs increased from 53% to 98% over four years – Number of LGs with adverse and qualified audit reports has decreased – PFM improvements have continued, as documented in the last 2009 assessment (4) – Sectors have gradually adopted the system – Public satisfaction with local services is increasing, although links to PBGS not documented – The higher level of awareness of the system among the LGAs has further incentivised skills acquisition in the LGAs, but more importantly it has resulted in behavioral changes among councilors and staff, who are now more self-disciplined with respect to compliance with legal provisions and guidelines previously disregarded (review 2008)	– First assessment just completed showing that only 50 LGs out of 138 passed the six MCs – It has already encouraged a strong LG focus on the weaker performance areas and created debate within the LGs about how to enhance performance – Since the information is yet to be made public, the debate is not in the public domain but among DPs and CG, and within some of the LGs. The LGs are increasingly aware of the need to be responsive and to comply with legal and regulatory frameworks, which has implications for their operations – Since much evidence is required to ensure achievement of the indicators, level of documents based on feedback appears to be on the increase. – Significant delays in the disbursement of funds but this should now be resolved.	• LGs have increased capacity as MCs have been more demanding • Most LGs successful in completing projects • Project size gradually increased • Community involvement slow to get established	– Documented significant positive impact in areas like financial management, and LG functionality – Trend is to focus on local revenue mobilisation

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
	– The overall environment for decentralisation in terms of changes in tax assignments, establishment of new districts (fragmentation) and lack of coordination with the sector reforms have somehow undermined some of the achievements in the most recent years.		– The design has meant that it has been possible to bring most of the donors behind this unique transfer scheme and harmonise and consolidate the overall IGFTS, moving rapidly from piloting to nation-wide systems – Created a move from ad hoc to transparent formula-based allocations – GoT and DPs are not yet using one funding stream, challenges in reporting and in the overall reform process for decentralisation, but work on this is under way. – Insufficient plans and measures for encouraging O&M.			
Funding sources	– The Government of Uganda finances most of the core grants – Previously a large number of DPs supported the grant system, but these are now providing support to the overall reform framework through sector support, and DPs support the assessments, related guidelines and systems through a basket-fund arrangement. From 2008/09, the DPs support Local Development Grant through a basket-fund arrangement (the amount is equal to 10%-15% of the GoU's contribution).	– Government of Kenya	– A large number of development partners (WB, Netherlands, Ireland, Canada, Germany, Belgium, Finland, Japan (from 09/10) and EU (up to 07/08)) – From 08/09, a larger GoT contribution made to LGDG funding pool	– Government and a number of DPs (KFW, Danida, etc.). The GoG is funding approximately 30% in the first year. Other DPs will contribute as well in the future.	• Government • Donor support – World Bank, EU, DfID.	– Government and a large number of development partners like UNCDF, EU, World Bank; France, AfDB.

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Design Features	Uganda (1) (2008)*	Kenya (2008)*	Tanzania (2) (2009)*	Ghana (2008, 2009)* (4)	Sierra Leone (2008)*	Mali (2008)*
Supported by systemic reforms	– Yes: Through the components on support to the overall decentralisation process, annual reviews of the process, support for development of budgeting, accounting, procurement guidelines, M&E systems and support to the key ministry: Ministry of Local Government – The assessment process has not yet impacted on sector grants, but this is the intention.	– Yes: Support under the KLGRP covering capacity building of the LGs and the Ministry of Local Government, development of budget guidelines and other regulations, IFMS, etc.	– Yes: Has led to an overall devolution of the development budget from 4% to 14%. – Support for the development of various guidelines and tools in cooperation with the Local Government Reform Programme. – Emerging initiatives to reform the entire development grant system and gradually mainstream the sector grants.	– Yes: Is linked to the emerging Fiscal Decentralisation Strategy and LG capacity building, but the grant system is a specific scheme.	• Yes: Through the wider development of Local Government under the IRCBP.	– Yes: Supported by institutional reform (public administration reform, decentrali-sation and decon-centration. It promotes aid reforms such as the Paris Declaration).
Coordination and harmonisation of support from DPs	– LGDP: Government + a number of donors (World Bank, Danida, Netherlands, Austria, Ireland etc.). Several donors aligned their support with the LGDP approach. – The success of the scheme has attracted funds from several donors, and enabled the GoU to up-scale. – The present PBGS (grants) are funded on-budget by the GoU, with some support from a donor basket fund. – It has been a strong tool in the move toward a genuine SWAp for decentralisation, but has not managed to impact the overall reform environment for decentralisation.	– Government-funded, fixed percentage of internal GoK revenues – DP support has focused on CB	– Government and a larger group of DPs (World Bank, Netherlands, Ireland, Finland, etc.) are supporting implementation of the new scheme – The mechanism has provided a vehicle for strong donor coordination and mainstreaming/ institutionalisation of the many smaller area-based district support programmes into one common window for support. – However, it is still a basket-fund arrangement and not general budget support, i.e. funds not fully merged with the government grants. Expected to be fully merged into government operations by 2013.	– It has been a useful tool and vehicle for discussions amongst/ between the DPs and the government on how to mainstream funding flows and rationalize the entire system, and provided a good "forum" for coordination.	• The IRCBP, and the LGDGP component, have been instrumental in co-funding DPs for decentrali-sation of governance in Sierra Leone.	– It has led to increased coordination between government and a number of donors, and joint support to the LG financing system.

* Year for up-dating of the information in this table.
CB = Capacity Building; CG = Central government, DDF = District Development Facility modality, DPs = Development Partners, IGFTS = Intergovernmental Fiscal Transfer System, LG = Local Governments, LGA= Local Government Authority, PM = Performance Measures, PBGS = Performance-Based Grant Schemes, MC = Minimum Conditions, QA = Quality Assurance.
Although there are country-specific nuances, LGDP-II (Uganda) and LGSP (Tanzania) have many similarities in their basic design, which also reflected in other country programmes. The system in Ghana also has many of the same features, but important differences as well such as focusing on the relative performance (comparing performance across districts).

(1) Uganda: Midterm reviews in 2001 and 2005.
(2) Tanzania: Midterm review completed in 2008.
(3) Some of the districts were later split.
(4) The Prime Minister's Office – Regional Administration and Local Government: Annual Assessment of Minimum Conditions and Performance Measures under the LGDG System for FY 2009/10, National Synthesis Report, May 2009.

Annex 2.2: Country Table – Overview of Experiences from PBGSs in Asia and the Pacific

Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
Grant/Program	Initiatives for Local Government Reform (ILGR) Project, started from 2006 with financing from World Bank, DFID and Government of Indonesia (GOI). Delivery Improvement and Local Governance (DIALOG) Project, under design and scheduled to commence in 2009 with financing from GoI and Australian Government (GoA), through a World Bank Trust Fund.	Start from 2004. District Development Fund (DDF) – start-up in Saravane Province (UNCDF/UNDP/). In (2007/08) expanded to four provinces by UNCDF/UNDP/ Luxembourg, to one other province (WB) and to another (LuxDev)	Start-up in 2005. Programme initially supported by UNCDF/UNDP with Irish Aid and NORAD. Now all capital grants funded by the Government (GoTL) Coverage: 2004/05 – 1 district 2005/06 – 2 districts 2006/07 – 4 districts 2008* – 8 districts 2009 – 8 districts 2010 – planned 10 districts 2011 – all districts *Government changed the FY to calendar year from Jan. 2008.	Start from 2008 and covers all nine provinces, supported by the Provincial Governance Strengthening Programme (PGSP).	The PBGS started in 2004 with support from the Decentralized Financing and Development Programme (DFDP) – local development funds (covered 20 LGs). The PBGS was scaled up to cover all 75 DDCs from 2008/09 and municipalities will be covered from FY 2009/10. Coverage of the Village Development Committees – VDCs – (3,915) will be phased in over three years, with targeting of 2,000 in FY 2009/10. A new multi-donor-GoN programme – the Local Governance and Community Development Programme (LGCDP) provides support to the PBGS from 2009. The information below mostly covers the system for the DDCs.	Started in 2000 with the (82) LGs in one district – Sirajganj – supported by the Sirajganj Local Governance Support Programme (SLGSP). From 2007 scaled up through the Local Governance Support programme (LGSP), which will gradually cover all 4,498 UPs over a five-year period. One component (learning and innovation) of the LGSP will pilot a new PBGS in all the 388 UPs in six selected districts.
Piloting or nation-wide	Under ILGRP, 40 LGs are expected to participate out of around 130 districts (LGs) in nine provinces grouped into two batches. Currently (2008), 14 LGs (from batch 1) are implementing the reforms (out of 22 LGs initially eligible), their selection based on a screening of two criteria: 1) reform-mindedness; and 2) possibilities for clustering the LGs. Additional LGs will be invited to participate based on an open screening process. DIALOG to be piloted in three provinces including Papua, Gorontalo and a third province to be identified. LGs to be selected, based on a set of criteria, including the assessment scores in PFM.	The various projects currently cover seven of the 16 provinces.	Pilot with gradual expansion – possible nation-wide coverage from FY 2010. To date all local assemblies have passed the MCs. The eight districts currently operational, and are implementing the 2009 budget.	Nation-wide covering all nine provinces from FY 2008/09 (seven provinces passed the MCs in the first assessment in 2008, after a reassessment). All provinces complied in the assessment in 2009 (after a reassessment). In the first two FYs, the provinces have been given a second chance to comply with the MCs (re-assessment).	The pilot has been scaled-up nation-wide from FY 2008/09 to cover all districts (DDCs). 47 of the 75 DDCs complied with the MCs and accessed top-up PBGS grants in FY 2008/09 and 67 met the conditions in the assessments for FY 2009/10.	Will be nation-wide within a five-year period. First year covered 1,088 LGs, of which 1,060 passed the MCs; second year covered 2,260 LGs and fourth year covers all UPs. There is a pilot with more complex systems and procedures in the LGs (UPs) within six districts (155 UPs were assessed for this purpose in FY 2007/08, and 140 complied with the MCs). In 2010 367 out of 388 complied with the MCs.

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
Type of capital grant and investment menu	Under ILGRP, pilot LGs are eligible to receive funding for sub-project investments in rural infrastructure for three years. Funds can be used to finance construction, rehabilitation and upgrading of public infrastructure and non-revenue-generating investments. Such investments should be identified as local priorities in the LG's poverty-reduction strategy and action plan (PRSAP) and are eligible based on a broad positive list. (i.e. a non-sectoral grant). DIALOG has a broad, sectoral (education and health) menu with a negative list.	Basic Block Grants (capital grant) for infrastructure investments; 5% for investment servicing costs. Non-sectoral grants. Indicative positive list and clear negative list. Pilot experiment of Social Protection Grant to be launched in 2009/10 in a limited number of districts, Pilot experiment of Operational Expenditure Block grant, to boost service delivery, is also planned for 2009–2010.	Capital grants for infrastructure investments; 5% for investment servicing costs on top of capital grants. Non-sectoral grants. Indicative positive list and clear negative list with indications of district and sub-district investment responsibilities. 70% of the total capital investments should go to sub-district type of investments, while 30% should go to District-type investments.	Capital grants for service delivery with permission to spend up to 20% on capital investment in administrative infrastructure (e.g. administration buildings) and 5% for investment servicing costs. Non-sectoral grant. Clear positive and negative list for eligible expenditures.	Capital grants with a provision for capacity building support, and a provision to use part of the funds for investment servicing costs to support preparation, monitoring of projects and training. Non-sectoral grant. DFDP-provided incentives to focus investments on certain groups: disadvantaged groups (min. 15%) and women (min. 15%). These incentives have been maintained in the roll-out. New grant guidelines which will clarify the positive and negative list of investments are being drawn up.	Capital grants with clear non-sectoral investment menu – positive and negative list. Non-sectoral grant. Incentives to use funds according to participatory planning and budgeting process.
Size of the Grants	Under ILGRP, grants amount to about 10% of the LG development budget – the size varies from Inter Drawing Rights (IDR) .5 billion to 9 billion per LG per year, or IDR 10,500 per capita. Under DIALOG, grants amount to about 10% to 12% of the development budget – the size varies from IDR 12 billion to IDR 16 billion per LG.	Varies between USD 1.50 and USD 2.00 per capita for the Basic Block Grant.	Started at USD 2.50 per capita. Currently USD 3.5 per capita since the government took over the grant in 2008. Plans are to continue with USD 4–5 per capita.	USD 3.3 per capita from 2008. Small increase (3%) per year.	Approx. USD 0.4 per capita for the DDCs enrolled until FY 2008/09. In FY 2008/09 PBGS funding for DDCs was USD 0.7 per capita, increasing to USD 1.1 per capita (average figures for all 75 DDCs, but with higher figures for those that were eligible) The size of the PBGSs topping-up grants for VDCs constitutes an average USD 0.8 per capita in FY 2009/10 (although this will be higher for eligible VDCs, i.e. about USD 1.5 per capita). All grants (regular GoN plus LGCDP funds) to the VDCs in FY 2009/10 will amount to about USD 5.2 per capita – of which only a small proportion will be accessed subject to compliance with MCs.	USD 0.33 per capita on average for the UPs under the LGSP (countrywide) (2008). USD 0.66 per capita on average for the UPs (LGs) in the six pilot districts (2008)

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
Allocation criteria	ILGRP and DIALOG: Formula: Based on size of the population, taking into account population density.	Formula with i) Small equal-shares component, ii) population-based component, and iii) poverty component (weighted by population).	Formula: Based on i) size of the population and ii) small equal-share component for sub-districts of districts which have Sub-District assemblies. In pilot areas with only District Assemblies, population-based allocations are used. This is due to lack of poverty data.	Formula with two criteria: i) Equal shares 20%; and ii) population 80%. From 2009, grants will be adjusted against the performance of the provinces (based on the results of the performance measures). This performance criterion will count for 20% in the formula.	Formula for DDCs: Based on i) population; ii) land area; iii) HDI; and iv) cost index + performance adjustments according to the results of the performance assessments.	Formula: Based on i) population, ii) a minimum "floor" allocation per LG + performance adjustment for the piloting, starting in FY 2010/11 (assessment completed in April 2010).
Capacity-building support and grants	No CB grants. Support rendered under ILGRP. Regional and national management consultants provide training and CB modules to LG staff responsible for implementing reforms. Under DIALOG, LGs will work with local universities and NGOs to do training-needs analyses and develop and implement CB programmes.	No CB grants. Only supply-driven CB support.	No CB grants. Only supply-driven CB support.	Only supply-driven (i.e. managed from the ministry and programme in the first couple of years; plans to move toward a CB grant system).	In DFDP: 6% of grants could be used on CB, however most was used to hire field engineers and technical officers. GoN has provided modest CB support grants to the non-compliant DDCs in FY 2008/09. From FY 2009/10 a genuine CB grant system will be introduced. Future system will combine supply and demand driven CB support. A strategy for CB is being designed, and related guidelines and manuals will be developed.	Significant supply-driven CB support from the project is planned. Introduction of a more demand-driven of CB has been discussed.

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
Examples of minimum-access conditions (MCs)	There are various stages of "screening" with requirements: i) entry, ii) pre-investment, iii) investment year 1 and investment year 2. The ILGRP's "Entry Requirements" are a letter of commitment and head of district decrees that cover: commitment to implement reform, commitment to establish reform units/committees, adoption of operations manual, amendment of local audit agency to cover procurement and FM reform verification; and announcement of budget, budget implementation report and availability of public documents in local media. Examples of "Pre Investment Requirements": announcement of service standards and procedures; public participation in planning and budgeting, issuance of PFM and procurement regulations. The conditions are generic and focus on institutional improvements, particularly on PFM, procurement, transparency and public participation. DIALOG: phased in two stages. Examples: transparency of budget and public participation in the process, improved PFM scores, health and education reform strategy & investment plan, health and education services indicators to be determined in the plan (to be defined by each participating province).	▫ Limited number of MCs, increased over time ▫ District Planning Committee met at least twice in the year ▫ Existence of finalised annual plan and budget approved by quorum of District Planning Committee ▫ Use of DDF allocations does not contravene negative list and other criteria for block grant allocations (distribution between village and district level investments – contribution of the population) ▫ Public disclosure requirements are met ▫ Evidence of consultations with local communities in planning/ budgeting process ▫ Compliance with existing laws and regulations of Lao PDR concerning procurement of goods, works and services.	▫ Incremental system with increasing number of MCs over time ▫ Regular assembly meetings ▫ Approved plans and budgets ▫ Compliance with negative list and other financial regulations ▫ Submission of budget execution report to assembly ▫ Audit report submitted to assembly ▫ Public disclosure of plans and budgets ▫ Public disclosure of tenders.	a. Staffing positions in place, b. Detailed and timely annual work plan and budgets c. Cashbooks are up to date d. Bank reconciliations done on time e. Initiatives to address audit queries within deadlines set f. Co-funding obligations	▫ Approved plan and budget ▫ Annual progress reviews conducted ▫ DDCs have publicly informed citizens and other LGs about approved programmes and projects ▫ Accounts completed and submitted for audit ▫ Internal audit function established ▫ Reactions to the findings of previous audit reports are made on a timely basis and as per regulations ▫ DDCs have released funds from their accounts to other LGs according to regulations ▫ Information centre established with minimum information available ▫ DDCs ensured that audits of all VDCs are conducted ▫ Co-funding requirements complied with (under the DFDP, but not an MC under the new scheme).	For the **learning and innovation component (LIC):** – Open LG office – Regular meetings of the LG councils – Participation of women in council meetings – Cash books in order – Tax assessments conducted **For the main LGSP:** MC = unqualified or qualified audit opinion (i.e. not adverse or disclaimer) Core staff in place Years 1 and 2 MC = purely financial audit by independent auditors Years 2 onward MC = "assurance" level audit (financial + other criteria) such as procurement and environmental and social safeguards, open meetings, etc.

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
	DIALOG's entry requirements are: written commitment from LGs, announcement of budget and budget implementation report in local media, minimum PFM Assessment score.					
Number of MCs	ILGRP: Six entry-level + 30 conditions during the various stages. For DIALOG (three core conditions). MCs focus on both generic (PFM, participation and transparency) as well as sectoral indicators (health and education). Sectoral performance is also focused on governance.	Five	Year 1 = two Year 2 = six Year 3 = eight There were some delays in 2006/07 due to conflicts in the country.	17 MCs in 2008, but reduced to eight in 2009 combined with introduction of a number (64) of performance measures.	FY 2009/10: 13 MCs for Districts (DDCs). FY 2009/10: Five for VDCs and increasing to eight for FY 2010/11.	LGs in the seven MCs in the 6 Pilot Districts, covering 388 UPs + compliance with the 9 access compliance criteria of the LGSP (covering the entire country): LGSP Nine MCs (demand has increased over the years).
Type of performance measures (PMs)	The system is based on on-off triggers, i.e. MCs.	None applied as yet.	None applied as yet.	Generic focus on institutional improvements, particularly financial management (PFM) and good governance.	Generic focus on institutional improvements (planning, budgeting, financial management, accountability, governance/ transparency)	Learning and innovation component: Generic focus on institutional improvements (basic functioning, planning, budgeting and PFM).
Examples of areas of performance measurement	The system is focused on minimum conditions.	N/a.	N/a.	In the first two years of the programme only MCs were applied. PMs have been introduced from year 3, i.e. from 2010 (assessment in 2009).	Quality in planning and budgeting, financial management, fiscal capacity, expenditure composition and poverty targeting, communication and transparency, M&E. Examples: i) Participatory planning process followed, ii) Linkage between plan and budget, iii) % of infrastructure projects completed within the approved costs and estimated budget, iv) % of revenues collected against the budget, v) % of budget targeted at disadvantaged groups vi) Actual spending on disadvantaged groups. All indicators have detailed specifications.	Functioning of standard committees, participation of women, tax collection targets, planning and budgeting management performance, transparency and accountability and office management (record keeping)

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
Number of PMs	ILGRP: 30 DIALOG: 22	N/a.	N/a.	64 PMs introduced in 2009 with a scoring system between 0–100.	New system: 57 PMs with a scoring system between 0–100.	LGs in the six pilot districts: 42 PM (first year as base-line, with no budget implication). 9 PMs for the first FY 2010/11. In the country-wide LGSP programme a few PMs may be used in the future, focusing on revenue-mobilisation performance (may be expanded over time).
Adjustment mechanism of the grants	All MCs have to be complied with in each stage. Failure to meet the requirement does not mean that the districts are dropped from the programme. But they cannot then "graduate" to the next stage of the programme, which implies that they cannot receive the investment funds in time. As an example, two districts did not fulfil the pre-investment requirements in 2006, while the other 12 districts started the implementation of investments in Year 1 (2007). The two districts just started in 2008 (after they fulfilled the requirements for 2007).	Non-compliance with MCs results in 50% reduction in following year's block grant.	Non-compliance with MCs results in 100% reduction in following year's block grant.	MCs: On-off triggers in the form of MCs and reporting requirements. Non-compliance leads to 100% withdrawal of funds. Relative scores in performance assessment will determine relative shares of allocation for performance (20% of PCDF funding).	MCs have to be complied with to access grants. Size of grants is adjusted against the performance reflected in a scoring system of 0–100 points: > 79 points: 30% increase 66–79: 25% increase 51–65: 20% increase 36–50: static/basic allocation < 36: 20% reduction The system ensures a balance across performance areas, as there is minimum requirement on scores within each composite performance area. Each DDC receives a basic grant entitlement even if it does not pass the MCs. For FY 2009/10, this takes up about 29% of the GoN funding but is not applied to DP contributions to the funding pool.	The scores on the MCs have decided eligibility. UPs will have to comply with all MCs. Best-performing LGs were enrolled in the first phase of the support. Adjustment of basic allocation against performance was introduced in subsequent phases under the pilot arrangement, starting from FY 2010/11.

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
Counterpart/ matching funding by LGs	Yes. ILGRP: 10% of the total investment cost is provided by LGs. DIALOG: LGs and provincial governments are required to co-finance the public-service investment plan, which is incrementally increased over time.	Varies depending on individual investment projects, with a maximum of 15% counterpart contribution from the population. In Khammouane Province (WB support), provincial budget is expected to finance 10% of total DDF funding pool.	None. LGs in East Timor do not have legal status as yet and thus have no revenues of their own.	10% counterpart contribution from the provinces in 2008 (reduced to 5% in 2009, due to insufficient financial capacity to comply and non-conducive revenue assignments).	DFDP required a 10%-15% local contribution from communities, depending upon the nature of projects and beneficiaries. The level of local contributions will be defined in new grant guidelines, and will vary depending on the type of investments being financed.	No formal requirements but strong performance measures to promote contributions to development projects in the pilot component of LGSP.
Method of assessment	Submission of evidence to the National Programme Secretariat (NPS) on the implementation of the reforms is needed, but internal auditors of the LGs are required to confirm that reforms have been implemented in the areas of PFM. The NPS, with support of the district-level facilitators and regional/national-level consultants, is mandated to verify reform actions. Twice a year, the WB reviews reports of the internal auditors and the NPS's verification of reform implementation. DIALOG, similar to ILGRP but with participation of provincial auditors and an independent assessment team.	Assessment committees appointed by GoL and/ or provincial governor.	Ad hoc committee (made up of two to three GoTL officials) nominated by the Ministry of State Administration. The Committee is composed of staff from the Ministry, supported by the LGSP.	Contracted out to private assessment teams, working jointly with the Office of the Auditor General. QA from programme.	External assessment, contracted private consultants with QA from the project office and the Local Bodies Fiscal Commission (LBFC). A more robust system for effective QA is being designed, and a sample of DDC and VDC assessments will be subject to QA through a process that reconciles assessment findings.	External assessment teams – accounting/ auditing companies (previously piloting of self-assessment, but this was not ideal). In the piloting (LIC) component, external consultants and external audit firms have carried out MC/PM assessments. LGSP has used private contracted auditing teams. Quality assurance built into the design from the project (LIC) and from the GoB, Office of the Auditor General (LGSP).
Assessment Manual	Yes: Very detailed MCs included in the Operational Manual.	No: Simple guidelines used.	No: Simple guidelines used.	Yes: As part of the Operational Manual.	Yes: With detailed guidelines and indicators.	Yes: With detailed guidelines on MC and calibration.

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
General experience	▫ The investment fund is adequate as an incentive for LGs to undertake reforms ▫ The conditions are perhaps too demanding (requirement bar has been set very high) ▫ The MC system has been rather complicated and demanding ▫ Most of problems relate to the low capacity of the national implementing department, legal problems in handling of loans/grants to LGs sourced from the World Bank.	▫ Very simple system in a context of no elected officials ▫ Focus of initial piloting is more on demonstrating that local level can plan, budget and implement investments.	– Good experience for central government, which for the first time has systematically evaluated lower levels of the administration – Improved local-level documentation; – Very simple system – Focus of initial piloting is more on demonstrating that local level can plan, budget and implement investments – Low understanding of the MCs in certain areas – Need for central government to improve training of local level in MCs and the consequences before the system can be fully operational	– Already prior to the introduction, the fact that the system was emerging has improved LG PFM. Accounts are being produced for the first time in many years, bank reconciliations completed, and provinces are participating in CB support and preparation for the new grant scheme. – The system is greatly appreciated by all stakeholders and has focused attention on improved performance in PFM.	– Good experience from the pilot scheme – Efficient tool for improving service delivery – Significant improvements in PFM, e.g. internal audit – Wider dissemination of the system and its implications before and after implementation – Improved LG documentation – Accountability improved – GoN wishes to expand the system to other grants in future – The success of the piloting has led to roll-out of the system and an increase in funding levels year by year.	– Good experience of possibilities to impact on LG performance – The system has spearheaded a focus on improvements in areas like planning, financial management and good governance. – Positive experience from earlier piloting has led to a scaling-up of the overall approach across the entire country over a period of five years.
Funding Sources	i) For ILGRP: Government of Indonesia, World Bank and DFID ii) For DIALOG, Government of Indonesia and the Government of Australia.	• UNCDF, UNDP, WB, Luxembourg No GoL contribution as yet.	• Previously, the government, UNCDF, UNDP, Norway, Ireland. • GoTL contribution to LDP grants is funding 100% of the requirements.	– Government 50% and DPs 50% (in FY 2009, the government had difficulties in adhering with this %, but is expected to meet its commitments from FY 2010).	– Piloting of DFDP: UNCDF and DFID – New LGCDP (FY 2009/10): Partly government and partly DPs. Regarding the DCs: GoN contributes 47% and the DPs: 53%. – For VDCs the GoN contributes to the entire "entitlement" component (84% of total capital grants) and DPs contribute to the topping-up, covering 2,000 VDCs (16% of total capital grants).	Partly government (approximately 50%) and partly a range of Development Partners.

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Design Features	Indonesia (2008)*	Lao PDR (2008)*	East Timor (2009)*	Solomon Islands (2009)*	Nepal (2009)*	Bangladesh (2010)*
Supported by systemic reforms	Yes: The support is linked to institutional reforms – issuance of local regulations/ head of district decrees on transparency and participation, PRSAP, FM & procurement. The reforms are also linked to national government regulations.	• No. But linked to gradual rethinking of fiscal decentralisation in the country as a whole.	– Yes: Linked to LG reform process (setting up elected municipalities to replace districts from 2010 onwards).	– Yes: This will be part of the new system.	Yes: Especially support to fiscal decentralisation, studies, reviews and reforms – it has generated the platform for a national programme of support to decentralisation. In the new LGCDP, the PBGS outputs are supplemented by many other initiatives at the policy and technical levels; e.g. mobilisation of communities, development of guidelines, CB etc.	Yes: Piloting has led to a reform of the entire grant system and roll-out of the PBGS to the entire country, as well as increase in the overall level of grants to Union Parishads.
Coordination and harmonisation of support from DPs	The programmes are linked to the multi-donor support facility ILGRP and DIALOG are both managed by same team within the World Bank and GoI.	• Not yet.	• Has led to a stronger coordination between the GoTL, UNCDF, UNDP and WB.	– SIG, UNCDF, UNDP, RAMSI (AusAID) and EC. – It has the potential to be a useful tool for coordination of support. The steering committee established is a useful forum for coordination between DPs and government.	DFDP pilot was supported by UNCDF and DFID The new LGCDP is supported by government and a large number of DPs. The MC/PM system is a major instrument in facilitating a gradual move toward on-budget funding and the development of a genuine SWAp. Part of the cooperation will be guided by a recently signed Joint Financing Agreement. Part of the funding from DPs will go on-budget through sector-budget support modalities. Other DP funding will be project-specific, but follow the same overall plan for support to decentralisation.	Piloting by GoB and UNCDF has led to a national programme. LGSP has attracted support from GoB, WB, UNCDF, UNDP, Danida, EC and related support from SDC. It is a major vehicle for coordination of support to decentralisation in the absence of a SWAp.

CB = Capacity Building; DDCs= District Development Committees; DDF = District Development Facility, CG = Central government, LG = Local Governments, LGSP= Local Government Support Programme (Bangladesh), LIC= Learning and Innovation Component of LGSP, MC = Minimum Conditions; PM = Performance Measures. SDC = Swiss Development Cooperation. SWAps = Sector Wise Approaches; VDCs = Village Development Committees.
* Year for updating of the table.

Annex 2.3: Country Table – Countries with PBGSs in the Pipeline or Under Reform

Design Features	Philippines (2008)*	Bhutan (2010)*	Pakistan – Existing Programme (2008)*	Pakistan: Proposal for Coming Programme (2008)*
Grant/program	A new multi-sectoral PBGS is under preparation by the Department of Finance (DOF) – named "the proposal" below. PBGS is ongoing or planned in two sectors in selected provinces – Health (National Sector Support for Health from 2007) and preparations for a new Agriculture Programme (MRDPII)	Local Governance Support Programme (LGSP) and the Royal Government of Bhutan's Grant system (approved in 2008). Started with RGoB funding from 2008/09, but with joint RGoB and DP funding from FY 2009/10.	PBGS funds for districts have been transferred since 2006. Various windows for PB grants; four types of PB are regulated: policy-support grants, CB grants, municipal infrastructure grants and performance-incentives grants So far, a Policy Support window has been utilized with the grant focusing on districts for education and health, supported by the ADB-funded Balochistan Devolved Social Services Program (B-DSSP, from 2005).	A new PBGS is under preparation under the: "Balochistan – Local Governance Service Delivery and Governance Project" to provide support to the municipal and union levels. Was planned from 2008 but has been delayed.
Piloting or nation-wide	According to the preliminary design, the new multi-sectoral PBGS will be a pilot scheme and will cover approximately 100 LGs in the first year. It is expected that it will be gradually rolled out (according to draft design, this may be changed during the final design) Sector-specific PBGSs are area- based and cover selected provinces.	Is nation-wide and targets all the 205 *Gewogs* (blocks) and all 20 *Dzongkhags* (districts) in the country.	Covers all districts in the entire province of Balochistan.	The planned PBGS is supposed to cover all 600 unions in Balochistan (with the exception of those in Quetta) and 18 town municipal authorities (based on absorptive capacity).
Type of capital grant and investment menu	Capital grants. The new scheme will focus on capital investments with clear positive and negative lists for eligible and non-eligible investments. The proposed PBGS will concern non-sectoral grants. Sector PBGSs are to be used for specific conditional sector investments (health and agriculture respectively). The proposal is that a part of the funding will be earmarked to finance investment servicing (5%) and operations and maintenance costs (5%), sourced from the LGs' counterpart contributions.	Capital grants. Non-sectoral: the grants are not tied (not earmarked) to specific sectors and/or projects, but 80% is tied to financing investments identified in the five-year plan, and the remaining 20% are untied. Design: Min. 90% for capital investments, and max. 5% for maintenance for larger projects, and 5% for investment servicing costs. However, this is an issue, which is under discussion, and present draft guidelines will leave up-to 20 % for non core capital investments.	The performance-grant system started in 2005/06 with the introduction of earmarked policy-support grants to districts (highly earmarked to specific sectors) but also a non-earmarked performance-incentive grant. There are different windows. The provincial government has developed a performance-grant system that funds sub-provincial governments through a number of windows. Thus far (2008), only the policy-support window has been utilized. The grant focused on districts within the areas of education and health, supported by the ADB-funded Balochistan Devolved Social Services Program (B-DSSP). These are earmarked grants. Clear rules on utilisation for specific sectors have been developed, as well as a negative list of non-eligible expenditures for each grant.	Non-earmarked grant for both capital and recurrent service-delivery expenditures. Non-sectoral grants to finance LG functions.

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Design Features	Philippines (2008)*	Bhutan (2010)*	Pakistan – Existing Programme (2008)*	Pakistan: Proposal for Coming Programme (2008)*
Size of the grants	According to the preliminary design, the proposed grant is expected to average between USD 0.6 and USD 1.7 per capita, depending on the type of LG. The existing sector grants are in the same range.	Budgeted size: USD 32 per capita for Gewogs in FY 2009/10, which is much higher than the original scheme design, increased to 36.5 USD per capita for FY 2010/11.	USD 1–2 per capita.	Approximately USD 1 (average per capita) for the rural unions and a higher amount for urban authorities.
Allocation criteria	Formula-based: Proposed multi-sectoral PBGS: 50% on needs-based criteria and 50% on performance indicators. The needs-based component includes: i) population (40%); ii) land area, (25%); iii) equal share (15%); and iv) number of poor citizens (20%). This basic amount will be adjusted against the LG performance allocation (50% of the total funding pool). A recent decision has been made to increase the performance-based criteria to 70% (2009). MCs will have to be complied with.	Formula-based: The allocation formula uses the following criteria: i) population (70%); ii) poverty index (25%); and iii) area (5%). There is a minimum level of funding per Gewog (a "floor" of Nu 1 million).	Formula-based: The first step is the allocation between sectors, with specific amounts for each, with flat (per district) allocations to water (Rs 2 million), sanitation (Rs 500,000) and health (Rs 4 million). Allocation is also based on the number of Union Councils in the District.	Formula-based: The intention in various draft proposals is to use an objective, needs-based formula, but data are scarce. Likely to be a flat allocation to different types of union (urban, rural, etc.) and highly based on population.
Capacity-building support and grants	The preliminary design includes a CB grant and there is a strong element of CB support in the programme (supply- as well as demand-driven support). The two sector PBGSs also have elements of CB support, but not in the form of CB grants.	Strong element of CB support included in the grant programme, support for PFM, guidelines, training etc. Future piloting of demand-driven CB grants to Gewogs is expected; a strategy for this will be developed.	Yes, an element of CB support. One of the grants is a CB grant to finance institutional reforms and HR improvement.	Yes – a strong element of CB support. The design is still under development, but it may include a CB grant system.
Examples of minimum-access conditions (MCs)	Expected 10–15 MCs. To be further defined, but will concentrate on planning, PFM, revenue mobilisation, good governance and basic safeguards for LG absorptive capacity.	Are under final design, but according to the original design these were: a) Annual Gewog Plan with planned investments in accordance with Gewog functional assignments and defined through involvement of local communities b) Monthly accounts as per Ministry of Finance rules c) Minutes of council meetings related to the Annual Plans	As a contract between the district and the Provincial Finance Department, containing the access criteria, continuation criteria and contract management: **Access Criteria** 1. Monitoring and House Committees set up and functioning 2. Executive Committee set up and functioning 3. Complaints Cell set up 4. CB: Funds earmarked in successive annual budgets 5. Byelaws of Zila and Tehsil/Town Councils approved and implemented 6. Suitably resourced Zila and Tehsil Council Secretariats operationalized	To be defined: PFM and generic reforms.

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Design Features	Philippines (2008)*	Bhutan (2010)*	Pakistan – Existing Programme (2008)*	Pakistan: Proposal for Coming Programme (2008)*
		The MCs will be reviewed yearly, and new MCs may be added, in order to provide progressive incentives for the LGs for improved performance/results such as a requirement to have addressed all major audit queries from the previous audit report(s) may be introduced, as well as. In addition to the three MCs, there ares a number of current triggers for releases of funds, e.g. provision of quarterly progress reports.	7. Internal audit office set up 8. Offices arranged according to District Government Rules of Business 9. Functioning Zila Mushawirat Committees (ZMCs) 10. Procedures to ensure transparency in place 11. Preparation of monthly & annual accounts & display at a conspicuous place for public information 12. Public Hearing by the Accounts Committee on objections to the statement of accounts Information about staffing and performance to be displayed at a prominent place Public hearing by the Accounts Committee on internal and external audit reports Annual stock taking of LG Property by the Zila/Tehsil Nazim Preparation and approval of budgets according to Law and Rules Inspection of Offices by the EDO Periodical report from Group of Offices for the Zila Nazim Performance Evaluation Reports or and other reviews Continuation Criteria Staff turnover, postings, transfers according to tenure Performance reports prepared and annual report published A summarized version of budgets and financial statements made available for public information. Source: Balochistan Performance Grant Rules, 2005	

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Design Features	Philippines (2008)*	Bhutan (2010)*	Pakistan – Existing Programme (2008)*	Pakistan: Proposal for Coming Programme (2008)*
Number of MCs	To be further defined, but will in the range of 10–15 for the multi-sector PBGS. It will cover PFM and accountability/ transparency MCs.	Present number: three. The number will be increased over time and may change from the initial design. In addition, there are a number of clear fund release triggers related to reporting and accountability.	19 access and three continuation criteria	To be defined but will be kept as simple and realistic as possible.
Types of performance measure (PM)	Proposal for the new PBGS: Generic indicators such as governance and transparency, planning, PFM, revenue mobilisation, environment and M&E. Agriculture sector PBGS Proposal: Accountability, action plan for PFM reforms and revenue mobilisation. Health sector PBGS (2007-): PFM and some specific health outputs. Fixed amount (80%) and performance-based amount (20%).	Performance measures will be included at a later stage in the implementation of the new grant scheme (in the first years only simple MCs has been applied).	Generic performance: PFM and good governance, but not focusing on qualitative aspects of performance (see below).	Planned to focus on generic performance in areas of PFM and good governance.
Examples of areas of performance measure-ment	Proposed multi-sectoral grant: Not yet developed, but measures will cover areas such as links between plans and budgets and quality of development plans. Agriculture sector PBGS (original proposal): One main PM, which is relative increase in LG own-source revenue mobilisation. Health PBGS: PFM indicators and indicators such as performance in allocation of drugs.	Not applicable yet. It is expected that the design of these will start from 2011/12.	LGs sign a Terms of Partnership (TOP) Agreement with the Provincial Government which covers access and continuation criteria and provides a set of contractual conditions specific to each PBG. There is nothing explicitly limiting the scope of grant-specific conditions, and the PG can come into effect only after the TOP is signed. The present system is focused on minimum access conditions and continuation conditions, not qualitative performance measures.	Grant for unions based on a simple audit plus simple plan/budget conditions. More in-depth minimum conditions and performance assessment for TMAs, as well as audit.
Number of PMs	Proposal in the multi-sectoral grant: Expected to be around 50 indicators.	Not applicable yet.	Not applicable (2008); there are only MCs.	To be defined.

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Design Features	Philippines (2008)*	Bhutan (2010)*	Pakistan – Existing Programme (2008)*	Pakistan: Proposal for Coming Programme (2008)*
Adjustment mechanism of the grants	The preliminary proposal indicates that 50% of the grant funding pool will be allocated based on relative LG performance (as reflected in the PMs and compared to the performance of other LGs). Health: 80% received when MCs are complied with; 20% set aside for performance grants. Agriculture (proposal) 50% of funds reimbursed from CG, but with strong own-source revenue performance an additional 20%.	Not applicable yet. The MCs determine access to the new annual capital grants.	Not applicable; there are only MCs.	To be defined.
Counterpart/ matching funding by LGs	Proposal for multi-sectoral grant: 10% for counterpart contribution from the LGs to cover O&M costs and investment-servicing costs.	Through community contributions depending on type of investments.	None.	To be defined.
Method of assessment	Proposal: External assessment teams. The teams include consultants and resource persons from the government agencies.	Gross National Happiness Commission (GNHC) and Ministry of Finance (MoF) will check and follow up on compliance with the MCs.	Checked by the Provincial Finance Commission (Secretariat) based on submission of documentation from the districts. The assessments of access and eligibility criteria are based on LGs certifying adherence in writing in the first year to access conditions, followed in subsequent years by both certification and the provision of documentary evidence of adherence to both access and continuation conditions. There is insufficient verification of results.	Assessment on the spot, probably external.
Assessment Manual	Being developed (2008)	Annual Grant Guidelines (being drafted) will specify conditions for access, reporting requirements, etc.	Access conditions specified in guidelines and agreements with each district and in the Balochistan Performance Grant Rules (2005)	Probably.
General experiences	There has already been some experience in PB reward schemes. Building on these, the general PBGS for multi-sectoral grants is now in its design phase.	There is a strong government and LG buy-in to the new system. The experiences from the first two years of the system have generally been positive and the system will be expanded in future.	The impression is that, to date, the incentives have not proved particularly strong.	

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Design Features	Philippines (2008)*	Bhutan (2010)*	Pakistan – Existing Programme (2008)*	Pakistan: Proposal for Coming Programme (2008)*
	The health sector has just started a sector-specific PBGS. Another sector – agriculture – has also designed a sector PBGS proposal (2008), but its future is unclear.	The design has already led to a strong coordination amongst DPs and between DPs and the RGoB.	Compliance requirements have **not** yet been rigorously enforced, and paper-based assessments have limited the quality. [182] Other funding flows have reduced incentives in the PBGS. Lack of sufficient information on the new system prior to introduction. Relying on a signed statement from the TMA that a condition is adhered to does not appear credible unless it is followed up by visits from the provincial government to verify adherence. Overambitious conditions with inadequate compliance.	
Funding Sources	Multi-sectoral grants: Planned to combine funding from government and DPs.	RGoB contributes 80–90% of funds and DPs the remainder part. A Financial Management Agreement has been signed with provisions governing minimum expected funding levels.	Supported by an ADB programme and the government.	To be defined. In 2008 the World Bank had planned significant support, but no specific agreements have been signed.
Supported by systemic reforms	Not directly, but the experiences from the introduction of the PBGS should influence the overall fiscal transfer system and lead to a gradual mainstreaming of funding principles and rationalisation. For the agriculture and health sectors the PBGSs will be part and parcel of the wider sector-reform process.	Yes. Support is linked to a range of administrative, fiscal (including issuance of regulations and guidelines) and HR reforms of the LG system.	Yes. Reform initiatives are part of the PBGS.	To be defined.
Coordination and harmonisation of support from DPs	It has the potential to be a robust coordination tool, particularly for CB support.	Already during design the programme has led to a high level of coordination between several DPs and RGoB (UNDP, UNCDF, Danida, SDC, and Austria). Other partners, such as JICA, subscribe to linkages and coordination with LGSP and are strongly involved in CB coordination.	Has not yet led to significant DP and government coordination and harmonisation, but the system makes use of the government system and procedures and is based on the legal framework and existing structures. Few consequences, as a very limited number of DPs are engaged in Balochistan.	A proposal has been prepared by the government, World Bank and DFID, but the proposal is still under consideration.

* Information is from the year mentioned, i.e. 2008 or 2009.
CB= capacity building; DDF = District Development Fund, DPs = development partners, CG = central government, LG = local governments, MC = minimum conditions. PM = performance measures, PBGS = Performance-based grant system, MRDP II = Mindanao Rural Development Project II, WB = the World Bank. RGoB: Royal Government of Bhutan.

(1) The actual final design might deviate from this proposal. Most of the data for this column is generated from the *Report: Preliminary Analytic and Design Work for the Development of a Performance Grant System for LGUs – IDF Grant for Developing Governance Performance Framework for Local Governments – Final Report, Volumes I – III*, Preliminary Design Report, January 2008, by NCG and IDP.
(2) The author is grateful to Mr. Tim Williamson for providing information about the systems in Pakistan.[182]

182 Based on a World Bank Review by Mr. Tim Williamson.

Annex 3: Various Assessment Methods in PBGSs[183]

The table below shows the advantages and disadvantages of using different modalities and procedures in a PBGS assessment – one of the core components of any PBGS.

Assessment method and examples	Advantages	Disadvantages
1) External assessment (fully and entirely out-sourced model) *Examples:* *Nepal, Bangladesh, Ghana and the Solomon Islands*	▫ May be seen as impartial (neutral), objective and fair ▫ Avoids conflicts of interest, which may arise in other models ▫ Ensures capacity and multi-disciplinary skills needed to carry out the assessment on a timely basis ▫ Increases the likelihood of capturing economies of scale as a few assessment teams can be involved in several assessments ▫ Ensures a standardized and professional approach to the assessment ▫ Provides incentives to carry out assessments in a timely and efficient manner ▫ Provides scope for QA/control from government institutions ▫ Ensures a clear division of roles and responsibilities such that the "assessors" are not the same as the "decision-makers" (who decide on the actual allocation and transfer of funds) ▫ Assessments are often short-term assignments (one-two months), hence it's more efficient to contract in resources as and when required	▫ Entails additional costs[184] ▫ May not ensure sufficient interaction with the various stakeholders, especially citizens (depends on the organisation). It may not lead to direct dialogue between citizens and LGs unless combined with a participatory process (see below) ▫ The external teams may lack local knowledge about the situation in the LGs. However, this can be mitigated when the teams include resource persons from the CG and LGs ▫ May lack the checks and balances introduced in model No. 6, where teams are of mixed composition ▫ The strengths of the model will depend on the capacity and integrity of the private sector and level of quality assurance
2) Government institutions/departments *Examples:* *Kenya, but with involvement of the Kenya Local Government Reform Programme and supervision from a Steering Committee, composed of members representing various stakeholders, including the private sector.* *Sierra Leone* *Pakistan (Baluchistan)* *New system in Bhutan (only with MCs)*	▫ Institutionalized ▫ Integral to overall monitoring and evaluation functions ▫ Possible to establish linkages with general inspection functions where some data may be easily available. Builds up the capacity of the government institutions ▫ Relatively modest costs ▫ Typically feasible where only a limited number of performance indicators are used. These indicators can often be measured through desk/office reviews of existing reports and documents	▫ Government may lack the necessary capacity and human resources ▫ This is a new function, which requires extra work for staff often already overburdened. ▫ Regular functions may suffer from less attention as staff dedicate their time to assessments ▫ May not always be perceived as fully independent and objective by all observers ▫ Government staff may not have sufficient incentives and time to take on such a time-consuming task (travel etc.) ▫ The government will endorse its own assessment results, i.e. there will be fewer checks and balances and more conflicts of interest ▫ The experience in testing this method in some countries has not been encouraging[185]. ▫ Does not ensure a clear division of roles and responsibilities vis-a-vis the actual transfer of funds ▫ If Government is responsible for some LG capacity building and monitoring activities, there may be a conflict of interest in assessing LG performance, which is largely dependent on the quality and appropriateness of this support.

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183 This annex has been drawn up based on the experience of various countries which have applied or are planning to apply PBGSs, particularly: Bangladesh, Bhutan, Indonesia, Nepal, Kenya, Uganda, Ghana, Tanzania, the Solomon Islands and the Philippines (which is at the design phase). The typology and examples used should nonetheless be of general relevance for the design of new systems in other countries.

184 Experiences from countries where external assessments have been conducted show that the costs of assessments have been in the range of 1% to 3 % of the total performance-based grant (0.6 % in Nepal).

185 E.g. Tanzania, during the early stages of testing/piloting and Bangladesh.

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Assessment method and examples	Advantages	Disadvantages
3) Self-assessment by LGs *in dialogue with citizens ("social audit")* *Examples:* *Tested in Bangladesh from 2003–2005.*	▫ Promotes interaction between citizens and LGs, ownership and accountability ▫ Promotes awareness-raising on the problems and challenges associated with LG systems and procedures ▫ Improves local knowledge about LG activities while promoting performance and ownership ▫ Ensures a clear division of roles and responsibilities vis-a-vis the actual transfer of funds	▫ Not fully neutral as unfavourable assessments by citizens of their own LGs' performance will lead to fewer or lower grants to the local area/communities ▫ May be of low quality due to lack of sufficient time and skills to properly and fully assess LG performance ▫ Not standardized across LGs, which is important if all LGs are involved in the same grant scheme ▫ May be difficult to organise in many LGs without a large number of local facilitators (hence very expensive and time-consuming) ▫ May compromise the relationship between LGs and citizens, as citizens may hesitate to raise their concerns openly. It will also blur accountability relationships ▫ The objectives behind this are better served by tools such as user-surveys, scorecards, etc. ▫ Reviews of this system show that it is prone to subjectivity
4) Assessment performed by the government's audit institution *Examples:* *In Bangladesh the Comptroller & Auditor General is supposed to approve the outcomes of external audit assessments, conducted by out-sourced audit (accountancy) firms.* *In the Solomon Islands the Office of the Auditor General supports the contracted consultants to perform the assessments, but they keep their independence. However, it means that the assessments are seen as very "serious" events*	▫ Audit skills (needed to cover an important part of the performance indicators) are available in the assessment teams ▫ Lower transaction and logistical costs compared to the out-sourcing model (contracting out) ▫ Ensures a clear division of roles and responsibilities vis-a-vis the actual transfer of funds ▫ Enables the auditors to move toward performance auditing as a supplement to financial auditing, combining the assessment missions with the audit missions	▫ May be too biased toward financial issues ▫ It is debatable whether financial auditors have the capacity to carry out more comprehensive assessments which go beyond financial auditing. This may compromise the quality of the financial audit ▫ Some issues will probably be far beyond the normal scope of audit functions, especially if performance indicators of good governance and transparency are included ▫ May create a number of timing problems, especially concerning the availability of staff ▫ May drain staff from the general financial audit ▫ The working style of financial auditors may be different from the style required during a performance assessment. It may, for instance, be difficult to combine purely financial audits with a participatory approach and the involvement of communities

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Assessment method and examples	Advantages	Disadvantages
5) Combined external and internal participatory assessment (models 1 and 3) *Examples:* *Some countries, such as Uganda, try to involve citizens in the dialogue on the assessments, but this is not a "clean model"* *In Tanzania the LGs conduct an internal assessment one to two months prior to the external assessment to identify gaps and to prepare for the external assessment, but it is more focused on the internal dialogue between staff and politicians in a local government*	▫ Ensures sufficient capacity and resources to carry out assessments on a timely basis ▫ Easier to adjust HR requirements and timing ▫ As a limited number of teams can cover several LGs, this increases the opportunities for capturing economies of scale ▫ Ensures a standardised approach ▫ Provides incentives to carry out assessments in a timely manner ▫ Involves local knowledge about the situation in the LGs ▫ Scope for quality assurance from government/programme ▫ Ensures wider citizen participation/involvement ▫ Promotes interaction between citizens and LGs, strengthens accountability and increases citizen awareness and understanding of the functions and responsibilities of LGs ▫ May be seen as impartial, objective and fair. However, it requires a clear separation of tasks and responsibilities between the two approaches ▫ Ensures a clear division of roles and responsibilities vis-a-vis the actual transfer of funds	▫ Significantly more costly and administratively demanding compared to the other options ▫ May require a large number of additional resource-persons to facilitate internal assessments and community involvement. This may compromise sustainability if the approach is intended to become a part of general government procedures (rather than those of a specific project) ▫ May lead to conflicts between community-based and external assessments ▫ It is a relatively complex and time-consuming model ▫ May lead to protracted discussions about the indicators to be used/ measured and final decisions on assessment outcomes
6) External assessment, contracting out, combined with inclusion of various stakeholders – *CG and LG representatives, NGOs and CBOs co-opted in the teams as resource persons* *Examples:* *Uganda (organized by the ministry)*[186] *Tanzania (organized by consultants).* *Nepal (out-sourced to private consultants, visits involve government representatives in the assessments as observers/QA)* *The model is also being considered in the Philippines.*	▫ May be seen as impartial (neutral), objective and fair ▫ Ensures the capacity and multi-disciplinary skills required to carry out the assessment on a timely basis ▫ Increases the possibilities for capturing economies of scale as a limited number of teams can be involved in several assessments ▫ Ensures a standardized and professional approach to the assessment ▫ Provides incentives to carry out the assessment in a timely and efficient manner ▫ Scope for QA/control from government institutions (however, this may diminish if the government representatives are lead representatives in the assessments) ▫ Ensures a clear division of roles and responsibilities vis-á-vis the actual transfer of funds, although less clearly than in model No. 1 ▫ Has been evaluated as an appropriate arrangement in a number of countries, based on piloting experience	▫ Will add some extra costs[187] ▫ May not ensure sufficient interaction with the various stakeholders, especially citizens (this depends on the organisation). It may not lead to direct dialogue between citizens and LGs, unless this is combined with a participatory process cf. above ▫ May be a bigger challenge to organize, as a variety of stakeholders have to be coordinated and brought together ▫ If it is led by government and the consultants only play a secondary role in managing logistics and in ensuring some QA, many of the disadvantages from model No. 2 may appear here as well. It may be difficult for neutral stakeholders to exert sufficient influence ▫ The number and influence of the consultants may vary, but a strong neutral role is important.

186 In Uganda the system has changed from one managed by contracted private consultants, with co-opted representatives from central and local governments, development partners and NGOs (the so-called "trained resource pool") and organized by a dedicated Project Coordination Unit (PCU) in the Local Government Development Project under the Ministry of Local Government. This approach was changed in 2007-08 to one whereby the Ministry of Local Government took charge of the assessment, with some (limited) quality assurance from private consultants. The stakeholders who met during the review of this approach, including representative from LGs, are now concerned that the quality of the assessments may have declined over time.

187 Experience in several countries where external assessments have been conducted shows that the costs of assessments have been in the range of 1% to 4 % of the total grant.

Various models can be combined. It should be noted that the assessment teams in model No. 1 can comprise a combination of private assessors, civil servants from central government and LG and NGO representatives (i.e. a variant of model No. 6). A pool of resource persons can be established from which the private contractor can select qualified experts from different disciplines. Model No. 6 can also be combined with internal prior assessments (as in Tanzania, where LGs conduct a prior internal assessment before the arrival of the combined teams of consultants and government officials).

Furthermore, any assessment model will require proper preparation and planning, training and capacity building of the assessment teams, and prior notification of the LGs to be assessed. Systems for quality assurance are equally important, as is widespread publication of, and full transparency in, the results.

Many countries have established steering committees (or the like) to finally and formally endorse the results of assessments (e.g. Nepal, Bangladesh, Solomon Islands, Tanzania and Ghana).

A decisive consideration is whether the assessments can be done from the desk/office in the headquarters of the ministry/programme concerned, or whether field visits/on-the-spot checks are required. The choice of model will depend largely on the complexity of the indicators used to measure performance. Simpler indicators (e.g. the extent to which LGs have submitted final accounts on time) can be measured from the "desk", whereas more nuanced and complex indicators (e.g. the quality of the planning process) require on-the-ground assessments. Experience shows that unless the indicators are very simple (e.g. on-off triggers such as the timely completion of final accounts[188]), assessments should be field-based in order to get a real sense of performance, particularly when it comes to using the more- qualitative performance measures.

Annex 4: Various Tools for Dialogue and Influence

Performance- Based Grant Systems in a Wider Context of Interactions Between Central and Local Governments

The introduction of performance-based grant systems (PBGSs) can be seen as part of athe wider dialogue and set of interactions between central and local government on the ways and means to ensure:

- on the one hand, the pursuit of national development objectives and targets in a decentralised context;
- and, on the other hand, the need to ensure that decentralisation objectives are met, leaving LGs with genuinely discretionary powers to address specifically local needs and a considerable degree of autonomy and decision-making power[189] – albeit within the framework of national guidance, legal frameworks and monitoring.

Any system of LG local government finance typically tries to balance these objectives.

PBGSs usually provide funding for the developmental needs of LGs. However, unlike transfers where funds are provided to LGs simply to execute specific functional mandates,

188 The simple indicators applied in the systems in Kenya and Bhutan. They may be made more sophisticated by the use of more-qualitative performance measures.

189 There are various objectives of decentralization, but most countries try to promote local efficiency, ownership and a higher level of citizen involvement/participation.

PBG transfers *incentivise improvements in performance by linking LG performance in pre-determined areas with their access to grants and to the amount of funding they receive.*

Although the PBGS approach is not the only way to promote improvements in LG performance, it needs to be seen as an innovative and encouraging move away from earlier systems of central government ex-ante, micro-management to a more targeted, ex-post, and results-based framework (see the table below).

PBGSs may also stimulate other types of accountability, particularly the links between LGs and their constituencies (citizens), by rewarding good performance in areas such as transparency, citizens' participation in budgeting, planning and project implementation, and other areas of good governance.

It is important to stress that most systems apply a combination of dialogue tools and other instruments to influence performance, and that any one set of tools (e.g. legal compliance control, central government inspection of LGs, or a very elaborated legal framework, etc.) would be ineffective on its own if not properly linked to other initiatives, and to the LG institutional incentives. Experience (in a number of countries[190]) also shows that the introduction of PBGSs (providing LGs with real incentives to improve their performance) sharply dramatically reduces the need to use rigid and cumbersome ex-ante control instruments. PBGSs allow for greater local flexibility on the input side, and – by moving from systems characterised by tightly earmarked sector grants towards systems based on relatively discretionary cross-sectoral grants – foster an increased level of local autonomy. On condition that such flexibility is accompanied by sound and unambiguous guidance, capacity building and other support, PBGSs can help central governments move away from heavy-handed and transaction costly ex-ante oversight (e.g. prior approval of LG plans and budgets, prior reviews of procurement packages and decisions, etc.).

190 E.g. Uganda, Tanzania, Nepal and Bangladesh.

Table 1: Various Forms of Central Government "Guidance" and "Control"

Instruments to ensure national development targets	Advantages	Disadvantages	Comments
Legal compliance and control	▫ Ensures clear "rules of the game", and is typically the first step in a decentralisation process ▫ It is fundamental that the rule of law be upheld and that public authorities (as well as individual citizens) comply with basic statutes and regulations	▫ The supervisory powers of ministries are often insufficient ▫ Follow-up and sanctions for non-compliance are often weak ▫ Legal compliance cannot stand alone ▫ Weaknesses in the legal framework in many countries, particularly with respect to the mandatory functions and obligations of LGs	▫ This is used in various forms in all countries, but can seldom stand alone
Audit	▫ Is an important instrument to reduce fiduciary risk s and is usually performed by an independent, neutral, and professional body ▫ The "rules of the game" are usually clear, and audit practices are generally shaped and informed by internationally recognised standards ▫ In some cases, there are clear rules about follow-up	▫ Audit institutions in many countries lack sufficient capacity in many countries ▫ Audit reports are often not followed -up by sanctions and other measures, and LGs often have limited incentives to follow -up on audit findings. The "trail" often goes "cold" when the audit report has been submitted, with no follow-up and/or sanctions when irregularities are identified ▫ Audits are largely limited to compliance with financial- management procedures, unless more sophisticated performance audits are introduced	▫ There has been a move away from purely financial audits towards more broad-based performance management audits in many countries, but the capacity of auditors to widen the scope of the audit process is often inadequate ▫ Should be combined with internal control and internal audit systems.
" Ombudsman" and other **inspection/control** systems and procedures	▫ These procedures supplement the legal- compliance control systems and are important for detecting very serious cases of abuse and malfeasance ▫ Can focus on severe and targeted cases and thereby reduce the costs of oversight (compared to audit) ▫ Can cover broader areas of governance	▫ Can typically only cover a few severe cases per year ▫ The follow-up on the cases may not always be effective ▫ The institutions in question are often weak in many developing countries ▫ Inspections are not fully trusted in many countries	▫ These institutions do not always cover activities at the LG level(s)
Decision-making control through detailed prior approval/appraisal procedures (e.g. of plans and budgets)	▫ May provide some assurance that national targets and priorities are being addressed, as well as a kind of control over LG decisions. In the best cases, it provides guidance to LGs before it is too late	▫ **May lead to blurred accountabilities (who is ultimately responsible for decision-making?)** ▫ **May undermine lead to lack of ownership and allow political interference** ▫ National priorities may override local efficiency ▫ May typically be excessive and lead to micro-management and unjustified interference ▫ It Often leads to delays and bottlenecks ▫ It can lead to conflicts between the LGs and CG authorities	▫ Is often used in countries where decentralisation reforms have recently been introduced (e.g. where countries have a longstanding tradition of highly centralised control, but where there are some emerging attempts to transform the system or where the political tradition is predicated on a strong central state, as in some francophone countries)

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Instruments to ensure national development targets	Advantages	Disadvantages	Comments
Ad hoc interventions/ interference in local decisions and requirements to perform special activities, e.g. due to political control	▫ Provides a rapid way of achieving central government CG objectives in a targeted, and flexible manner	▫ Constrains the LG planning and budgeting processes ▫ Undermines ownership, trust and downward accountability ▫ Leads to unclear roles and responsibilities ▫ May result in instability, un-predictability, confusion and conflict in the relationship between CG and LGs ▫ Impinges on LG local government planning, budgeting and budget execution	▫ This system is Often used in non-immature, decentralised polities and/or systems in transition or with weak political legitimacy
Control of the inputs through a high level of conditional (earmarked) grants	▫ Provides the funding agency with some confidence that funds will be spent in targeted sectors or areas that are seen as being national policy priorities ▫ May lead to a higher level of transfers to LGs as sectors are more confident that funds are spent as intended within certain areas – although earmarked, sector -conditional grants allow for some local decision-making power (e.g. on location of projects, flexibility across sub-sectors etc.)	▫ May undermine local decision-making, autonomy, ownership and accountability ▫ May lead to high compliance/transaction costs (e.g. in terms of reporting and accountability) ▫ Does not ensure efficiency in utilisation, as it only focuses on the inputs (reducing opportunities for local prioritisation). and lit may be difficult for the CG central government to be aware of and address specific local needs (i.e. the allocative-efficiency objectives of decentralisation will not be fully realised)	▫ This is typically one of the first steps in fiscal decentralisation, and flexibility is often increased as CGs central governments learn to trust LGs and become more confident of LG performance ▫ A proliferation of earmarked grants may also occur as sector ministries (and sector- support development partners) often find the model attractive ▫ Most countries – both developing and high -income countries – apply a combination of earmarked and non-earmarked grants. The usefulness of this approach depends on the type of expenditure assignments (e.g. whether it is delegated or devolved task)
Dialogue between central and LGs, e.g. through finance commissions, processes for budget negotiations/agreements, etc.	▫ This Promotes common understanding, involvement, transparency and ownership, as it is based on close coordination, consultations and (ultimately) consensual decision-making ▫ Thus is a flexible arrangement, which may allow rapid responses to challenges	▫ Cannot stand alone ▫ Agreements are sometimes not kept by one of the parties and there is often no means for sanctioning (or sanctioning is unpopular) ▫ May be difficult due to institutional and cultural constraints ▫ LGs may sometimes believe that they have little choice but to agree with the CG central government	▫ Is in any case an important supplement to other measures ▫ It is used in many European countries in the management of intergovernmental fiscal relationships ▫ It requires a certain level of trust between central and local governments
Guidance and capacity-building support	▫ Provides LGs with means to improve their performance and to better understand how they need to improve ▫ May support any of the other tools	▫ **May not provide sufficient incentives to improve performance** ▫ **May not always address local needs and capacity gaps (may be too supply- driven)**	▫ Often an important way to complement other measures, but cannot stand -alone. Is typically an important element of the PBGS (see below)

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Instruments to ensure national development targets	Advantages	Disadvantages	Comments
National minimum- service delivery (NMS) standards combined with increased autonomy if these are complied with	▫ Focuses on outputs instead of inputs ▫ Provides LGs with room to decide on the most efficient ways to achieve targets, leaving the choice of inputs open for LGs (mix of inputs and processes) ▫ Provides citizens with a tool to monitor LG compliance	▫ May lead to standards which are unrealistic and very costly to achieve and lack realism ▫ As standards are often set at unaffordable levels, it may be problematic to prioritise reduction in these standards across the sectors, leading to endless discussions on where to cut down and on how to ensure funding of these standards ▫ The minimum standards may not reflect the real needs in each of the LGs ▫ May lead to undue central control over LG decision-making powers and compromise local prioritisation and ownership, particularly if directly linked to the grant allocations	▫ The impact depends on the design, the extent to which the standards are realistic, and how closely far these are linked to the grant system ▫ Experience has shown that (a) calculating the cost implications of LGs' compliance with national minimum standards and (b) making the NMSs realistic/attainable within the potential pool of funding are demanding and costly tasks
Support to **civil society** to engage more actively with LGs	▫ **It is important to ensure LG downward accountability** ▫ **Promotes ownership, legitimacy of LGs and empowerment of citizens** ▫ **Builds trust in local governments**	▫ **Can hardly stand alone, particularly if the LGs are not willing to enter dialogue and lack incentives to engage with citizens** ▫ **Citizens often lack (access to) sufficient information and have limited capacity to provide oversight of LGs**	▫ This should typically be promoted in any system and should supplement all the other tools
Performance- based grants (adjustment of the size of the grants as an incentive to promote LG performance in certain areas)	▫ **Targets LG incentives and promotes improved performance in defined areas, without leading to rigid ex-ante control of decision-making processes** ▫ **May lead to higher levels of LG autonomy and greater discretionary powers, thus enabling locally specific needs and aspirations to be met. Experience has shown that if the right incentives are provided to LGs, sector-wise control and earmarking of funds can be relaxed without compromising national targets and priorities, while at the same time fostering good local governance** ▫ PBGSs, if properly designed and implemented, are characterised by strong LG ownership ▫ Improves the accountability: a) upwards vis-à-vis the funding agencies; b) downwards: vis-á-vis the citizens (e.g. by supporting citizens in their dialogue with LGs on performance; and c) horizontally (within an LG, e.g., by strengthening of the dialogue tools between politicians and staff) ▫ Can increase the impact and efficiency of CB capacity building support as core CB areas are defined and promoted ▫ Compared to some of the other tools, PBGSs are both more comprehensive (in the areas they cover) and exert influence throughout the year	▫ **Are relatively costly to design and implement** ▫ Can require a relatively complex management system and require considerable institutional capacity to implement ▫ Assessment results can be manipulated, thus weakening the integrity of the assessment process	▫ **There is valuable good international experience to learn from** ▫ **There has been a general trend away from rigid ex ante (prior) input control to more performance-oriented systems, not only for LGs but also for CG central government agencies** ▫ Should be combined with CB capacity building support to enable LGs to address their performance gaps ▫ A move towards a PBGS should lead to changes in other instruments, such ase.g. ex-ante controls over LG decisions (e.g. prior central government approval of plans and budgets). These controls will will need to changed or be removed ▫ The PBGS must needs to be well-designed and supported by strong implementation capacity ▫ It is important that the PBGSs and the other M&E systems, including inspection and audit, are well-coordinated

Implementing the environmental, social and economic policies necessary to achieve the Millennium Development Goals implies considerable financial resources. It also raises the complex question of how the resources can be deployed to greatest effect. Too often resources come pre-labeled or pre-packaged. A 'thematic' problem is identified and measures are designed – and resources assigned – to deal with it. This can be the case for health, education, agriculture, sanitation or a wide range of single issues.

Yet, it is at the local level – where people live – that the challenges of development are most keenly felt. Development challenges are by nature complex and interrelated. They can rarely be resolved through the mandate of one central agency or through tight central control. They require holistic responses, by the people closest to them, people at the local level. UNCDF local development programmes encourage local government systems to deliver such responses. Can they do so consistently? What measures can be taken to ensure that local capital is deployed for the most effective development purposes?

UNCDF, the UN's capital investment agency for the world's least developed countries, through its support to the introduction of performance-based grants in many countries since the early 1990s, has been at the forefront of the development of innovative practices within the areas of intergovernmental fiscal transfers and the capacity development of local governments. These innovations have helped to ensure that, as local financing increases, local government capacity to deliver the goods is also enhanced.

This publication shares the experiences of UNCDF and others in designing and implementing performance-based grants. The piloting of performance-based grant systems demonstrates how local catalytic capital can be deployed to bring about real improvements in local development and poverty reduction by encouraging local governments to improve their capacity and focus on results.

UNCDF is the UN's capital investment agency for the world's 49 least developed countries. It creates new opportunities for poor people and their communities by increasing access to microfinance and investment capital. UNCDF programmes help to empower women, and are designed to catalyze larger capital flows from the private sector, national governments and development partners, for maximum impact toward the Millennium Development Goals.

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978-92-1-101228-6
53900
9 789211 012286

Printed by means of environmentally-compatible technology on 100% FSC recycled paper.
Design: Inís Communication – www.iniscommunication.com