

CONCEPTUAL BASIS FOR PERFORMANCE BASED GRANT SYSTEMS AND SELECTED INTERNATIONAL EXPERIENCES¹

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List of Abbreviations

CB:	Capacity Building
CBG:	Capacity Building Grant
HMG/N:	His Majesty's Government Nepal
LG:	Local Government (in Nepal Local Bodies (LBs))
LGDP:	Local Government Development Plan
CG:	Central Government
MCs:	Minimum Conditions
O/M:	Operational and Maintenance
PG:	Performance Grant
PGs:	Performance Grants
PMS:	Performance Measures
SWAp:	Sector Wide Approach
UNCDF:	United Nations Capital Development Fund
UNDP:	United Nations Development Programme

1. Introduction and Concept

1.1 Introduction

This note introduces the concept of performance-based grant systems (PGs), presents a brief overview of the international experiences and major design issues for any PG system, and finally outlines some of the key design issues to be considered in future discussions in new countries considering an introduction, replication/roll-out of the PG system.

As intergovernmental fiscal transfers² is one of the main local government (LG) revenue sources in the developing countries and account for more than 60 % of the total LG sources in many countries, it is utmost important for the success of the overall decentralisation process, that the transfers achieve their objectives and promote the right incentives. The way the transfer systems are designed impact on the efficacy of these. Despite this fact, many programmes aimed at fiscal decentralisation have been introduced without proper focus on the *incentives* they create in terms of revenue mobilisation, administrative performance, accountability, good governance, etc.³

However, in recent years a number of innovative reforms and good lessons have been introduced in some countries that warrant further attention. The reforms with performance-based grant systems (PGs) have been introduced to promote the LG incentives in order to enhance capacity and performance. They have acted as important tools for improved vertical links between Central Government (CG) and LGs and between the LGs and their constituencies.⁴

The innovative feature behind the new PG funding schemes is the linkage between the transfers and the performance/capacity of the LGs to absorb. As documented from the country experiences, below, these systems have shown encouraging results and have great potential for further application.

PG systems vary from country to country, but the common defining characteristic of these grants is that they are aimed at promoting a positive change in some aspects of the performance of the LGs, which receive or try to get access to the grants. PGs may also be used to identify capacity building (CB)⁵ gaps and needs of LGs and to provide input to the overall M&E and supervision systems.

² The terms “transfers” and “grants” are used interchangeably in this note.

³ Cf. e.g. OECD, DAC Evaluation Series - “*Lessons Learned on Donor Support to Decentralisation and Local Governance*”, OECD 2004 and the World Bank Operations Evaluation Department OEC, “Capacity Building in Africa, Advance Copy, 2005, which identifies lack of incentives as one of the major problems in capacity building. Please also refer to: 1) Steffensen and Trollegaard, NALAD: “*Fiscal Decentralisation and Sub-National Government Finance*”- Synthesis Report, May 2000, NALAD, the World Bank/Danida/USAID for an overview of the finance system in six Sub-Saharan African countries and 2) Steffensen and Tidemand: “*A Comparative Analysis of Decentralisation in Kenya, Tanzania and Uganda*”, Synthesis Report August 2004, the World Bank

⁴ UNDP: “*Taking Risk*” - Background Papers, UNCDF, 1999, p.68.

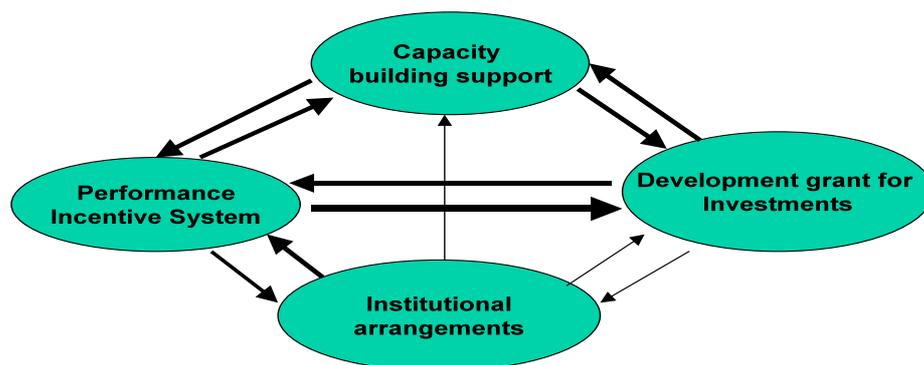
⁵ Please note that this document refers to ‘Capacity Building’ following the practice in most literature on Performance Based Grant Systems. However, the authors fully subscribe to and

Unlike grants where funds are distributed to LGs simply to give them the means to execute specific functional mandates, PGs *incentivise improvements in performance by linking the LGs' performance in pre-determined areas with the access to and the size of funding*. The system is a move away from tight ex post control of LGs to strong performance-based incentives, coupled with ex ante monitoring and assessment.

1.2 Links to Capacity Building

To be most effective, a performance based (capital) development transfer scheme needs to be supported by a strongly coordinated capacity building process and capacity building support to the LG (e.g. in the form of capacity building grants) to enable LGs to address weaknesses in capacity and improve performance, and support the LGs to prepare appropriate capital projects (planning, feasibility studies, monitoring etc.). The performance system will provide LGs with strong incentives to use the capacity building support more efficiently, and the capacity building support will provide the necessary support to improve LG performance as illustrated in the diagram below.

Diagram 1 - Components in a Performance Based Grant Allocation Scheme



The local development grant for investments, the capacity building support and the built-in performance incentive systems can be designed to be mutually strengthening and have a significant impact on the basic conditions for LG service delivery. One way of doing this is to introduce, alongside the capital component of the PG, a capacity-building grant. This grant will obviously be of a much smaller amount than the capital grant (it will be funding various capacity building activities such as training, smaller equipment, etc., rather than ‘hard’

embrace the shift in emphasis implied by ‘Capacity Development’ which is the terminology used within the UNDP.

investment activities), and should be more easily accessible than the PG to enable all LGs to improve the performance. In other words, whilst one expects a certain number of LGs to fail to access the capital grant every year, the capacity building component should be structured to ensure that all LGs can access it, provided that they have shown signs of commitment, for example through elaboration of plans and budgets for capacity building.

In order to concentrate the institutional-strengthening incentive, and for efficiency reasons (LGs are better placed than central government to decide what specific sort of capacity they need), LGs should be allowed significant discretion both over what sort of capacity needs to be built and where the inputs should be sourced. For quality control purposes, certain constraints may be placed on this discretionary power, with central Ministries playing a central role in determining training standards and vetting vendors, yielding a model in which supply and demand side imperatives are balanced and mixed.

The credibility of the assessment of the LGs performance and the institutional arrangements, with central support to system development and procedures (e.g. planning, budgeting, accounting and procurement guidelines and support), are pivotal for the success of a PG system.

1.3 Grant Objectives and focus - multi-sectoral - versus sector specific

In terms of their orientation and focus, PGs can be distinguished from one another along two basic dimensions:

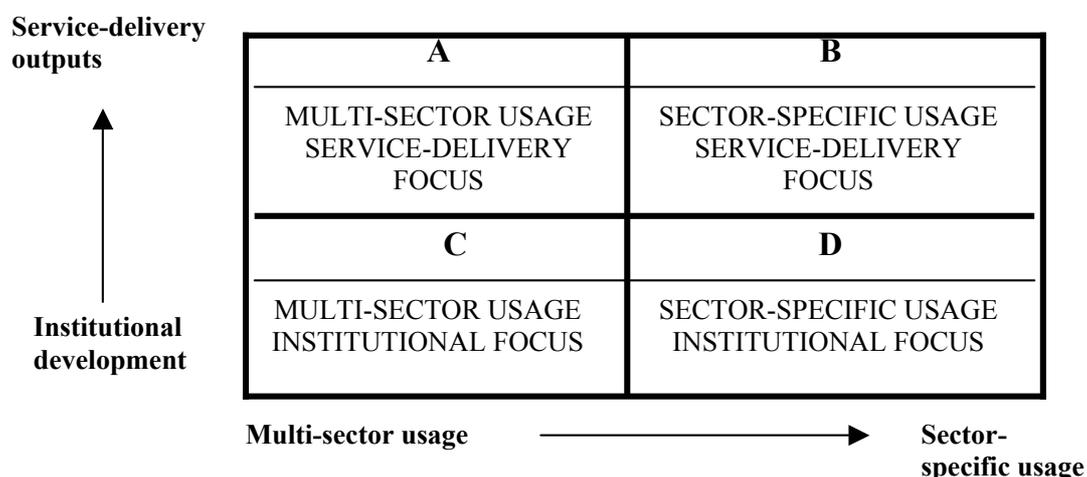
- 1) The type of performance, which the grant is trying to leverage, particularly multi-sectoral/ **institutional** versus **sector** performance and
- 2) Use of funds (the extent to which the funds are earmarked for specific purposes or have a broad menu/LG discretionary funds⁶).

The Chart below identifies four different PG options along these two dimensions:

⁶ In some countries these are called “block grants” or non-sectoral/non-categorical grants.

CHART 1

1) TYPE OF PERFORMANCE: GOALS - SECTOR SPECIFIC MEASURES or INSTITUTIONAL DEVELOPMENT



2) USE OF FUNDS MULTI-SECTOR or SPECIFIC ("EARMARKED")

Multi-sectoral versus sector-specific performance indicators

PG systems may be "*multi-sectoral*", aimed at improving the overall generic institutional/organisational performance of the LGs, or "*sector-specific*". Most experiences from developing countries have been within the first category. To what extent should the PG try to leverage broad improvements in overall institutional capacity and performance⁷; and to what extent should it focus on specific (and often more short-term) improvements in sectoral outputs? In the former case, the things that LGs would need to demonstrate to access PG funds would tend to be improvements in broad, cross-cutting areas such as financial management and planning. Examples of this could be requirements to have clean audit reports, submissions of development plans in time, transparency and open citizen access in planning and budgeting preparations etc.

In *sector specific* systems the performance criteria would tend to focus on achieving certain service-delivery targets, such as number of classrooms constructed or measures of various unit costs. It is important that goals are not too many or too mixed within the same grant mechanism. Laying multiple sectoral delivery objectives over institutional development objectives is likely to send conflicting messages for 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

⁷ 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 and top-down). The particular focus will vary from country to country.

type grants (see diagram 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 delivery is unlikely to emerge. In countries where decentralization is a relatively recent phenomenon, and LG capacity remains a key challenge, focusing on cross-cutting *institutional* strengthening is probably the key priority and type C systems are therefore often applied. Type A grants are most appropriate for more mature institutional environments where the basic structures have few weaknesses and local systems are robust, strong and accountable and when the sectoral responsibilities are fully devolved to LGs.

Usage of funds

To what extent should local discretion be given to LGs over the usage of the grant funds; and to what extent should these funds be earmarked for expenditures determined by the centre? Invariably, national governments (and/or donors) will apply some parameters for local discretion in some areas to ensure adherence to national targets - typically, they may specify that funds should be used for capital investment and/or they may disallow certain types of such 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 only be spent on, say, 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 achieving the overall objectives of devolution. Systems with more autonomy in resource utilization will typically be supported by stronger incentive systems/performance measures.

As indicated above, PGs need to be large enough to give LGs a real incentive to do the things they are trying to get LGs to do in the context of other funding flows they are receiving. The aggregate transfer amount will obviously be partially determined by the total number of LGs that are being targeted, but each LG needs to benefit (or lose) meaningfully if it complies (or does not comply) with the system.⁸

1.4 Grant allocation and poverty targeting

Funding amounts can be determined and distributed according to clear criteria (formula-based) or on the basis of ad hoc decisions/case by case. The advantages of formula based systems are widely known. They are more transparent, predictable and equitable than are ad hoc transfers and more suitable for the local planning process. The standard thinking is that PGs should move in this direction, also as PG are related to institutional performance rather than project specific interventions and the pilots in various countries have all applied clear and transparent allocation formulas.

⁸ It should be noticed that many countries have started rather modest and then gradually expanded the PG system.

There may potentially be some tension between focusing on *performance* and *poverty* targeting. In the long term the basic rationale for a PG is that unless LG performance improves, service-delivery performance to the poor will suffer even if funds are targeted at poorer areas. However, in the short term, if a performance grant disburses funds to LGs on poverty grounds even if they do not meet performance targets, any incentive to improve performance will obviously be lost.⁹ Some ways of reconciling these objectives within a constrained budget environment would be to restrict a performance-oriented grant to poorer rather than richer LGs, and/or develop a design, which focus on more weakly capacitated LGs if this is the overriding policy goal and/or, as most countries have done, to include poverty or poverty proxy measures in the basic allocation criteria prior to the adjustment for the results on the performance measures. It should also be noticed that some of the, in other aspects poor, LGs (e.g. in terms of poverty count and or revenues) have actually performed better than more well endowed LGs in e.g. both Uganda and Kenya. These experiences have shown that there is no direct link between general poverty and possibilities to improve on institutional performance as long as the indicators for performance are reasonable and well designed.

1.5 Assessment system and administration.

While funds may be allocated across the LGs on a formula basis, a PG system requires that this allocation is not an entitlement: the funds are only actually disbursed if the beneficiary LG performs according to a number of pre-established criteria, typically called '*minimum conditions*' (*MCs*) which are to be seen as 'minimum safeguards' for handling of funds. Examples of *MCs* are that the LG has received a clean audit report, has submitted all financial statements in time, has prepared a development plan, etc. In addition to the *MCs*, most systems operate with '*performance measures*' (*PMs*), which are used to adjust the grants up and downwards (reward and sanction) to incentivise good LG performance. Examples of these may be the extent to which LGs have ensured an open access to the budgeting process, has made financial materials available for the public, has made environmental assessments, etc.

The mechanism through which this performance is assessed is vital to the functionality of the PG system: if it does not work properly, or lacks integrity and objectivity, the incentive structure, which constitutes the real added value of the PG will be fatally weakened, and the grants will be robbed of their core purpose. Structuring the administration of the grant to minimize conflicts of interest - through keeping the assessment as *independent*, and as far away from the rest of the grant administration machinery as possible is therefore very important.

PGs are usually managed and overseen by a central government ministry or department, such as the Department of Finance or Local Government (or sector ministries if sector-oriented) and are funded from central revenues and/or donor

⁹ OED, 2004, op cit p. 18 discusses the "core capacity - the minimum level of capacity that must exist to implement proposed performance improvements.." The same is the case with the *MCs* for absorption of discretionary development funds.

loans or grants. The likelihood of the success of the incentive system depends on the allocation of roles and responsibilities surrounding the assessment process. The core problem is that the Ministry, which normally administers such a grant, also tends to be subject to most political pressure to ensure the release of funding, and is thus vulnerable to pressure to dilute and manipulate the assessment process. There are a number of ways in which to manage this risk: the assessment process can be contracted out, carried out as team-work, it can be audited and surrounded by transparency, it can involve LG representatives and other stakeholders, etc.

For a PG to be effective, the performance of the targeted units has to be regularly (e.g. annually) assessed. It is important to mention that while the administration costs will only amount to a small fraction of the overall costs of funding flow, this kind of grant requires more substantial administrative infrastructure than for example an unconditional block grant, but as mentioned, significant parts can be contracted in on a seasonal basis.

2. International Experiences

2.1 Performance based grants

Below is a review of some of the experiences from the East African and Asian countries with the use of PGs. A number of Asian and African countries have experimented with an elaboration of performance based grant allocation incentives, especially addressing the generic elements of the LG administrative performance. Table 1, below, shows some examples from five countries on how the various key design parameters have been handled in places, where these systems have been tested and applied in the more recent years. The system in Uganda, (Local Government Development Plan (LGDP)-I and II)¹⁰, which has been applied over several years, and has inspired many other countries, is of particular interest.

The experiences from innovations with PG systems in various countries have generally been very positive.¹¹ Especially the combination of MCs, PMs, capital grants and capacity building grants have provided LGs with strong incentives to improve on performance within key institutional generic performance areas like planning, budgeting, financial management and project implementation, but also

¹⁰ The original ideas behind elaboration of PG systems originated from a UNDP/UNCDF supported DDP/KDDP tested successfully in a few districts from 1997. The Second Local Government Development Programme is supported by the World Bank (IDA), DANIDA, Austria, the Netherlands and Ireland in the tune of USD 165 Mill. From 2004-2007, PAD May 2003. Other donor agencies, e.g. DFID, USAID, have aligned their support to this transfer scheme.

¹¹ Please refer to 1) Local Government Initiative - *Pro-poor Infrastructure and Service Delivery in Rural Asia*, ADB, ADB Institute and UNCDF, Manila February 2004, 2) *Programme Review of the Local Government Development Programme in Uganda, Final Main Report 2002*, by Steffensen, Land and Ssewankambo and 3) the Local Government Support Programme - *Development of a Capital Grant and a Capacity Building Programme in Tanzania*, December 2003, Volume 1, PWC (Tidemand, Steffensen, Pyndt et al). Similar reviews have been conducted in Nepal, Bangladesh and Kenya.

within areas of good governance. Examples are Uganda and Kenya where local development plans and budgets are now being elaborated with larger involvement of the citizens, more transparency and inclusiveness than prior to the introduction of the systems. Final accounts are being produced, mostly on time, financial management weaknesses are being addressed, internal audit functions are being established, accountability procedures strengthened, and councils and committees, tender boards and other statutory bodies have started functioning, etc. The improvement in these areas over the last 3-4 years have been significant and the impact of the PG system well-documented.¹²

As it appears from the table below, most of the piloting and national roll out of grant schemes, which include performance based allocations, have been made within the area of non-sectoral capital grants, often supplemented by various forms of CB support to the LGs. There are few examples of large-scale performance based sector specific recurrent and development grant schemes. However some countries have experimented with this as well, e.g. Uganda in the area of school construction (school facilitation grants) where LGs with good performance in terms of input/output ratio have been rewarded with extra funds, and where there are initiatives underway to extent the good lessons learned from the non-sectoral development grants to all other recurrent and development grants in the country. There are also plans in some countries, e.g. in Uganda and Tanzania, to link the *flexibility* in the utilisation of funds/the level of autonomy against the LG performance within key financial management areas.

Most of the PG systems have applied *generic* institutional performance measures, within areas such as planning, financial management, fiscal capacity and tax effort, expenditure prioritisation (reward for poverty focus in expenditure allocation), transparency and accountability. In the five countries shown in Table 1, below¹³, clear minimum access conditions for grants are applied and the size of the development grant is adjusted against the performance of the LGs within key performance areas. A number of countries¹⁴ have initially applied only minimum conditions for eligibility and during subsequent phases some of these have introduced more qualitative and complex performance measures like the ones in Uganda, Tanzania and Bangladesh. Hence, there is a clear tendency to develop and fine-tune the performance-based systems once they are in place, and to elaborate second and third ‘generations’ of the systems.

¹² Please refer the footnote above. Similar experiences are seen from other parts of the World, e.g. in Bangladesh.

¹³ In Tanzania, a new system will be gradually rolled out, starting in FY 2004/05.

¹⁴ E.g. Tanzania, Senegal, Bangladesh and Cambodia. Development of PG is also considered in other countries, e.g. Sudan.