



# **FISCAL DECENTRALISATION AND SECTOR FUNDING PRINCIPLES AND PRACTICES**

## **ANNEX 5**

### **Performance-Based Grant Systems –Concept and International Experiences**

The views expressed in this paper are those of the author(s) and do not necessarily reflect the view or policies of the Ministry of Foreign Affairs of Denmark.

**Jesper Steffensen**  
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## Abbreviations & Acronyms

ADB:	Asian Development Bank
Bn:	Billion
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
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
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. Background for Performance-Based Grants<sup>1</sup>**

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 on the likely success of the overall system of local government finance and decentralisation as a whole.

The coming publication on performance-based grant systems (PBGSs) is aimed at providing a detailed overview of and evidence-based insights into the design and implementation of PBGSs for LGs. PBGSs are intended to be integrated into national systems of IGFTs, with a view towards providing LGs with tangible incentives to improve their overall institutional, organisational and functional performance, thus reducing the risks associated with IGFTs and making decentralisation become more effective, efficient and responsive as a strategy for the delivery of public goods and services. Among other agencies, UNCDF and more recently Danida have been actively involved in piloting the use of performance-based grants – and the experience gained from supported projects and programmes has generated significant lessons about the design and implementation of PBGSs in developing, low- and middle-income countries.

## **2. Overview**

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

### **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 a 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, 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 that there is a minimum capacity

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<sup>1</sup> This Annex is an abstract of a forthcoming publication on performance-based grants, funded by UNCDF with Jesper Steffensen as the author.

available 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). 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 become eligible for all or part of their grants). PMs are assessed for all LGs, but assessment results only impact on those LGs that (by virtue of having demonstrated compliance with MCs) are eligible to receive grants – the size of which is either increased or decreased depending 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.

By linking the level of funding that LGs receive in the form of fiscal transfers to their 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, 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 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 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, 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

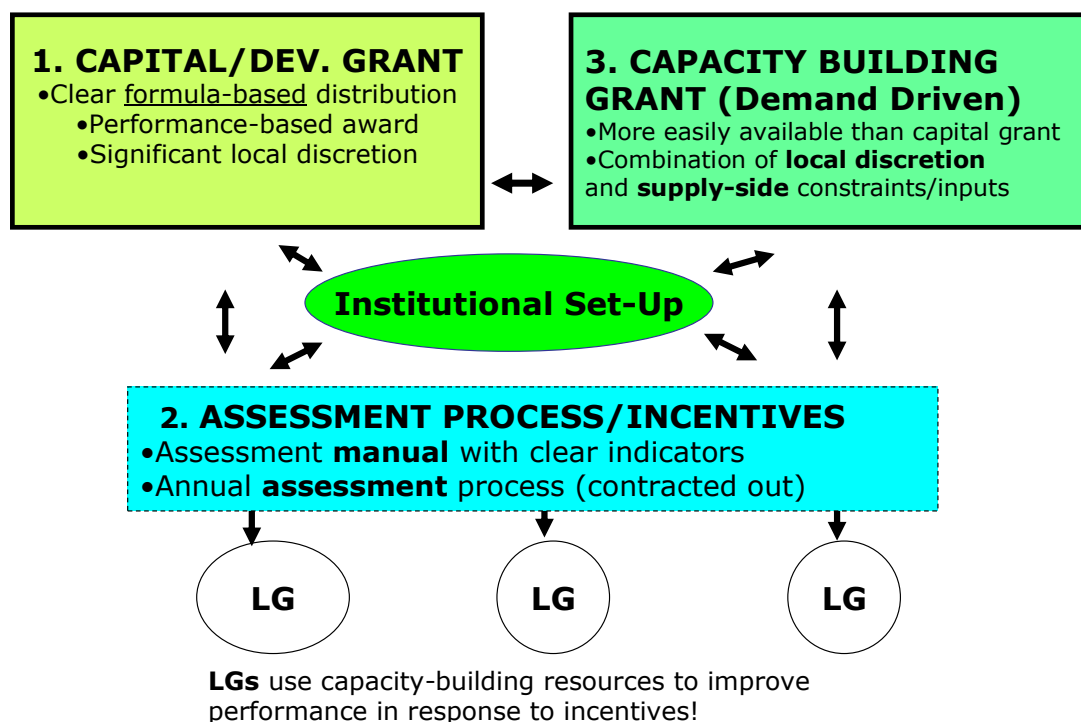
and/or more sector-specific dimensions to performance (such as sector-specific deliverables).

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 specific 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 the weaknesses that are 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.
- The figure below illustrate the systems:

Ideally, a mutually reinforcing triangle should be established between 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.

**Figure 1: Mutually Strengthening Components of a PBGS**



A general description of each of these components is given below.

### **Capital Development Grant Component**

The capital development grant component (performance grants) is the number one 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 that are being targeted in a country 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<sup>2</sup>. 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.

### **Assessment System and Process**

#### ***Assessment system and measures***

<sup>2</sup> It should be noted that many countries have started with limited and modest PBGSs and then gradually expanded the system.

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 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 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 various 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 towards 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, 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 more simple 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 lead to lack of buy-in and 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.

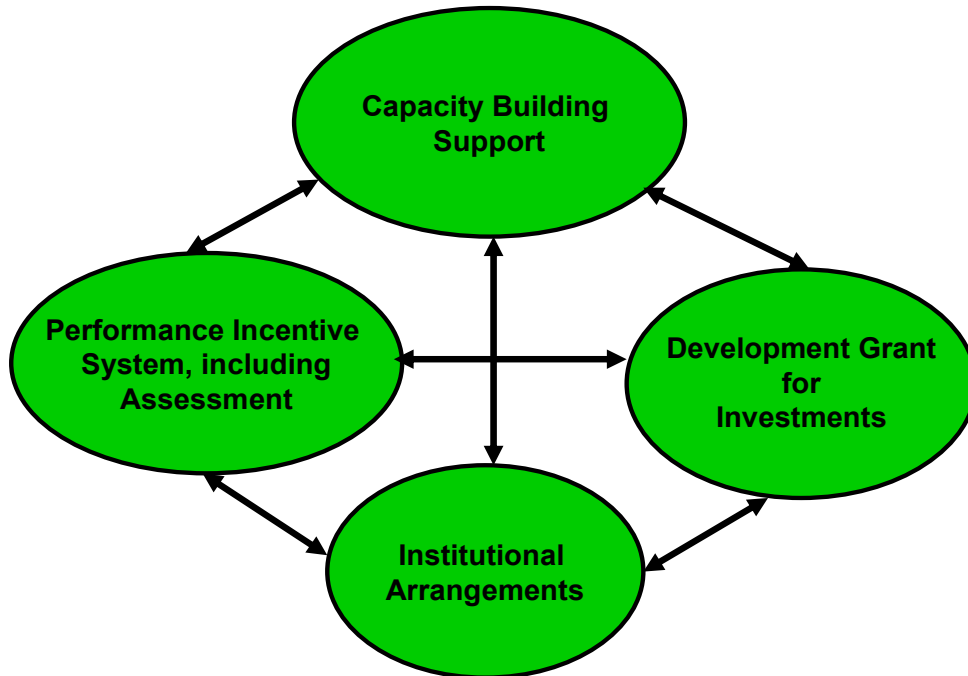
## **Capacity Building**

To be most effective, a performance-based (capital) development transfer scheme needs to be backed up by well designed options for capacity building for LGs (e.g. in the form of capacity building grants) to enable them to address weaknesses in capacity and to improve performance, and 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 capacity building support should enable LGs to address the functional gaps, identified during annual assessments, in an efficient and targeted manner. Furthermore, the assessment system provides good incentives for the 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 more simple 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, capacity building support will provide the necessary means and incentives to improve LG performance:

**Figure 2 – 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 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 items, 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 capacity building grants, provided that 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<sup>3</sup>.

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 capacity development needs that LGs will need sufficient autonomy for local choice and decision making.

A forthcoming publication will review how these principles have been applied in practice, focusing particularly on 15 low- and middle income countries<sup>4</sup>.

### ***International experience***

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 4 districts with a gradual expansion in the number of LGs covered. By 2003, Uganda's PBGS had been scaled up on a nation-wide 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 nation-wide, and several other countries are planning to use similar approaches. There is now considerable on-the-ground international experience of using 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***

2. In looking at 15 different developing and middle income countries in which PBGS approaches have been used, a number of patterns and issues emerge, *inter alia*:
  - although a few countries have tried out (or are in the process of trying out) 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,

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<sup>3</sup> 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%.

<sup>4</sup> Steffensen, Jesper in UNCDF: Performance-Based Grants – Concept and International Experiences, 2009.

- 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 towards 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 towards 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 measure 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’ level. 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, out-sourced assessment teams, training of assessors, etc.), some have sought to “internalise” the process by making assessments into “in-house” functions (with the potential 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 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 in encouraging 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***

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

- 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 dramatically improved 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;
- local government 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, thus contributing to a more meaningful interface between LGs and citizens and better informed dialogue, and other improvements in 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 can be and 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 towards 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 than generic) needs;
- there is considerable evidence to the effect that PBGSs facilitate greater coordination between and amongst development partners – the safeguards associated with PBGSs allow DPs to more easily enter into basket funding arrangements, which may later evolve into genuine “sector” budget support for decentralisation (using SWApS). In addition, PBGSs often provide an initial 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 thus greater allocative efficiencies) and the incentives provided for improved planning, budgeting and costing, design, contracting, project implementation and supervision and operations & maintenance.

Despite the evidence for these achievements and benefits, it remains nonetheless 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***

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 performance;
- 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 dis-juncts with the annual budgeting cycle, and so on. An overwhelming focus the technical aspects related to PBGS design runs the risk of overlooking such fundamental challenges and reform issues;
- the 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. Whilst 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 lead 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 potential problems that are often 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 and hoped for results. This highlights the need to keep sight of the wider picture in designing performance-based grant systems for LGs.

## ***Conclusions and recommendations***

### ***Conclusions***

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 being paid 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 some encouraging evidence that PBGSs impact positively on areas such as the cost efficiency of service delivery and targeting of poverty alleviation.

Although the PBGS approach is not the only way to promote improvements in LG performance, it should 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. By moving away from systems, characterised by tightly earmarked sector grants, towards systems based on relatively discretionary cross-sectoral grants, PBGSs foster an increased level of 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, up-ward and horizontal accountability.

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

However, it is important to note that the PBGS approach is not an all embracing panacea – and PBGS reforms need to be complemented and coordinated with other measures, such as HR and payroll reforms, 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 those LGs that are performing 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 for a PBGS approach, particularly in terms of HR management (with LG staff being at least partly accountable to local political bodies or a strategy and means to encourage that the LG officials pay attention to the results), LG finance arrangements, 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;
- 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.

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 contribute towards establishing the “right” context.

### ***Recommendations***

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 reform 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 out, 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 to oversee implementation of the system;
- integrate into PBGS design a clear strategy for CB support, which combines supply- and demand-driven approaches and ensures high quality CB services;
- given the innovative nature of the approach, establish sound 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 capacity-building 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 the 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 with sector grants;
- regularly review and follow-up on the 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 need to 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).