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**Conditioning Intergovernmental Transfers  
and Modes of Interagency Cooperation  
for Greater Effectiveness of Multilevel Government  
in OECD Countries**

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## INTRODUCTION

Multilevel government presents a formidable challenge: the necessity to coordinate, among governments, the policies for achieving efficiency and effectiveness of public service delivery and investment. This challenge emanates from the dilemma between the need for autonomy of subcentral public agencies on the one hand, and the aim of avoiding inconsistencies in policy-making and economic inefficiencies on the other. The former is essential for embedding local preferences in decision-making and mobilizing local resources that are both needed to promote efficiency; yet inconsistency and inefficiency are likely to produce conflicting results, adverse in homogeneity, unfairness, ill-designed public services, and ultimately a waste of public resources.

The response to this challenge is manifold: (i) constitutional and ordinary laws seek to minimize conflicts through a (hopefully) unambiguous assignment of responsibilities and resources to the different layers of government and subcentral public agencies; (ii) procedural rules and institutions, including the judiciary, aim at providing potentially effective conflict-resolution mechanisms; (iii) intergovernmental financial arrangements are tailored toward integrating inter-jurisdictional spillovers and toward providing incentives through the earmarking and conditioning of grants; and (iv) public authorities set up institutions and procedures for interagency coordination and cooperation where appropriate.

This study looks into topics (iii) and (iv) only. In a first part it examines the usefulness of conditioned intergovernmental transfers for revealing information, providing appropriate incentives, mitigating risks, strengthening subcentral institutions, triggering desired reforms at subcentral levels, and coordinating policies among governments. The second part of the paper considers a selected number of effective coordination mechanisms in OECD countries, in particular programs relating to vertical cooperation between central and subcentral authorities (e.g. the Australian COAC Reform Council or the German Joint Tasks) and to horizontal cooperation among regional and local authorities. It also includes a discussion on broader coordination concepts such as those embedded in the Fiscal Responsibility Laws of Australia, New Zealand, the United Kingdom, Mexico and Hungary. Finally it makes a tentative assessment of the newly created “Fiscal Compact” of EU Member States that sets sights on macroeconomic coordination at the supranational level.

## PART I: CONDITIONING INTERGOVERNMENTAL TRANSFERS

### 1.1 Classifying intergovernmental transfers and limiting the scope of study

There are many ways to classify intergovernmental transfers. For the purpose of this study it is important to distinguish between financial flows that represent general budget support without any intention to interfere with the recipient's policies, and those where the donor government attempts to encroach on a recipient's policy through financial incentives or the conditioning of grants. Only the latter are relevant in this context.

Moreover the term "conditioned" needs elaboration.

1. One may argue that all intergovernmental transfers are subject to observing the general rules of law, in particular organic budget laws, prudential and auditing rules and regulations as well as agreements on the sound management of public budgets (such as procurement obligations, or the EU's Agreement on Budgetary Discipline and Sound Financial Management (IIA), for instance). This is all too obvious but not meant to inflict upon recipient's policy preferences, so they shall not represent conditions as termed in this paper. They may however serve as coordinative instruments. So some discussion in of coordinative agreements is relegated to the second part of the paper.
2. Unconditional funding is typically given through revenue sharing, i.e. tax sharing or general grants (general revenue grants). The allocation of general grants is often made on the basis of formulae that reflect fiscal capacity or various needs criteria. Where such criteria are objective and non-manipulable (e.g. population, area size, proportion of pensioners, standardized taxes etc.) the grants will be neutral with regard to a recipient's policy except for a pure income effect, but in some cases, notably formerly socialist countries (e.g. Hungary), the grant is given on the basis of "norms", e.g. the number of hospital beds. One may argue that such grants are conditioned as they foster the "norm", in this case, the creation of beds (failing to address hospital services). Nevertheless, for the purpose of this study, "normative grants" are considered unconditional general grants, just with defective allocation criteria.
3. Albeit unconditional in principle, general grants (and even tax sharing) may be given on a discretionary basis and hence become subject to conditions. Where an adjustment is made on purely fiscal grounds (for instance to change the vertical fiscal balance), this does not directly interfere with subcentral policy priorities, again except for the income effect. For that reason we do not examine *ad hoc* adjustments of that type. But where unconditional entitlements (such as formula grants) become subject to performance criteria (including macro policy objectives), or tax-sharing flows are earmarked to certain expenditure items (such as debt service) or special funds, there is clearly an intention of the grantor to influence the grantee's policy. Legal entitlements such as formula grants or tax-sharing transfers dictate softer constraints however. Given the legal "ownership" of the grants and tax shares, they can only be withheld temporarily while conditions are not being met. Therefore the sanction is limited and has usually only a signaling or shaming effect.

4. Another distinction is between conditional grants and specific-purpose grants. At first sight a grant allotted to a specific purpose appears to be conditioned. Yet the question is to what extent this “condition” is binding. If the recipient would spend own resources for that specific purpose anyway then the “condition” does not really bite. Hence the specific-purpose grant is as good as a general grant since it unties unconditional own resources. If the money from a specific-purpose grant is larger than what the recipient would spend consistent with local preferences, one could consider the amount overspent a waste of public resources. So the specific-purpose grant rests at the borderline between an unconditioned general grant and a conditional grant.
5. The specific purpose grant emphasizes the need for revealing information for conditions to become binding. There are various ways to address this issue. The most common approach is through reporting requirements *ex ante*, but these may not convey the recipient’s true preferences. A typical solution to overcome this problem is cofinancing – either indirectly or directly. Australia, for instance, counts specific-purpose grants received as own resources when calculating the entitlement for unconditional general revenue grants<sup>1</sup>. Another way of revealing information on local preferences is through matching requirements. We shall examine specific-purpose grants in this study to see under which conditions they are effective in achieving their objectives. But we shall address them in the broader context of “specific grants”, “mandated grants” and “capital grants” that include varieties not simply earmarked to a purpose, but provided with qualitative and quantitative conditions aiming to achieve certain objectives.
6. It should be noted that, despite the usual rigid allocation of funds to budget titles or departments, there also exist interdepartmental transfers within a jurisdiction (microtransfers).<sup>2</sup> These may be considered specific grants as they are usually related to an exchange of services between departments or public agencies. This study does not specifically consider such transfers although they have won prominence more recently through interdepartmental or interagency contracting. However most of the issues addressed in the context of intergovernmental transfers also apply to microtransfers.
7. Finally it is important to notice that grants may be personalized or be assigned to public budget units. Of course direct transfer payments made to private households or companies cannot be termed “intergovernmental”, yet often such transfers are channeled, for various reasons, through public budgets at lower tiers of government. This bears the risk of incomplete funding (partially “unfunded mandates”). Subcentral authorities then either have to complement the funding with own resources to honor their legal obligations or open-ended personal entitlements for which they are responsible; or they may be given policy discretion in the way they allocate a given fund to private subjects. An example of the former is social assistance by local governments in Germany; an example of the latter is found in the European Agricultural Fund for Rural Development (EAFRD) or the TANF program of the United States<sup>3</sup>.

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1. However this “claw back” is to be understood only in relative terms since the total amount of the general grant is invariably linked to the general sales tax (GST).

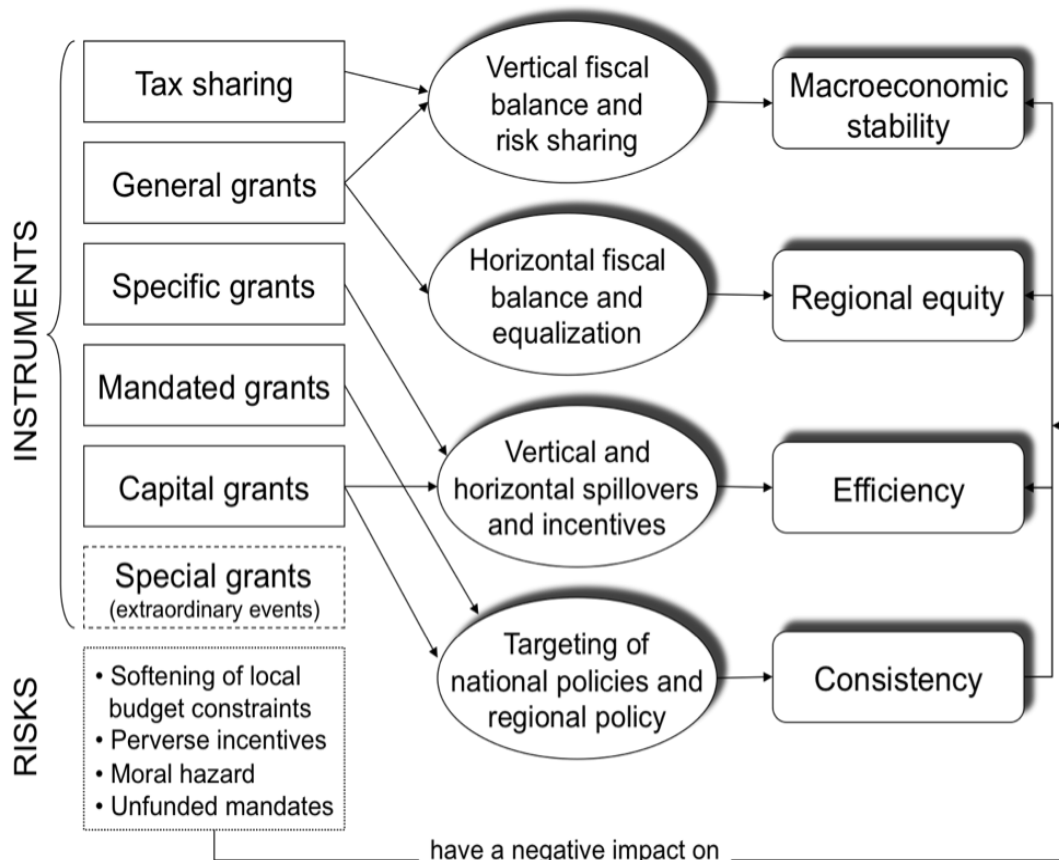
2. See Paul Bernd Spahn, „Contract Federalism“, *Handbook on Fiscal Federalism* edited by Ehtisham Ahmad und Giorgio Brosio, E. Elgar, Cheltenham, 2006, pp. 182-197; and the Chapter “The Case for Intra-Government Efficiency” of „Equity and efficiency aspects of interagency transfers in a multi-government framework“, in: Robin Boadway and Anwar Shah (eds.) *Intergovernmental Fiscal Transfers: Principles and Practice*, Public Sector Governance and Accountability Series, The World Bank, Washington D.C., 2007, pp. 75-106.

3. One of the most significant reforms passed by the 104<sup>th</sup> Congress of the US in 1996 was the conversion of the open-ended entitlement grant, Aid to Families with Dependent Children (AFDC), to a capped block grant called Temporary Assistance to Needy Families (TANF) to be managed by the States.

## 1.2 Types of conditional grants and main policy objectives

With these considerations in mind, we shall classify intergovernmental transfers as follows (Figure 1). This classification is by main policy objective of the grant.<sup>4</sup>

Figure 1: The classification of intergovernmental transfers by objective



Source: Own classification.

We call “general grants” all intergovernmental transfers whose main purpose is to provide general budget support to subcentral levels of government. This funding is typically unconditioned and equivalent to the recipient’s own resources (taxes and shared tax entitlements). The main purpose of general grants is to keep the vertical fiscal balance and to share financial risks arising at the revenue side of consolidated public budgets. As such they are ideal instruments to convey macroeconomic constraints to subcentral budgets.

4. We do not treat “special grants” in this study, which are meant to address singular, exceptional, unanticipated or extraordinary events only. An example of such more permanent grant program is the European Union Solidarity Fund, which is to come to the aid of any EU Member State in the event of a major natural disaster. Australia uses the term “special grant” for the (historic) grants made exceptionally to “claimant States”.

General grants, and sometimes tax shares allocated on the basis of formulae rather than by derivation, are also used to equalize the funding of subcentral budgets among regional or local government at a given layer of government (equalization grants). Again these grants are typically given without conditions.

We call “specific grants” all intergovernmental transfers that aim at integrating vertical or horizontal spillovers and providing incentives for efficiency. Where they are effective these grants also serve to coordinate policies among governments or public agents in a *quid-pro-quo* manner. Specific intergovernmental transfers may also be used to address economies of scale through incentives to form “optimal” spatial units for public service delivery, which is expected to mitigate fiscal competition among jurisdictions.

The specific grant is hence an instrument to compensate external benefits – whether vertically between levels of government, or horizontally among governments at the same layer of government. This is the main rationale for cofinancing decentralized public services and investments. For instance, the German joint task “Improvement of regional economic structure” represents a mechanism aimed at compensating the vertical spillover effects between the nation’s and the region’s interests in the area of economic development. It is achieved through coordinated spatial programming and selective priority cofunding.<sup>5</sup> The approach has been extended to incorporate supranational policy objectives transmitted through the support programs of the EU.

Another example of vertical specific grants is the Canadian Health Transfer (CHT), a block grant given by the national government in support of the health systems of provinces and territories. It is provided for the purposes of “maintaining the national criteria” for publicly provided health care in Canada, and is hence subject to the general guidelines laid out in the federal Canada Health Act: universality, accessibility, comprehensiveness, portability, and public administration.

The Swiss intercantonal financing of higher education may serve as an example for horizontal spillover effects that are compensated via specific grants. These are based on the Constitution (*Bundesverfassung*, BV) and operate through intercantonal agreements. The central level of government may participate in cofinancing such services as an interested, but neutral broker and facilitator.<sup>6</sup>

Other examples for horizontal specific grants are transfers to special-purpose districts or bodies (e.g. for river basin management, mass transit, irrigation, conservation, sewerage, solid waste management, water supply, and other utilities) that are common in many OECD countries, notably the United States and the United Kingdom. These entities may be able to raise own taxes and charges, but are usually supported by appropriations from central, regional and local governments. Similarly the German counties (*Kreise*) are financed through upward-oriented grants from municipalities located in their jurisdiction. This way of financing overarching functions, as well as the formation of special districts, emphasizes the importance of economies of scale in delivering public services at the appropriate regional level or through specialized public entities.

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5. Gesetz über die Gemeinschaftsaufgabe "Verbesserung der regionalen Wirtschaftsstruktur". The law stipulates the “measures must comply with the principles of general economic policy and the objectives and requirements of regional planning and zoning“ (Article 2).

6. “The Cantons may enter into agreements with each other and establish common organisations and institutions. In particular, they may jointly undertake tasks of regional importance together” (BV, Art. 48.1). And “The Confederation may participate in such organisations or institutions within the scope of its powers” (BV, Art. 48.2).

By contrast, the German horizontal transfer system, *Finanzausgleich*, between States (*Länder*), or similar arrangements between municipalities in Denmark, is *not* motivated by the integration of regional spillovers. It simply aims at interregional equalization by redistributing unconditional revenue. This does not mean that the income effect resulting from the scheme is irrelevant for regional development. Quite the contrary! However this study does not dwell on unconditional equalization payments among governments, including general grants that flow horizontally.

We use the term “mandated grants” whenever there is a principal-agent relation between the donor and the recipient of the grant (a mandate), for instance for conveying national priorities to subcentral public entities to achieve consistency in policy making or for targeting central objective where the implementation of the policy is devolved to lower tiers. Mandated grants could also compensate for regulatory or social standards imposed onto lower tiers of government by central authorities. For instance the United Kingdom government compensates municipalities for the full cost of the council tax for those on low incomes (“council tax benefits”).

Of course the delineation between specific grants and mandated grants may be difficult to draw in practice. Moreover it raises sensitive constitutional questions. For instance the CHT could be interpreted as a specific grant to integrate vertical health-benefit spillovers in Canada (which does not raise doubts about provincial budget autonomy), or be interpreted as a mandated grant handed out by the Canadian government (the principal) to impose national health policy onto provinces and territories. The latter may be politically resented, and there are examples where subcentral governments have rejected transfers that come in the guise of mandated grants just to underline their budget autonomy.<sup>7</sup> However the term “unfunded mandate”, which is often used to complain about insufficient funding of subcentral budgets, implicitly acknowledges a mandated grant, because the term has a meaning only if there is a principal-agent relationship between the policy setting authority and a local executive agency.

The “capital grant” does not constitute a category on its own, but is either a specific or a mandated grant for financing public capital formation. But it is useful to call attention to this type of grants not only because it is tied to public investment and regional development, but also because such grants exhibit special characteristics in view of their bulky and singular, ephemeral nature. So capital grants are typically assigned to specific projects for a limited time span, which renders it unsuitable to base their allocation on formula apportionment.

All types of intergovernmental transfers exhibit policy risks. For instance inadequate allocation criteria or false conditioning might soften budget constraints, distort economic incentives, in particular produce moral hazard, or render grant programs ineffective through unfunded (or partially funded) mandates. These exhibit economic inefficiencies and bear on policy consistency, regional fairness and even macroeconomic stability. Undoubtedly such risks ought to be minimized, but they must also be put into context with the significant coordination gains to be reaped from a well-designed transfer system.

Before we discuss the pros and cons of conditioning intergovernmental grants, we shall look at some path setting grants systems as they have evolved in the United States and the European Union. Both systems do not provide for mandated grants since neither the US federal government nor the EU Commission are in a position to impose their policy objectives in a principal-agent relation.<sup>8</sup>

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7. The history of US categorical grants is full of examples where moneys have been rejected because of daunting “strings” attached to the transfer.

8. While this assertion is certainly accurate in the case of the EU, where the sovereignty rests with Member Countries, it may be debatable with respect to the United States. In fact, during the 1990s, the arrangements were criticized as violating the 10<sup>th</sup> Amendment of the Constitution, since the conditions imposed on



### 1.3 Categorical grants in the United States and grant programs of the EU

The term “categorical grant” is used in the United States to encompass a host of particular grants-in-aid programs, projects, services and activities to provide federal domestic assistance (FDA). They represent almost 90 percent of all federal aid and have evolved (and proliferated) over time in an uncoordinated fashion, often responding to *ad hoc* policy decisions and “pork-barreling” within Congress. In 2011 there were 2.200 federal aid programs, of which 1,912 in the form of grants, provided by 14 federal departments and about 50 federal agencies, commissions, foundations, endowments and boards.<sup>9</sup> FDA programs are available to: State and local governments (including the District of Columbia and Indian tribal governments); Territories (and possessions) of the United States; domestic public, quasi-public, and private profit and nonprofit organizations and institutions; specialized groups; and individuals. In 2011 the grants represented 4,1 percent of GDP, 27,5 percent of State and local expenditure, and 22,4 percent of federal domestic outlays (excluding defense, etc.).<sup>10</sup>

Although categorical grants evolve largely *ad hoc*, an attempt is made by the President’s Office of Management and Budget (OMB) and the General Services Administration (GSA) to classify the various instruments by common characteristics.<sup>11</sup> They break down FDA in accordance with 15 types of assistance, of which seven are of a financial type, and eight are non-financial. The classification is reproduced in Table 1.<sup>12</sup>

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receiving the grants had become more and more stringent going far beyond operational objectives (for instance a 21-year-old drinking age or a 55-mph speed limit on interstate highways). However the Supreme Court has denied a principal-agent relationship between the Federation and the States, and reaffirmed categorical grants as non-mandated because entering into a grant program was “voluntary”. However there are also cases in which the Court has limited the ability of Congress to impose conditions. For instance New York disputed federal legislation pertaining to the disposal of low-level radioactive waste, arguing that the legislation compelled States either to follow congressional instructions or accept ownership of the waste. In its ruling, the court stated, “In this provision, Congress has crossed the line distinguishing encouragement from coercion.” (U.S. Supreme Court, *New York v. United States*, 505 U.S. 144, (1992).)

9. The breakdown of programs by main Departments is as follows:

Number of programs	Percent of total	Department
439	20%	Health and Human Services
255	12%	Interior
239	11%	Agriculture
151	7%	Education
125	6%	Justice
991	45%	Others

10. “Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013”, *Special Topics, Aid to State and Local Governments*, OMB, Washington D.C., Table 18–2C, p. 304.

11. See 2011 Catalog of Federal Domestic Assistance, Executive Office of the President, Office of Management and Budget and the General Services Administration, Washington D.C.. The primary purpose of the Catalog is “to assist users in identifying programs that meet specific objectives of the potential applicant, and to obtain general information on Federal assistance programs. In addition, the intent of the Catalog is to improve coordination and communication between the Federal government and State and local governments.” The following mainly draws on this Catalog.

12. Of course not all categories of FDA are relevant for this study, in particular non-financial FDA, unconditional grants (category A) and direct payments to individuals (categories C and D) as well as lending operation, guarantees and insurance (categories E – G).

**Table 1: The classification of FDA in the United States by type of assistance**

<b>Financial types of assistance</b>	
A. Formula Grants	Allocations of money to States or their subdivisions in accordance with distribution formulas prescribed by law or administrative regulation, for activities of a continuing nature not confined to a specific project.
B. Project Grants	The funding, for fixed or known periods, of specific projects. Project grants can include fellowships, scholarships, research grants, training grants, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, survey grants, and construction grants.
C. Direct Payments for Specified Use	FDA provided directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance on a particular performance by the recipient.
D. Direct Payments with Unrestricted Use	FDA provided directly to beneficiaries who satisfy Federal eligibility requirements with no restrictions being imposed on the recipient as to how the money is spent. Included are payments under retirement, pension, and compensatory programs.
E. Direct Loans	Financial assistance provided through the lending of Federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
F. Guaranteed/Insured Loans Programs	The Federal government makes a pact to identify a lender against part or all of any defaults by those responsible for repayment of loans.
G. Insurance	Financial assistance provided to assure reimbursement for losses.
<b>Non-Financial types of assistance</b>	
I. Use of Property, Facilities, and Equipment	Programs that provide for the loan of, use of, or access to Federal facilities or property.
J. Provision of Specialized Services	Programs that provide Federal personnel directly to perform certain tasks for the benefit of communities or individuals.
K. Advisory Services and Counseling	Programs which provide Federal specialists to consult, advise, or counsel communities or individuals.
L. Dissemination of Technical Information	Programs that provide for the publication and distribution of information or data of a specialized or technical nature.
M. Training	Programs that provide instructional activities conducted directly by a Federal agency for individuals not employed by the Federal government.
N. Investigation of Complaints	Federal administrative agency activities that are initiated in response to requests to examine or investigate claims of violations of Federal statutes, policies, or procedure.
O. Federal Employment	Programs that reflect the Government-wide responsibilities of the Office of Personnel Management in the recruitment and hiring of Federal civilian agency personnel.

Source: 2011 Catalog of Federal Domestic Assistance, OMB and GSA, Washington D.C.

By contrast to the provision of FDA in the United States, the EU Commission has aimed at controlling the evolution of supranational assistance from the outset by establishing comprehensive funds under general rules. The main instruments are the European Agricultural Guarantee Fund (EAGF), which finances direct payments to farmers and measures to regulate agricultural markets, the European Agricultural Fund for Rural Development (EAFRD), which addresses rural development, the European Social Fund (ESF), which responds to the diverse employment challenges faced by Member States, and the European Regional Development Fund (ERDF), which aims at strengthening economic and social cohesion in the EU and correcting imbalances between regions through public investments.

Over time the European Commission felt the need to address specific country groups, for instance Member States with an economic or social backlog (addressed by the Cohesion Fund), or candidate and potential candidate countries for accession to the Union (addressed by the Instrument for Pre-Accession Countries, IPA). Moreover there are four special initiatives developed by the Commission in co-operation with the European Investment Bank group and other financial institutions to render cohesion policy more efficient and sustainable.

Overall the EU assistance programs appear much better structured, and procedural rules are more coordinated, than in the United States, although there is a similar tendency toward proliferation. However the European Union attempts to consolidate programs from time to time (for example under IPA), and the programs operate under harmonized rules. Nevertheless the Commission has clearly embarked on presenting its grant programs by category rather than by type of fund, which is obvious from their Internet site. This may simply aim to “assist users in identifying programs that meet specific objectives of the potential applicant”, but of course going the route toward categorical grants also requires reflection on the specific conditioning of grants, adopting the programs to the circumstances of the targeted activity and rendering them operational and effective.

Similarly there were various attempts in the United States to blend categorical grants into block grants for broader categories not only to give beneficiaries greater leeway in using the grants, but also to combat excessive fragmentation. Today it is customary to officially distinguish the block grants from the narrower categorical grants.

Indeed categorical grants in the United States had long been criticized as being administratively burdensome, too restrictive to allow for tailoring to specific regional conditions, producing duplication and overlap among grants programs, and provoking a propagation of grants at work in a similar geographic area, yet administered by different federal agencies without coordination.

Block grants in the United State date back to 1966 (“Partnership for Public Health”), and were extended during the Nixon and Reagan Administrations. In particular the Omnibus Budget Reconciliation Act (OBRA) of 1981 consolidated 77 categorical programs into nine block grants. The Clinton Administration proposed many reforms that would have consolidated categorical programs into block grants, yet most of them were never passed. An important reform of his Administration was, however, the conversion of the open-ended entitlement grant Aid to Families with Dependent Children (AFDC) to a capped block grant called Temporary Assistance to Needy Families (TANF)<sup>13</sup>.

Block grants are typically awarded on a formula basis specified by law providing the recipient with more latitude to define the use of the funding than for categorical grants. For instance the States may use TANF funds in a variety of ways to meet any of four purposes set out in law. Also each State has the discretion to determine eligibility requirements for TANF benefits. Despite the efforts to consolidate grant programs in the form of block grants, today’s FDA programs are still highly fragmented and the number of programs keeps on increasing.<sup>14</sup>

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13. See also footnote 3.

14. In 2003 federal assistance encompassed “only” 1.754 such programs compared to 2.200 programs today. For an account of the history of categorical grants see Ben Canada, *Federal Grants to State and Local Governments: A Brief History*, Report for Congress, Congressional Research Service -The Library of Congress, Washington D.C. (Order Code RL30705).

## 1.4 Similarities and dissimilarities between US and EU funding systems

We take the US categorical grants and the EU funding system as a starting point for looking into the conditioning of intergovernmental transfers. This is warranted by the large inventory of grants, especially in the United States, which presents a particularly diverse and fertile ground for analysis.

At first it is necessary to narrow the scope of the study to exclude those programs that are not intergovernmental. Apart from direct transfers to individuals and families, this includes entitlement programs where the money passes through subcentral budgets and for which the Federal Government and the States may share the costs. The US Administration distinguishes between three categories of programs: payments for individuals, grants for physical capital, and other grants. In 2011 the split among these categories was 63,9 | 15,9 | 24,2 percent.<sup>15</sup> In the EU payments to individuals and companies are much smaller, counting only for about 20 percent of the budget.

The programs aiming at individuals, whether through categorical or block grants, usually work through eligibility criteria and/or legal entitlements set by supranational, national or subnational legislation. In the United States, the major grants in this category are Medicaid<sup>16</sup>, TANF, child nutrition programs, and housing assistance. In the European Union payments to individuals and companies are mainly given for research, education and training, transport, and energy. As argued in the beginning, payments for individuals are not examined in this study. It puts the focus on category B programs, project grants, which, in 2011, represented a total 1,458 of 1,912, or three quarters of all grant programs.

Project grants in the United States exhibit an interesting new trend that is prominent in many OECD countries: intergovernmental contracts. A good quarter of the project grants are now ruled by “cooperative agreements” among governments or public agencies, with increasing tendency. The grants are awarded competitively and are typified by a specified end product or duration. For the EU Commission competitive contractual arrangements are the rule for most of her grant programs. Competitive agreements certainly provide a high degree of flexibility and adaptability, yet this adds complexity to the analysis.<sup>17</sup>

Moreover many US categorical or block grants are given with matching requirements, i.e. beneficiaries have to cofund the programs from own resources. For EU grants complementary funding is the rule, with only a few exceptions (notably projects taking place outside the EU).

A specific form of matching condition in the US is known as the “maintenance of effort” (MOE) requirement.<sup>18</sup> It calls for grant recipients and sub-recipients to maintain a certain level of State or local fiscal effort to be eligible for full participation in federal grant funding. For instance the TANF block grant specifies a minimum that the States must spend to assist low-income families in order to receive the full grant. While matching requirements are typically used to reveal the policy preferences of the recipient, and of course for cofunding and risk sharing, the MOE also serves to standardize minimum services at a nationally harmonized level.

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15. See Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013, Special Topics, Aid to State and Local Governments, OMB, Washington D.C., Table 18–2C, p. 304

16. Medicaid is a means-tested, needs-based social welfare program that provides health coverage to certain categories of low-income people, people with disabilities and elderly needing nursing home care.

17. See also OECD, Linking Regions and Central Governments: Contracts for Regional Development, Paris, 2007.

18. See also the Appendix for an example of MOE.

Another important division made in the United States is between mandatory and discretionary grants. This refers to the legal base of the grant program. Programs whose funding is provided directly in authorizing legislation are categorized as mandatory. Funding levels for discretionary grant programs are determined annually through budget appropriation acts.<sup>19</sup> In this terminology the EU would classify most of its grant programs as “discretionary”, with the notable exception of the (open-ended) subsidies given to farmers within the EU’s Common Agricultural Policy (CAP).<sup>20</sup>

A final distinction made in the United States is for grants assisting States and localities with construction and other physical capital activities (capital grants). The major capital grants in the United States are for highways, but there are also grants for airports, mass transit, sewage treatment plant construction, and community development.

The EU does not distinguish grants for fixed capital formation as such but emphasizes policy objectives such as direct aid to investments in companies (in particular SMEs) to create sustainable jobs; infrastructures linked notably to research and innovation, telecommunications, environment, energy and transport; financial instruments (capital risk funds, local development funds, etc.) to support regional and local development and to foster cooperation between towns and regions; and technical assistance measures. However it indicates that the focus is clearly on investment, including human capital formation.

EU grants are also used to leverage funding through loan agreements with International Financial Institutions (IFIs) and other lenders, which is typically for capital spending (including institution building and technical assistance). Beneficiaries are then also subject to the conditions imposed by the lenders, which include macro-fiscal policy objectives where the IMF or the Worldbank become involved.

### **1.5 A proposed typology of funding mechanisms by type of condition**

The foregoing review of funding mechanisms in the US and the EU may be useful to categorize intergovernmental transfers by type of condition. An endeavor to classify is made in the following scheme (Table 2).

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19. These definitions correspond to the (former) distinction of the EU budget between compulsory spending, i.e. that resulting from EC treaties (including CAP) and international agreements, and the non-compulsory residual. The Lisbon Treaty has given parliament the power over the whole budget from 2009 on, including compulsory spending, which was initially excluded from its competency.
  20. However the reforms over the years have moved the CAP away from a production-oriented support policy by “decoupling” subsidies from particular crops and introducing the close-ended Single Payment Scheme (SPS), which is subject to “cross-compliance” conditions relating to environmental, food safety and animal welfare standards. National governments are able to complement this scheme from own resources and in accordance with own policy priorities.

**Table 2: A typology of intergovernmental transfers by condition**

Type of intergovernmental transfer		Conditions attached	
<b><i>Tax sharing and general grants (general revenue grants)</i></b>			
1a	Own taxes, fees, fines etc. collected by senior government and transferred to legally entitled subcentral authorities	Unconditional own revenue	
		Own revenue tied to specific purposes or specific budgetary and non-budgetary funds	
1b	Shared taxes allocated according to derivation (origin principle)	Unconditional own revenue	
		Conditional intercept for specific purposes or financial liabilities of recipient (e.g. debt service)	
1c	Shared taxes or central revenue allocated according to a formula	Equivalent to 1d or 1e	
1d	General grants based on formula allocation of a well-defined revenue sharing pool (funding level)	Unconditional equalization grants (objective and exogenous criteria)	
		Quasi-conditioned “normative grants” (subjective and/or endogenous criteria)	
		Conditioned performance-related grants	
1e	General grants where the grant pool (funding level) is based on annual appropriations, but with transparent formula allocation	“Discretionary grants”; conditions similar to those under 1d	
1f	General grants with no clear rules and with a seemingly arbitrary allocation driven by political considerations	“Discretionary grants”: Non-transparent allocation mechanisms; conditions are not spelt out	
<b><i>Specific grants (specific-purpose grants)</i></b>			
2a	Lump-sum or formula-based close-ended grants with latitude to define the use of the funding within the scope of a larger program (“block grants”)	With or without matching requirements	Unconditional funding within the scope of the specified program
			With standardized “maintenance of effort” (MOE) criteria or norms
			With legal or contractual performance-based criteria for specific results
			With legal or contractual performance-based criteria for overall budget results or macro-economic criteria (e.g. debt)
2b	Lump-sum or formula-based close-ended grants with compulsory use of the funding within the grid of a narrowly defined program or project (“categorical grants”)	With or without matching requirements	Unconditional funding within the scope of the specified program
			With standardized “maintenance of effort” (MOE) criteria
			With legal or contractual performance-based criteria for specific results

Type of intergovernmental transfer		Conditions attached
2c	Open-ended grants provided directly in authorizing legislation (“mandatory [block or categorical] grants”)	Specific funding on the basis of legal eligibility criteria, but with sufficient policy leeway of the grantee, especially with regard to eligibility criteria <sup>21</sup>
<b>Mandated grants</b>		
3a	Cost recovery schemes provided by the central government to subcentral governments for acting on behalf of the funding authority (close-ended funding of “mandates”)	Spending strictly confined to the execution of a mandate with full transparency on the costing of the program or project
3b	Open-ended grants provided directly in authorizing legislation through subcentral budgets (“mandatory grants”)	State and local governments are compelled to either provide centrally controlled services directly to beneficiaries, or act as a simple “pass-through agent” to contract with providers or award grants to eligible recipients

*Tax sharing and general grants.* The various items described under 1a through 1f in Table 2 are typical general revenue instruments to establish vertical fiscal balance and to equalize financial resources among regions (see Figure 1). These transfers are unconditional, but occasionally there are certain strings attached to their spending. For instance, the US States tend to tie their motor vehicle fuel taxes to public spending in the field of transportation.

For US States, conditional intercepts, the withholding of transfers by the donor for specific purposes or financial liabilities of recipients, are not uncommon. For instance, Colorado has a School District Intercept Program (SDIP), which requires the State Treasurer to guarantee the timely payment of bonds issued by school districts. The program not only obliges the Treasurer to make any bond payments a school district fails to honor, it also requires the Treasurer to withhold the entire amount of the bond payment from the district’s equalization payments until the State is fully reimbursed. If a district receives equalization payments from the State, its bonds are automatically enrolled in the program.

Items 1d and 1e make a distinction between systems where the funding level is either fixed by law (e.g. a share of a tax such as VAT in Germany or GST in Australia) or made through annual budget appropriations (as in the United States or the United Kingdom). The recent crisis has illustrated that the senior government can abuse this scheme to alter the vertical fiscal balance arbitrarily in its favor. However, if used responsibly, this ability can also be applied for macroeconomic stabilization purposes. For instance, the US Federal Government employed the existing grants structure to provide swift fiscal relief during the recent recession when States faced severe and unforeseen economic conditions.<sup>22</sup> Similar policy reactions were observed in France, Germany, Poland, and the Nordic countries although the financial shelter provided to subcentral governments was also due to automatic stabilizers in some instances.<sup>23</sup>

21. Funding levels for most mandatory programs can only be changed by changing eligibility criteria or benefit formulas established in law and are usually not limited by the annual appropriations process.

22. See: American Recovery and Reinvestment Act (Recovery Act), Public Law 111-5, enacted in February 2009.

23. For more information on the impact of the crisis on local budgets in Europe see *Local Government in Critical Times: Policies for Crisis, Recovery and Sustainable Future*, Report of the European Committee on Local and Regional Democracy (CDLR), Council of Europe, Strasbourg (France), 2011.

As said, these instruments tended to be mostly unconditional in the past, but, increasingly, senior governments now make use of performance criteria of a more general nature, for instance for rebalancing budgets and/or securing macro stability. Such criteria might be introduced through national legislation (e.g. an internal Stability Pact or a Fiscal Responsibility Law) or through intergovernmental agreements. Such agreements even emerge at the supranational level, e.g. the EU's Stability and Growth Pact (SGP), or the more recent Fiscal Compact, which is part of the wider Treaty on Stability, Coordination and Governance (TSCG) that was signed by 25 EU Member States recently.

Although there was a monitoring mechanism and even a framework for sanctions within the SGP before (the Excessive Deficit Procedure (EDP), which applies to Member States having breached either the deficit or the debt criterion), monitoring was incomplete and/or deficient, and financial sanctions have never been applied. More recently, however, (spurred by the financial crisis in particular the sovereign debt crisis of some Member States) the EU authorities appear to be poised to applying stronger control mechanisms and sanctions. This is proven by the recent decision of the Commission to use the Cohesion fund, albeit special funding, for applying macro-conditionality in the case of Hungary.<sup>24</sup>

*Specific grants.* The various US categorical grant programs, and similar grants in other OECD countries, can be collapsed into three basic types (2a through 2c), all provided either with or without matching requirements. Specific grants can be given on the basis of legal or statutory arrangements, and they can be ruled by cooperative agreements among governments.<sup>25</sup> These cooperative agreements may not be a novel instrument, but they are clearly becoming more prominent in recent years.

Many transfers from line ministries are made in the form of specific block grants to subcentral levels of government or public agencies. Such grants are often formula-allocated on the basis of specific needs criteria such as the number of students, class size, type of school, etc., but once the allocation is made the States have full budget flexibility to spend these funds *within* the relevant sector. Examples are the Australian Specific Purpose Payments (SPPs) for Healthcare and for Schools, or US State programs, financed by the federal Department of Housing and Urban Development, that provide grants to units of local government covering a wide variety of projects from revitalizing neighborhoods to improving community infrastructure, offering public facilities and creating or retaining jobs.

As said before, the US TANF block grant is provided with standardized MOE criteria, but still leaves full policy discretion as long as the standards are respected. Similarly federal Community Development Block Grant (CDBG) funds are available to local municipal or county governments for projects to enhance the vitality of communities by providing decent housing and expanding economic opportunities. These grants primarily serve persons of low and moderate income, as the State must ensure that at least 70 percent of its CDBG grant funds are used for activities that benefit these persons.

An example of block grants with performance-based conditions is provided by the Australian Research block grants (RBG), which are allocated according to performance-based formulae, yet are independent of funding for specific research projects, programs, or fellowships. The beneficiaries have considerable autonomy in deciding what research projects, personnel, equipment and infrastructure this funding should support. Of course, any earmarking for specific outlays of a project would simply hinder innovation and obstruct productive research.

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24. See for instance *International Herald Tribune*, "E.U. agrees to punish Hungary for budget slips", 14.3.2012, front page.

25. These agreements should be distinguished from the older term "negotiated grants", which often refers to non-transparent, politically determined partisan arrangements. The modern forms of cooperative agreements are typically open to the public and subject to parliamentary control, or even approval, and auditing.



Another example for a grants program based on cooperative agreement is the United States Social Innovation Fund, established in 2009, which aims to improve people's lives in low-income communities. The selection process of this program is highly competitive and subject to a rigorous four-part review process.

Specific grants subject to more comprehensive macroeconomic conditioning are still the exception. They tend to infringe on the budget autonomy of lower tiers of government and are therefore resented politically. Moreover it is questionable whether such conditioning should work through specific grants rather than unconditional funding such as general grants. In some instances there may be no other option than to rely on specific grants, for instance for the European Commission that does not provide unconditional funding to her Member States.

However intergovernmental agreements may increasingly be used to impose macroeconomic or solvency conditions, if only by imposing financial sanctions or by automatic intercepts of grant monies, for instance to serving the grantees debt obligations as in the case of many US municipalities.

The coordination of macroeconomic policies for decentralized sovereign government still remains a challenge that is likely to be better addressed through contractual intergovernmental arrangements rather than the grants system itself (except for local governments). More will be said about such arrangements in the second part of this paper. However the crux of macroeconomic coordination lies less in the coordinative arrangements themselves rather than the modes of enforcing them. Where coercion by legal means is excluded, this does require financial sanctions, reverse grants, financial intercepts and/or the temporary suspension of grants.

*Mandated grants.* As said before, grants are called "mandated" whenever there is a principal-agent relation between the donor and the recipient of the grant. For instance the German *Länder* may implement federal policies according to Article 85 of the Constitution (*Grundgesetz*, GG) in a strict principal-agent relationship (*Bundesauftragsverwaltung*). They then act on behalf of the central government, and not on their own. In these cases, e.g. the construction or repair of autobahns and federal highways<sup>26</sup>, the federal government is required to carry the material costs according to Article 104a (2) GG. It is obvious that this type of grant is subject to strict supervision by the grantor government.

The subsidies to farmers provided by the EU are perhaps an example of mandated grants supplied directly through subcentral (national) budgets. Initially open-ended, these grants have mostly turned into close-ended Single Farm Payments, for which the recipient government has now larger discretion in defining operational and eligibility criteria. So a mandatory "passing through" grant has turned into a cooperative arrangement, including cofunding by the grantee. This relaxation of conditions seems to be a more general tendency for mandated grants, especially for open-ended grants based originally on strictly defined criteria by the donor.

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26. Article 90(2) GG assigns this function explicitly to the States (*Länder*) under federal supervision and control.

Another example of a mandated grant is the Mexican PRONASOL of the Salinas Administration, which was a social development program, where communities could receive State funding towards projects such as drinking water or paving roads, provided they agreed to contribute part of the cost and/or supply the necessary labor. This program, initially praised by international institutions such as the Worldbank because of its potential to mobilize local coparticipation, was later abandoned because it was abused by local PRI authorities and manipulated for political ends<sup>27</sup>. This demonstrates the risks of mandated national grants that could erode with extending competencies of subcentral authorities in charge of a national program, and this despite the disciplining role of matching conditions.

## 1.6 Main objectives of grant conditionalities

Grant conditionalities are generally considered to entail significant benefits for coordinating policies within multilevel government. With tightening public budgets and pressures for reform there are high expectations to enhance budget performance through the conditioning of grants in a multilevel public policy environment. For instance the 5<sup>th</sup> Cohesion Report of the EU explicitly calls for the use of stronger conditionalities to achieve its policy objectives.<sup>28</sup>

The main advantage is, perhaps, the need to clearly specify policy objectives, both for the donor and grantee, and to translate these objectives into quantifiable and observable criteria. This is propitious for an effective exchange of information, the promotion of performance and cost effectiveness, and the mitigation of risks, which in turn will help to coordinate public decision making, assist weak subcentral institutions, and provide guidelines for desirable reforms at lower tiers of government.

### *Revealing information*

It is obvious that subcentral authorities are usually better informed about their policy environment than central government, which motivates decentralization in the first place. However where central policy objectives are to be implemented within multilevel government, information asymmetries might distort policy decisions leading to inconsistencies in policy-making and, possibly, the an inefficient exploitation of the grants system by rent-seeking lower-tier authorities. It may foster clientelism or unwarranted largesse in using the transfers received.<sup>29</sup> This will undermine not only policy effectiveness but also the accountability of public officials and the legitimacy of public expenditure more generally.<sup>30</sup> Hence the objective is to reduce the existing information gap between layers of government through an appropriate conditioning of grants.

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27. “PRONASOL has fostered intensive grass-roots activity throughout the country. If implemented as designed, PRONASOL could strengthen the capacity of community residents as well as local governments to play important roles in identifying felt needs and providing public services. Some evidence suggests PRONASOL could help reduce the costs of local projects compared to conventional, ministerial investments.” In: Tim Campbell and Sara Freedheim, *PRONASOL in Principle: Basic Features and Significance of Mexico's Solidarity Program*, World Bank Latin America and the Caribbean Region Department in its series Reports with number 1994/016.

28. “Three proposals in the EU budget review have a particular impact on Cohesion Policy: concentrating financial resources, the system of conditionality and incentives, and focus on results. From: *Investing in Europe's Future*, Fifth Report on Economic, Social and Territorial Cohesion, European Commission, Brussels, 2010, p. xxv.

29. See for instance the experience made in Mexico with the PRONASOL program mentioned above.

30. William Tompson, *Policy Conditionality, Governance and Investment Outcomes*, OECD Internal Document, Paris, July 2011.

However there is a basic dilemma for the grantor when formulating grant conditions: There is the risk that conditions imposed by the grantor do not match, or even run counter, local preferences.<sup>31</sup> This is particularly true for public investment and regional development programs. For efficiency reasons, it requires the active involvement of subcentral authorities and the revealing of local preferences for coordinating, financing and implementing public investment in multilayer government.

The typical instruments for involving beneficiaries and for revealing their preferences are matching requirements for grants. The higher the compulsory matching funds the more likely the beneficiary government is to reveal its policy priorities. The working of matching requirements can, perhaps, be reinforced by asking for additional private sector involvement, for instance *via* public-private partnerships (PPP) and other forms of private financial engagement. This gives confidence to private creditors for improving the assessment of operational and financial risks. But this is as far as matching requirements can go.

Given the information gap and asymmetries, excessive precision in conditioning grants tends to be counterproductive and is to be avoided. An exception is of course standard setting through procedural or technical norms. This includes the rules that reign sound public financial management (PFM) in general, including conditionality addressing fiduciary and procurement systems, specific PFM components<sup>32</sup> and “softer” norms such as shared experiences and good practice. More widely, conditionalities may also address issues of “good governance” or require a regulatory impact analysis (RIA), for instance, which have become standard conditionalities as imposed by IFI lenders.<sup>33</sup>

In a similar vein it makes sense to investigate, a priori, a beneficiary’s ability to carry out the program or project and to ascertain that certain pre-conditions are met before cofinancing it. For instance an assessment of administrative capacity, independent feasibility studies and cost-benefit analyses as well as, perhaps, joint planning and implementation among public agencies will serve to eliminate information asymmetries that could jeopardize the successful accomplishment of a program or project. Technical assistance may also contribute to reducing information asymmetries.

Nevertheless the senior government might also be interested in conveying information on its own policy priorities to lower tiers of government. Again this is best achieved by setting matching norms associated with the grants program. The MOE conditions of some US categorical grants may serve to illustrate this case.<sup>34</sup>

Moreover, procedural or technical standards can serve the purpose of transmitting central priorities in an indirect way. For instance the grant could be subject to an Environmental Impact Assessment or call for a supported program or project to be consistent with, or form integral part of, a national plan for regional development. Or the grant may require adherence to technical emission standards such as for building wastewater treatment plants. In all these cases the policy objectives embedded in the national plan are expected to sway subcentral policies indirectly. Unfortunately this only shifts the conditioning of grants to another level: the integration of subnational interests into national standards or development plans. Some standards can, and must, be imposed in an authoritarian manner, for instance on food safety or the handling

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31. For instance, the federal program for promoting the development of cycling did not necessarily reflect the chief priorities of municipalities in East Germany after unification.

32. For instance multi-stage tenders and other sequenced procedures can prompt agents to reveal information as these procedures are executed.

33. See Devesh Kapur and Richard Webb, *Governance-related Conditionalities of the International Financial Institutions*, G-24 Discussion Paper Series, United Nations, New York and Geneva, August 2000.

34. See the example in the Appendix.

of toxic waste. But where authoritarian solutions, and hence mandated grants, are inappropriate, this calls for a powerful instrument for information exchange among governments: negotiation.

The most appropriate form to convey information mutually between grantor and grantee is indeed a performance-based contractual arrangement rather than the imposition of a policy by law, decree or a mandated grant. It requires the parties concerned to combine their efforts and share knowledge at the negotiation table, which is prone to generate a fertile environment for coordinating and fine-tuning policies among governments, but it may also reveal potential conflicts from the outset. “This can have a value of its own, contributing to communication and information sharing among levels of government long before they are awarded”<sup>35</sup>. Performance-based contracts do not only necessitate the exchange of information on policy objectives and financing needs, but also an assessment of the beneficiary’s administrative ability to cope with shared objectives and needs.

### *Promoting performance and cost effectiveness*

The primary debate relating to the conditioning of grants concerns the promotion of performance and cost effectiveness. Traditional conditionality would be confined to quantitative and qualitative performance criteria, including prior actions, and the attainment of policy targets and of structural benchmarks. But this leaves open whether conditionalities are more successful by focusing on policy actions *ex ante*, or on policy outcomes *ex post*.

Of course, performance should ideally be formulated in terms of the outcomes related to a policy that is supported by a grant. However this may pose a number of problems where the causal chain between funding a program and its outcome is vague, cannot be fully controlled by the beneficiary authority, may be undermined by short-term disturbances (such as the recent financial crisis) and/or can be expected to bear fruit only in the distant future. At worst a policy strategy may even change before the outcome of a conditioned grant has had time to materialize.

This is why IFI conditionalities tend to focus mostly on *ex ante* policy actions such as those related to structural and public sector management issues. Casual empiricism derived from studies relating to IFI conditionalities suggests that successful performance is indeed positively correlated with good governance and better policies.<sup>36</sup> Moreover the study on IFI conditionalities emphasizes the provision of funding to be preferably tailored to a positive track record of subcentral authorities rather than “elaborate promises for future efforts”.<sup>37</sup>

Another key finding of the study on IFI conditionalities is the point that “the quality and impact of policy-based lending and budget support tend to be greater with fewer, more focused and streamlined conditions that are critical to the success of the program”.<sup>38</sup> This also applies to intergovernmental transfers and would caution against overly detailed and prescriptive performance conditions attached to specific grants. It would also respect the difficulty to effectively monitor the implementation of performance

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35. William Thompson, op.cit.; citing Michael Smart and Richard Bird, “Earmarked Grants and Accountability in Government”, in J. Kim, J. Lotz and N. Mau (eds.) *General Grants Versus Earmarked Grants: The Copenhagen Workshop 2009*, Korea Institute of Public Finance and Danish Ministry of Interior and Health, Copenhagen, 2009.

36. Harold Bedoya, “Conditionality and Country Performance”, in: *Conditionality Revisited: Concepts Experiences, and Lessons*, The Worldbank, Washington D.C., 2005, pp. 187-196.

37. Conditionality Revisited, op.cit., p. 4.

38. *Op.cit.*, p.4.

conditions, especially where they are complex, are formulated vaguely, do not set specific deadlines, and do not entail consequences for the beneficiary in case of non-compliance.

Performance measurement of public service delivery is usually based on a number of indicators or benchmarks, some of them used *ad hoc*, others forming more comprehensive indicator systems for specific policies.<sup>39</sup> Such indicators are typically used to monitor the performance of lower tiers of government, but they can also be exploited to condition intergovernmental grants. The key question is however what ensues if the beneficiary of a grant fails to meet the performance criterion. If there are no financial sanctions, it is hard to argue that the grant is conditioned. The indicators or benchmarks tied to the grant then simply serve to inform recipients on desirable outcomes, which has a value of its own.

It has been criticized indeed that “(h)itherto, there has been no explicit link between the performance of a country or region in one programming period and the availability of funds in subsequent periods.”<sup>40</sup> This is not fully true for IFI lending where the release of a credit tranche is usually conditioned on achieving a prior (short-term) policy goal or on implementing certain actions. In this vein the EU appears to move away from intrusive micromanagement to more general *ex post* conditioning and the disbursement of money in tranches, for instance for the recent assistance given to Greece. Of course a mechanism to integrate specific performance into prospective periods would be desirable, but it is often highly contentious politically. For instance it will raise political resistance where the constitution, or the law, prohibits discriminating against regional authorities. What should be acceptable, however, is relaxing the performance conditions and allowing greater leeway and flexibility for those authorities with a proven track record in the past.

It has also been tried to incorporate past performance in future conditioned grants through financial award programs. For instance, the EU Cohesion Fund had set aside a “performance reserve” for the 2000-2006 programming period.<sup>41</sup> Similar programs are (or were) found in Italy<sup>42</sup> or the United Kingdom<sup>43</sup>. This performance reserve may work where the release of funding is based on a non-discriminatory trigger or

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39. An overview of indicators measuring performance in decentralized government is found in Lee Mizell, *Promoting Performance: Using Indicators to Enhance the Effectiveness of Subcentral Spending*, OECD, Public Governance and Territorial Development Directorate, Working Paper No. 5, Paris, 2008. The use of performance indicators for regional policy is discussed in OECD, *Governing Regional Development Policy*, Paris, 2009.

40. William Tompson, *op.cit.*

41. “During 2000-06, the EU introduced a mandatory “performance reserve”, which held 4% of Structural Funds allocations to each EU member state in reserve until 2003, and tied distribution to a set of negotiated targets. Italy built on the EU model by developing a national performance reserve intended to bring about lasting effects on regional governance in “Objective 1” (lagging) regions, as well as to some administrations operating at the central level of government. The scheme set aside an additional 6% of funds, effectively making access to 10% of regional development policy funds conditional on performance, equivalent to 1.43% of national public capital spending (3.9% of public capital spending in southern Italy). While the overarching goal of the reserve was to promote institutional capacity-building for regional development, its specific objectives were to modernise public administration, to promote and anticipate reforms in some sectors deemed crucial for achieving development objectives, and to balance the constraints to rapid Structural Funds spending implicit in the N+2 de-commitment rule by creating incentives to select and organise more complex and higher quality projects.” From William Thompson, *op.cit.*, Box 1.

42. See for instance Chapter 6, “The National Performance Reserve in Italy”, in OECD, *Governing Regional Development Policy*, *op.cit.*

43. Explicit financial rewards for performance were offered to England’s Regional Development Agencies (RDAs) for a short period of time.

formula; it may be opposed whenever it requires discretionary policy decisions for disbursements, which must be resented by those singled out as “under-performing”. It may have also been for this reason that the UK performance reserve was finally abandoned.<sup>44</sup>

It is particularly difficult to make an explicit link between past performance and the conditioning of grants in the case of capital spending. Capital grants, by their very nature, are confined to specific projects whose implementation is limited in time. In this case it is obvious that the focus is on assuring certain conditions *ex ante*, such as verifying technical feasibility, cost-benefit relations or the capacity to administer the project. Benefits may also be reaped from conditionalities attached to competitive tenders for capital grants, which mobilize a multi-stage selection procedure where inclusion in a second round is conditional on first-round performance.<sup>45</sup>

The problems may be easier for linking grants to cost effectiveness. These conditions work implicitly through benchmarks and can be imposed in a non-coercive normative way. For instance, where tax capacity or needs criteria are being used for allocating grants, even if unconditional, these measures may act as useful reference point for standard tax effort and standard needs. The Australian general grants based on the recommendations of the Commonwealth Grants Commission provide an illustrative example. By applying standardized criteria the grants neither reward over-performers nor do they penalize underperformers directly<sup>46</sup>, but they provide a host of valuable indicators on the costing of specific public services measured against normative benchmarks, albeit national averages, which should leverage accountability. Again such mechanisms are largely inadequate for capital grants because public investments need political prioritization.<sup>47</sup> Hence assuring cost effectiveness for projects financed by capital grants requires some form of intergovernmental negotiation and political agreement.

### ***Mitigating risks***

Managing risks within multilevel government is complex, and using financial instruments for controlling them is particularly challenging. As an alternative to grants there are other financial instruments for mitigating risks such as intergovernmental loans, guarantees, or insurance that may be more appropriate for hedging risks than grants. The inventory would be incomplete without mentioning non-financial measures such as the direct provision of specialized services or the personalized allocation of public support through food stamps, the direct supply of medical services or school vouchers. They all aim at enhancing policy targeting and limiting the risks of abuse. Such instruments can be useful in controlling the risks posed by elite capture, clientelism, rent-seeking and insider-outsider problems where there is a lack of accountability. But overall risk management within multilevel government is convoluted by the fact that some well-intentional, but badly designed, financial aid programs might create new risks through the softening of budget constraints, perverse incentives, moral hazard or the breakdown of service delivery through unfunded mandates (see Section G.0 of this Chapter).

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44. Reputation was critical to the RDAs, because, as statutory bodies, they could be dissolved. This fact also contributed to conservatism when setting targets. See OECD, *Governing Regional Development Policy: The Use of Performance Indicators*, OECD, Paris, 2009.

45. William Thompson, *op.cit.*

46. The reward/penalty is indirect where the actual costs of a program are lower/higher than those covered by applying the standard.

47. However standardizing the costs of an investment might be possible in many instances (e.g. the funding of school buildings).

Nevertheless the conditioning of specific grants has often been proposed to mitigate risks through cofinancing investments with pioneering, innovative or experimental characteristics.<sup>48</sup> Indeed such programs are found in practice, for instance the Australian Research block grants (RBG), the programs of the Office of Innovation and Improvement (OII) of the US Department of Education, the Knowledge Infrastructure Program of Industry Canada, or the programs for supporting “elite universities” in France and Germany. It is no coincidence that these programs typically focus on human capital formation and the development of public knowledge bases. They aim at providing the necessary social infrastructure for fostering innovation that is ultimately expected from research centers and private economic agents, not from the public sector itself. This is why these grants are prominently given directly to institutions of research and/or innovative private companies, and not to other governments except for some specialized public agencies.<sup>49</sup>

It may be questioned whether grant programs are indeed suited to mitigate the risks associated with innovation and/or uncertainty. True, the grant will eliminate the risk of failure, which is then carried by the taxpayer. But the incentive to succeed is usually stronger than under a protective grant program where the costs of failure are borne by the innovator. Moreover hedging risks through grants might encourage inefficient rent seeking and moral hazard *even within* government. Without a grant, however, some basic research might never materialize, especially where the investment and operating costs are high and the prospects for short-run marketable returns are low, for instance research performed by the European Organization for Nuclear Research (CERN). So there may be a case for funding certain public activities with conditioned grants to mitigate innovation risks where large social benefits are at stake, but the line between risk hedging and “base funding” is impossible to draw in these cases.

The argument for public support is weaker for risky activities that promise direct private profits. For the reasons mentioned above, hedging such risks is better left to the private sector itself. Nevertheless potential profit-generating projects are often funded through grants that claim to address structural economic problems such as the need for venture capital, small business research, consumer protection, the digital economy, eco-efficiency or the sustainable development of the private sector. All of these initiatives are expected to engender substantive externalities for society as a whole, let alone specific benefits through higher employment or a larger tax base. But one may reasonably presume that such policies often serve to flaunt modish policy phraseology rather than eliminate underlying structural risks.

At last even *the design* of risk-hedging conditioned grants is not without problems:

A difficulty in designing conditioned risk-hedging grants is to find an adequate benchmark for “success”. This is usually the outcome of a consultative process where – in addition to political support – interagency negotiations play the key role. But establishing appropriate criteria and benchmarks often exceeds the competency of government officials, which is why all of the programs mentioned rely on external peer reviews to assess the program needs and the qualification of beneficiaries *ex ante* as well as the outcome of programs *ex post*.

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48. See, for instance, Hans-Jörg Blöchliger and Camila Vammalle, “Intergovernmental Grants in OECD Countries: Trends and Some Policy Issues”, in J. Kim, J. Lotz and N. Mau (eds) *General Grants Versus Earmarked Grants: The Copenhagen Workshop 2009*, Korea Institute of Public Finance and Danish Ministry of Interior and Health, Copenhagen, 2009.

49. The “Innovative Economy” programs of Industry Canada may serve to illustrate this case. It may indeed be hazardous to expect innovation to emanate predominantly from the public sector.

Finally, and most sobering, it may be true “that risk-sharing will be more attractive when donors are less informed *ex ante* about which outcomes are feasible.”<sup>50</sup> This underlines the peril of risk-sharing grants falling prey to political meddling and “elaborate promises” on the future rather than being subject to efficiency considerations. In other words: The case for mitigating risks through the conditioning of grants, particularly *within* the public sector, rests on shaky grounds.

### ***Coordinating among governments***

The case for using conditional grants to coordinate policy objectives and actions among government is strong, unlike for managing risks. It stems from the ability of a well-designed grant system to reveal and trade information and, where cooperative agreements are used, to establish mutual trust among public officials and to identify administrative and technical competences and limitations.

Coordination among governments has a vertical and a horizontal dimension, which can also be combined to achieve vertical and horizontal coordination simultaneously (“dual coordination”). It can be supplemented by a policy network approach “to account for the various governmental and non-governmental actors at different stages of the policy process”.<sup>51</sup>

An example for successful *vertical coordination* is, as said, the US program Temporary Assistance to Needy Families (TANF). It is designed to convey information between layers of government both upward through cofinancing obligations, and downward through “maintenance of effort” (MOE) requirements.

The example of intercantonal cofinancing of higher education in Switzerland cited earlier is an example of successful *horizontal coordination* through grants. More recently, Switzerland has begun to apply a more elaborate approach to regional contracts, involving both performance indicators and financial incentives<sup>52</sup>. With performance-based conditionalities a grantor should, in principle, be less concerned with the specific activities of a grantee as long as broad guidelines are followed and measurable outcomes are achieved.

*Dual coordination* is often found where a senior government is needed as a driver for reform and/or a broker for resolving conflicts that emerge between subcentral authorities. Such conflicts are often motivated by different party affiliation of local politicians, a lacking perception of positive horizontal spillovers, and uncooperative free-rider strategies. France, for example, used contractual grant arrangements to jointly manage policies in the context of its decentralization strategy. Another area for dual coordination through grants is regional policy, which typically necessitates the intervention of a senior government to arbitrate between diverging interests of subcentral authorities. In this spirit, the EU’s Regional Development Fund (ERDF) has assumed an important role in promoting interregional cooperation, realizing network externalities among agencies, and trading experiences among regional and local authorities within Member States, but also across borders.

Other examples of dual coordination in regional development are, again, Switzerland where programmatic monitoring activities are largely associated with contractual arrangements between the federal government and each canton; and Germany, where joint financing for certain aspects of regional

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50. William Tompson, *op.cit.*

51. Ian Bache, *The Politics of European Union Regional Policy: Multilevel Governance or Flexible Gatekeeping?*, Sheffield Academic Press, Sheffield, 1998, p. 25.

52. OECD, *OECD Territorial Reviews: Switzerland 2011*, OECD, Paris, 2011.



policy is typically based on law, not contracts, for instance for building and refurbishing local mass transportation systems (*Gemeindeverkehrsfinanzierungsgesetz GVFG*).<sup>53</sup>

While the coordinating role of conditioned grants is out of question, such grants tend to evolve into more formal institutional arrangements for coordinating policy among government some of which are addressed in the second part of this study.

### *Helping to overcome weak institutions*

“Conditionality cannot compensate for weak government commitment or implementation capacity.”<sup>54</sup> In essence this is true, but many grant programs help to overcome weak institutions by assigning parts of the money to capacity and institution building. This is the case in particular where new responsibilities are devolved to subcentral governments, which usually entails the dissemination of appropriate management tools and the formation of human capital to cope with the new functions. For instance, in its decentralization reform, Italy has focused on increasing capacities and accountability at sub-national levels, empowering sub-national governments as they transferred new responsibilities to them.<sup>55</sup>

Technical assistance can be given in various forms, the contracting out of institution building and training to third parties; the transfer of institutions and manpower to subcentral levels of government; capacity formation provided directly by the senior government; or twinning projects with experienced public administrations – as was successfully applied in East-Germany after unification. However conditions concerning technical assistance are as potent as the beneficiaries are receptive to absorbing assistance. That means: technical assistance must be demand driven, not determined by supply. Where this basic premise is ignored, conditionalities meant to overcome weak institutions simply do not work.

“Finally, where there are concerns about the degree of accountability of recipient government officials to local voters, Smart and Bird<sup>56</sup> suggest that earmarked grants with effective monitoring can create stronger incentives for efficient fiscal management and public service delivery than might be generated by the political process alone. However, the risk is that such financing can serve to perpetuate the very problem that it mitigates, weakening the pressure to strengthen local accountability”.<sup>57</sup>

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53. *Gesetz über Finanzhilfen des Bundes zur Verbesserung der Verkehrsverhältnisse der Gemeinden (GVFG)* of 1971 as amended in 2011 (BGBl. I, p. 554). The law defines eligible projects based, *inter alia*, on standardized cost-benefit analyses, the pre-conditions for the grants, and the scope of financial support. However joint financing is being dismantled following the federalism reform of 2006 as supposedly blurring the accountability among governments. See *Gesetz zur Entflechtung von Gemeinschaftsaufgaben und Finanzhilfen (Entflechtungsgesetz – EntflechtG)* of September 2006 (BGBl. I, p. 2098). At present the specific federal grants are given to the States as block grants earmarked to local mass transportation. They will become unconditional general grants after 2013.

54. *Conditionality Revisited, op.cit.*, p. 4.

55. OECD, *Linking Regions and Central Governments: Contracts for Regional Development*, OECD, Paris, 2007.

56. Michael Smart and Richard Bird, *op.cit.*

57. William Tompson, *op.cit.*

### *Triggering desired reforms at the subcentral government level*

Receptiveness of subcentral authorities to nationally desired reforms is also a prerequisite for the successful conditioning of grants aimed at promoting these reforms. Where this pre-condition is met, the grants can in fact assist the promulgation of reforms in two ways: by easing the transitional costs of implementation; and by conveying reform-related information, for instance by providing benchmarks. In particular instances the conditioning of grants may also support subcentral politicians in fending off the resistance of vested interest groups.

However the transmission of the rationale for a reform is, again, best taken care of via intergovernmental discourse, negotiation, and finally a mutual agreement in which the grants serve as a catalyst. Conditioned transfer payments can then grease the way for reform by supplementing badly needed resources for stressed subcentral budgets, especially during times of crisis that often trigger such reforms.<sup>58</sup> Reforms should not simply fail because their implementation would overstrain subcentral budgets.

The Australian National Competition Policy (NCP) may serve as an illustration for conditioning grants to promote reforms in education. In the 1990s the Australian governments, including the central government, undertook to implement a series of reforms conjointly through NCP. It proceeded in three tranches from 1997-98 and was concluded in 2005-06. The National Competition Council conducted regular multi-jurisdictional assessments of progress through benchmarks, which formed the basis for decisions by the Australian Government to make grants to the States and Territories.<sup>59</sup> Although the grants were dubbed “competition payments”, the program was not really competitive: if all States had fulfilled all reform commitments, all would have received their full payments.

NCP is now widely recognized as having made a significant contribution to Australia’s welfare, and that all governments had made substantial progress in meeting their reform commitments.<sup>60</sup> The program also demonstrates that the grants involved need not be large, mainly because the policy was based on an intergovernmental agreement and a mutually accepted settlement scheme rather than being imposed from above.

An example of *competitive* grants aiming at subnational reforms is embedded in the American Recovery and Reinvestment Act of 2009 (ARRA), legislation designed to stimulate the economy, support job creation, and invest in critical sectors, including education. *Inter alia* this program supports the ‘Race to the Top Fund’, a competitive grant program designed to encourage and reward States that are laboring the ground for education innovation and reform, achieving significant improvement in student outcomes, and implementing ambitious plans in four core education reform areas.

‘Race to the Top’ rewards States that have demonstrated success in raising student achievement and have the best plans to accelerate their reforms in the future. It differs from the Australian NCP in that the conditions are set on priorities defined by the federal government rather than on priorities agreed conjointly. “The programme may therefore risk stifling state-based innovation and promoting federal authority in an area that is largely a sub-national competence”.<sup>61</sup>

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58. Indeed new government and crises typically provide windows of opportunity to trigger or promulgate reforms, but this often needs extra funding.

59. See Box 5 in William Tompson, *op.cit.*

60. *Review of National Competition Policy Reform*, Productivity Commission Inquiry Report, Australian Government, No. 33, Canberra, 28 February 2005. <http://ncc.ncc.gov.au/docs/PC%20report%202005.pdf>.

61. William Tompson, *op.cit.*

This criticism of centrally imposed conditions points to two important aspects: to the challenge of respecting subcentral budget autonomy (discussed in Section 0.0 of this Chapter); and to an important precondition for successful subcentral reforms: ownership. Indeed intrinsic commitments to reform (“ownership”) are more decisive for success than externally imposed conditions tied to specific grants.<sup>62</sup> This again emphasizes the need for a broad policy dialogue and the joint elaboration of reform strategies in multilevel government.

Where the willingness to “own” a reform is distributed unevenly among subcentral authorities this may entail yet another risk of policy failure: grantors are then inclined to focus on authorities that are committed to reform rather than to try persuading reluctant reformers. It favors an asymmetric approach to decentralization that entails regional inequities in sharing out the reform benefits. This may not be bad in principle where competition among jurisdictions may stimulate new policy initiatives that are truly “owned” and, perhaps, better tailored to local preferences. But it also requires legal flexibility and a vibrant political environment for policy adjudication, citizens’ coparticipation, and the political readiness to accept diversity and “multiple speed”.

### ***Increasing the effectiveness of public investment***

As said before, capital grants, that are to promote effective public investments, are particularly difficult to design because of the singular and time-limited character of capital projects. Performance criteria have to be customized to the grant because of a typical lack of comparable benchmarks. It is therefore not surprising that the conditioning of capital grants takes a more formal approach focusing primarily on *ex ante* prerequisites (Section H), on procedural and technical criteria (financial management, fiscal capacity, development planning, transparency and accountability, interaction with local governments, human resource development, procurement), and on monitoring project implementation and functional processes. Larger projects are usually implemented in tranches, which allows a stepwise progressive allocation of capital grants based on intermediate performance measures such as balanced scorecards (a mixture of financial and non-financial indicators each compared with a “target” value).

Where objective benchmarks, for instance the standardized cost of a representative investment or operational targets for a capital project exist, there is still the need to prioritize these investments. Information on the political priorities of subcentral governments must be secured through parliamentary approval, preferably in the form of a longer-term strategy, which is usually reinforced through matching conditions and sometimes complemented by private cofinancing requirements – in particular private loans. Involving private lenders or IFIs<sup>63</sup> promises a more objective and independent look into the feasibility, operability and sustainability of the project. Moreover the need to repay loans may give recipients greater incentives to operate efficiently.

Sustainability also requires securing the funding of operational costs that are linked to the investment, which could mean pledging specific revenue streams to project financing or introducing new user charges. All other conditioning has to be customized to the specific policy environment in which the investment is to take place.

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62. In fact it has been argued that the imposition of conditions may even contradict the notion of ownership, particularly for more “coercive” conditionality arrangements. (Andrew Mold and Felix Zimmermann, “A Farewell to Policy Conditionality?”, *Policy Insights*, No. 74, OECD Development Centre, Paris, August 2008).

63. Where IFIs are involved there could be an additional benefit: IFIs can inject their expertise in designing and running capital projects and provide technical assistance where needed.

A first approach to customized conditioning is to embed the capital project into a coherent national investment strategy or development plan with clear policy objectives. Consistency with the strategy or plan will then become a pre-requisite for funding. A second approach consists of using specific-purpose agencies, for instance the Environmental Protection Agency (EPA) or the Economic Development Administration (EDA) in the United States, and to earmark the grants to projects that fall into their mandate and competency. Within this mandate the grants could be tied to narrower policy priorities or actions, for instance the prevention of water pollution, solid waste management or the redeployment of polluted facilities. The second approach is clearly more centralist, although the relevant national agencies maintain State outlets that are to cooperate with subcentral authorities, and there are specific programs that address local concerns.<sup>64</sup> However assigning grants to specific national agencies has the advantage of employing highly specialized expertise for subcentral project implementation that is often difficult to match by the limited experience of lower-tier officials, notably in local government.

Another area of decentralized public capital formation with overarching policy objectives is regional policy. Again the application of performance-oriented conditionalities to regional policy instruments faces the same difficulties that were sketched before in this Section, which is why, in most countries, such conditions have been limited or do not exist until recently.<sup>65</sup> Moreover regional policy denies the ring fencing of funding to narrow policy objectives since it necessitates a multi-dimensional, multi-sectoral policy approach. It requires intergovernmental coordination that takes the complementarities and interactions among various policies into account, which is best achieved through negotiation and contractual arrangements.

Alternatively, the blending of grants with loans may be employed. “Hitherto, most regional policy funding in the OECD has taken the form of grants, but instruments such as loans and even venture capital funds are growing in importance, particularly with respect to large infrastructure”.<sup>66,67</sup> An example of an initiative for blending EU specific grants, bilateral donors with IFI and other third-party lenders is the Western Balkan Investment Framework (WBIF) that aims to streamline cooperation and increase financing capacity for investments contributing to socio-economic development and the accession process in the Western Balkans. The selection procedure is competitive and subject to institutional coordination through a Steering Committee that takes all decisions related to the Joint Grant Facility, and which provides strategic guidance. A pre-condition for funding through the WBIF platform is that projects must be nominated or endorsed by the National IPA Coordinator of the respective country. Projects with regional impact take precedence when deciding among applications.

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64. For instance EPA has set up competitive grant program, Community Action for a Renewed Environment (CARE), that offers an innovative way for a community to organize and take action to reduce toxic pollution in its local environment.

65. Moreover the traditional “compensatory” approach to regional policy tends to undermine performance-related grant conditions.

66. John Batchler and Martin Ferry, “EU Cohesion Policy in a Global Context: Comparative Study on EU Cohesion and Third Country and International Development Policies”, *Task 4: Draft Final Report*, European Policies Research Centre, University of Strathclyde, March 2011. Cited in Tompson, *op.cit.*

67. “The revolving nature of loan-based funding may also make it possible to leverage limited resources further, allowing financing to continue beyond a given programming period. This is likely to be a factor of increasing importance in the current fiscal environment, and the Commission may want to explore the implications of encouraging national governments and those responsible for the design of regional-level operational programmes to make greater use of loan-based funding in the next programming period: rather than being treated as a stock of funds to be disbursed entirely as grants, recipients could lend at least some portion of them, on whatever terms were deemed appropriate, to participants in qualifying development projects.” (William Tompson, *op.cit.*)

Whatever the institutional setting for allocating capital grants within regional policy: It raises questions of procedural legitimacy and, possibly, political discrimination in assigning grants where the application of conditions to different beneficiaries does not appear to be fair and consistent, or even relevant. This cannot even be eased or remedied by contracting where the coordinating institution and/or the procedural rules lack credibility. Political sensitivity then typically opts for a sufficiently uniform policy package that spreads out grants evenly rather than betting on vibrant or promising regional centers of growth. While there is no consensus on the strategy for a successful regional policy, the strategy is clearly biased toward the “fair-share-for-everybody” approach that is likely to be less effective for stimulating economic growth.

### ***Incorporating environmental standards in project grants***

The issue of quality environmental standards tied to projects for grants or loans is rather complex. In principle „green objectives“ (environment protection, developing renewable, sustainable energies, incorporating environmental concerns in building rules etc.) can be, and are, attached to any grant program, not only to those targeting green objectives *per se*. The application form may then provide a tick box to simply ascertain the conformity of the project with environmental objectives. Obviously the box is ticked routinely where it would otherwise knockout the grant. The only benefit is then for well-meaning politicians wishing to demonstrate their commitment to green objectives.

To enhance the quality of information the grant can be conditioned on an Environmental Impact Assessment (EIA). This is a multidimensional “tick box” to ensure that the environmental implications of decisions are taken into account more comprehensively before the decisions are made. The exercise is “to identify and prevent any negative impact, or limit it to a tolerable level and (provided that the negative impact is inevitable but still tolerable) introduce compensation measures. In addition, the assessments should identify, monitor and manage any residual risks.”<sup>68</sup>

For EU grants, environmental impact assessments can be undertaken for individual projects, such as a dam, motorway, airport or factory, on the basis of the 'Environmental Impact Assessment' – EIA Directive) or for public plans or programs on the basis of the 'Strategic Environmental Assessment' – SEA Directive).<sup>69</sup> Consultation with the public is a key feature of environmental assessment procedures to secure legitimacy. All projects and programs cofinanced by the EU have to comply with these Directives to receive approval for funding.

Both instruments, the EIA and public consultation, can be called “procedural standards”. They aim at incorporating into the preparation phase of a project all relevant information for achieving “green objectives” and at including citizens by raising their awareness and by securing political legitimacy. However the link to performance measures and policy outcomes is usually weak because the impact is not immediate (and may even be contested).

However the ambition of EIAs is to also serve as a management tool for steering and shaping projects over their entire life cycle (i.e. from planning to completion). This process distinguishes different phases: a preliminary appraisal (“screening”) to determine the environmental relevance of the project; the definition of the assessment scope (“scoping”) to identify the environmental consequences and risks more accurately; and the design and implementation of an environmental and social impact study to examine all individual

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68. Guideline of KfW Entwicklungsbank for conducting business in an environmentally, socially and climate friendly manner ("Sustainability Guideline"), January 2011.

69. Directive 85/337/EEC, as amended, and Directive 2001/42/EC.

aspects of the project, including participatory approaches to involve affected local groups.<sup>70</sup> These steps will cover the entire program or project.

Another type of standards used in environmental policy has stronger technical connotations. These “technical standards” are usually very specific and tailored to concrete activities that bear on the environment. They constitute benchmarks that the investment must match relative to its emissions.

Examples for technical standards are those for wastewater treatment plants that are guided by the Urban Waste Water Directive in Europe.<sup>71</sup> The objective of the Directive is to protect the environment from the adverse effects of the discharge of untreated urban wastewater and wastewater from certain industries.

As usual these standards set by the EU are transposed into national legislation by the Member States with the consequence that any institution giving loans or grants must ensure that the project complies with these technical standards.<sup>72</sup> IFIs have their own procedures, which overall correspond to the EU Directives but may be even more far-reaching. For instance the Kreditanstalt für Wiederaufbau (KfW) undertakes more comprehensive Environmental and social impact assessments as well as climate change assessments with a wider range of environmentally relevant appraisal standards.

## **1.7 Challenges of grant conditionalities**

### ***Respecting the autonomy of subcentral governments***

The design of intergovernmental fiscal arrangements is convoluted by the need to respect the budget autonomy, and sometimes sovereignty, of subcentral authorities. This does not only apply to the relationship between supranational institutions such as the EU and her Member States, but also to nations with federal constitutions that protect their sovereign constituents against federal intrusion. Moreover the Member States of the Council of Europe are all committed to local self-government, which includes local budget autonomy.<sup>73</sup> Local governments in non-European OECD countries may even enjoy greater political and financial independence, for instance in the United States.

It is obvious that mandated grants are unsuited within such an environment. Moreover, for reasons of political, economic or social cohesion, the grant systems are bound to respect the principles of universality, non-discrimination, equity and fairness. These principles can be realized through general grants, including equalization grants (typically based on fair-minded formulae), but are difficult to achieve with conditioned specific grants. Indeed conditions can easily be claimed to violate subcentral autonomy, and they often smack of discrimination.

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70. *Guideline of KfW Entwicklungsbank, op.cit.*, p. 4-5.

71. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31991L0271:EN:NOT>.

72. Another issue is linked to financing institutions that offer their loans or grants to non-EU Member States. There is a requirement that the projects should also fulfil environmental standards.

73. “Local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population.” *Charter of Local Self-Government*, Article 3 (1), Council of Europe, Strasbourg, 1985.

“In its stronger versions, conditionality may be seen as an outside imposition and domestic agents may be reluctant to press the case for controversial policy or institutional change (even if they privately favour it), preferring instead to “blame” the costs of reform on the donor. The domestic political base for the policy is thereby weakened and incentives to comply are lowered. Local actors, being less committed, are likely to be less effective in implementing such measures and local structures of accountability may be undermined rather than strengthened, as the focus shifts to satisfying the external donor’s requirements.”<sup>74</sup>

Therefore, for political convenience, the grantor typically takes recourse to block grants for a specific policy domain, but uses allocation mechanisms akin to those for general grants, for instance formulae, applies an (often overburdening) set of procedural and technical rules, including unproductive fig-leaf reporting, but avoids intrusive mechanisms such as financial sanctions. This all undermines the efficient working of the specific grant system, without dodging political resentments, since economic theory requires the originator of a policy to bear its full costs “at the margin” in order to be efficient (“marginality principle”).

The answer is again performance-based contracting. Such contracts have proliferated in recent years as illustrated by FDA in the United States where about one quarter of the grants are now given in the form of contractual agreements. However there are clear limitations of this instrument where regional fairness and cohesion is at stake. There is the temptation of donors to “cherry-pick” those subcentral authorities, programs and projects where the grant conditions can be met most easily. The money might then flow to the more prosperous regions where it is least needed.

A solution to this problem is the formation of subcategories of eligible beneficiaries such as for the EU’s Cohesion Fund. It allows to target, based on objective and non-discriminatory criteria, a subset of public authorities (or programs) that share a common policy objective or deficiency, while maintaining the principle of budget autonomy, and still exclude those with lesser needs. However this two-stage allocation mechanism is not fully satisfactory as it may become inequitable *within* the subset defined, especially where contracts are given competitively. The answer is again some rationing through formulae or minimum quota, yet this, again, tends to impair the conditioning of grants.

A clear solution to respecting subcentral policy autonomy is to keep the conditioning of grants sufficiently “light”, involve the recipients in joint decision making and resource allocation, and secure the success of a program or project through procedural rules and democratic control mechanisms, including the participation of citizens. Unfortunately the temptation to follow the easy routes and to implement policies that are regionally “balanced”, i.e. reasonably uniform, cannot be avoided in this strategy. Some inefficiency may therefore have to be accepted to broaden the basis for political consensus and citizens’ participation in due respect for subcentral government autonomy and for democratic principles.

### ***Perverse incentives, moral hazard, and adverse selection***

Where grant conditionalities cannot address performance or output directly, which is often the case, the alternative is often to focus on input-oriented forms of conditionality. And inputs also include policies – as when funding is contingent on putting certain policies or institutions in place *ex ante*. The risk is then that grant beneficiaries focus on attaining or maximizing input criteria (for instance create hospital beds) rather than outcomes (health services). Or they follow dysfunctional policies and set up flawed institutions, which they do not “own”, just to please the senior government or international donors. Where expenditure conditionality is employed, it can be hard to ensure that the result is additionality rather than expenditure

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74. William Tompson, *op.cit.*

displacement.<sup>75</sup> A grant system that relies excessively on input or expenditure criteria therefore risks creating perverse incentives.

Similarly there are dangers of applying ever more complex conditionalities that are aimed more at appeasing taxpayer/donor interests than securing policy success.<sup>76</sup>

“These [conditionalities] can divert attention from programme goals, while adding to the administrative burden involved. Ironically enough, a heavier administrative burden may have the perverse effect of aggravating insider/outsider problems and strengthening the grip of local elites on external funding, since the greater complexity is likely to be more of a barrier to those who are less well informed, resourced or connected.”<sup>77</sup>

Other types of risks are associated with information asymmetries between public authorities at different layers of government. These information asymmetries may provoke “moral hazard” or “adverse selection”.

Moral hazard may emanate from the beneficiary of a grant having more information on its actions and policy risks than the grantor who is to pay for the risk. This could encourage the beneficiary to take inappropriate action where the interests of the grantor and the grantee are not aligned.

A typical (but moribund) example is a grant that covers the full budget deficit of a subcentral authority (“gap-filling grant”), which was typical for the formerly socialist countries. In this case there is no hard subcentral budget constraint, which liquidates all incentives for containing expenditures, setting policy priorities, and reducing costs. Other types of grants (still frequent) use allocation criteria that the recipient government can influence or manipulate. Occasionally this is even praised as providing “incentives” although such incentives can produce perverse results, for instance if the grant is to foster certain types of expenditure. It may lead to an inefficient restructuring of the subcentral budget or distortions through “creative” bookkeeping.

Another type of inefficiency resulting from conditioned grants is linked to the emergence of unfunded mandates. Subcentral governments may have been lured into accepting additional responsibilities that were initially funded by grants in full, but do not keep pace with the development of expenditure needs. Unfunded mandates could then entail an inadequate reduction in the level of public services and produce economic and social inequities.

Matching requirements, which are often seen to counterbalance such tendencies, are impotent to cope with moral hazard where the grant produces “additionality”, i.e. it frees otherwise committed resources from the budget.<sup>78</sup> The only successful strategy to limit moral hazard appears to be the use of objective, independent, non-manipulable and standardized allocation criteria for the grant, which imposes a hard budget constraint. This implies resisting the temptation to incorporate “incentives” into the grant system, including the use of rewards through “payment reserves”.

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75. William Tompson, *op.cit.*

76. Devesh Kapur, “Conditionality and Its Alternatives”, in A. Buirra (ed.), *The IMF and the World Bank at Sixty*, Anthem, London, 2005.

77. William Tompson, *op.cit.*

78. See point 4 on page 3.



Of course even a hard budget constraint has to be renegotiated where subcentral governments face insolvency and the senior government is called to the rescue. This may not only be linked to external influences such as the recent financial crisis. It could also result from moral hazard where subcentral authorities bet on a financial intervention ordained more by political convenience or pressure from the public rather than economic logic. This can only be avoided by a continuous monitoring of subcentral public budgets; restraints in the form of prudential rules, expenditure or debt limitations; and clear regulations governing subnational debt workout or bankruptcy procedures.<sup>79</sup> And of course the better information flows between administrations are organized – either through coordinating institutions or cooperative agreements – the lower is the risk of information asymmetries and of resulting inefficiencies. The main advantage of agreements in this context is the buildup of trust. In general, trust among public officials facilitates potent forms of accountability and conditionality without incurring excessive costs.

Another key factor to avoid the insolvency of lower tiers of government, in particular local government, is the strengthening of their own revenue base. Where own subcentral revenues are lacking or weak, the senior government is, almost by definition, compelled to bailout subcentral authorities in financial distress. This predictability and inevitability of a central bailout through grants is likely to encourage moral hazard behavior.

Another problem related to information asymmetry is adverse selection. It is caused by hidden information rather than hidden actions. “Hidden” information also includes “hidden agendas” such as political considerations, or shared political taboos, on which the recipient government can play a game.

A first phenomenon connected to conditioned grants relates to the “reluctance of public officials to put public money at risk (and the political sensitivity of doing so)”, whereby risk sharing may actually lead to less experimentation and risk-taking.<sup>80</sup> Risk-averse grantors may then seek to choose projects with a high probability of success only. This may be called adverse selection “of cofinancing”.

A second concern is that recipient governments get used to receiving conditioned grants almost as an entitlement, especially where political affiliation matters more than the conditions. In this case recipients do not take the conditions seriously any more. For example for the EU cohesion funding, the sense that regions are in some sense “entitled” to the grant, if they only qualify on the basic criteria, appears to be well established.<sup>81</sup> This is adverse selection “for political convenience”.

A third aspect relates to the fact that risks are distributed unevenly among regions, sectors and/or activities, and some of them cannot be insured because of an apparent lack of opportunities and/or structural deficits. For instance it would be adventurous to take the risk of fostering a newly established, isolated green-field operation in research and ignore the strong agglomeration spillovers of existing research clusters. The allocation of conditioned grants is therefore necessarily selective and tends to focus on regions, sectors, and/or activities where the expected returns are highest and where support programs are least needed. This is another variant of adverse selection, perhaps best called “by inequitable risks”.

Adverse selection engendered by grants could be seen as penalizing those regions, sectors and/or activities that face stronger challenges because of higher risks, for instance for declining industries, unskilled labor force, or weak public institutions. Mitigating such “risks” cannot be achieved through “risk-sharing” grants. This is why in particular regional and sectoral policies need a more comprehensive

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79. See for instance the Hungarian *Municipal Debt Adjustment Act*, Law XXV, in effect since 1996.

80. William Tompson, *op.cit.*

81. *Op.cit.*

policy approach. It requires structural economic and social adjustments supported by transfers of a compensatory or equalizing nature, not by conditional incentive grants.

A fourth phenomenon relates to the fact that excessive conditioning may cause potential beneficiaries to abstain from applying for the grant altogether, in particular where there are alternative sources of funding that they can access. It may be called adverse selection “through excessive conditioning”.

This type of adverse selection is all the more likely the greater the burden of conditionalities. It does not only apply to development finance where the game was particularly virulent during the Cold War<sup>82</sup>. It is a contemporary phenomenon also for the EU that has to reckon with competitive funding from potent donors such as China, Russia or Saudi Arabia even for her Member and potential Member States. This makes again a case for a “light” conditioning of grants.

### *Adaptation of conditions to varying environments*

There is no one-size-fits-all design for conditioning grants. The idiosyncrasies of particular places, public administrations, local preferences and conditions for project implementation must be taken into account when designing a grant. This is again a warning against too detailed and specific standardization of grants conditionalities.

The need to adapt grant conditions to varying environments is particularly relevant for regional policy that needs a multi-objective, multi-sectoral approach, with the specific blend of policies necessarily varying among regions. Hence the conditioning of grants for regional plans is extremely complex and impossible to specify in general terms. And it “implies a need to co-ordinate such regional plans with national – and, in some cases, supranational – sectoral policy frameworks, particularly in respect of things like major transport infrastructure.”<sup>83</sup> The risk is again adverse selection “for political convenience” whereby policy makers focus on regions where conditionalities are met more easily, not on regions where the grant could be more effectual.

A first necessity for adapting grant conditions to varying environment is to look into the institutional environment in which subcentral governments operate. This includes value judgments and perceptions (the “political culture”, for instance accountability, transparency, the rule of law, or citizens’ participation as well as adverse elements such as corruption), human capital requirements, administrative capacities, and procedural rules and practices.

The assessment of the institutional environment should also comprise an identification of coordination gaps, the analysis of existing coordination mechanisms and a look into the need to set up new coordinative arrangements for inter-jurisdictional policy arbitration, for instance in regional policy.

Adaptation of centralized policies, and of grant conditions in particular, to varying environments is again best achieved through inter-jurisdictional agreements based on extensive negotiation and policy adjudication. The primary purpose of such agreements is “not to fix the parties into a complete set of binding and enforceable rights and duties but rather to serve as mechanism for collective decision-making which generates trust and facilitates co-operation and information-sharing”.<sup>84</sup> In other words such

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82. “In any case, donors insisting on policy conditions may soon find themselves sidelined – many developing countries have found alternative official and private sources of finance that come with fewer strings attached.” Felix Zimmermann, “Home-owned and Home-grown: Development Policies that Can Work”, *Policy Insights*, No. 71, OECD Development Centre, Paris, July 2008.

83. William Tompson, *op.cit.*

84. *Op.cit.*

contracting is generally “relational” rather than “transactional” in character. “The wider the scope of the contract and the greater the degree of uncertainty facing the parties, the more likely it is to be relational rather than transactional”.<sup>85</sup>

### ***Monitoring and enforcement of conditionalities***

The conditioning of grants is as policy relevant and effective as is the framework set up for monitoring, controlling and enforcing the conditions. Where this framework is seen to be weak, the grant conditions are not credible and will not achieve their policy goals.

As regards monitoring and control, the grantor must take up this function – or delegate it to a trustworthy, independent external body – and be in a position to take corrective action in case of non-compliance or breach of conditions. Obviously the need for monitoring and control requires reporting, a sound evaluation methodology, human resources for analysis and dispute resolution, which all adds to the costs of conditioning grants. The higher is the complexity in the case of performance-based agreements, the higher are these costs. Also the grantor’s administration must be able to adapt the conditions attached to a grant to specific policy environments, assess the relevance and impact of changing circumstances, for instance elections, and take appropriate action to maintain the credibility of the conditioning. It requires a highly qualified workforce, diplomacy where cooperative agreements are at stake, and long-run institutional memory. Where staff contracts are short and/or staff is rotated frequently, this institutional memory cannot be established.

For these and similar reasons senior governments often link the grant conditions to short-term proxies that allow evaluations to be made sooner rather than later. This can make a program more effective through better targeting, but also through the ability of the donor to intervene timely in the case of abuse. It also supports regular auditing processes. For longer-term programs or projects, especially where independent judgment is seen to secure professional authenticity and political legitimacy, the grantor can set up a temporary commission for inquiry or make use of more regular peer reviews. This could also help to resolve potential conflicts and/or implicit enforcement of the rules.

Implicit enforcement through intrinsic compliance of the grant recipient (“ownership”) does not only render the conditioning of grants more effective; it also saves resources that would otherwise have to be devoted to monitoring and control. Again, intrinsic compliance is best achieved through performance contracts for effective cooperation. Many of the enforceable provisions could then emerge from the negotiations and be internalized as “guide posts” for both parties rather than being imposed by one party.

It is particularly difficult to establish monitoring and control procedures, let alone sanctions, where the parties engage in programs of project with a high degree of uncertainty, for instance when adopting new and innovative projects. In these cases the imposition of grant conditions top-down is counterproductive and must lead to conflicts during implementation. Performance contracts will then provide an avenue for sustaining a dynamic of cooperation among levels of government through intrinsic commitments. Although such contracts may lack binding and enforceable constraints, they can help sustain a dynamic of cooperation among levels of government over the long run.<sup>86</sup>

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85. OECD, *Linking Regions and Central Governments: Contracts for Regional Development*, OECD, Paris, 2007.

86. OECD, *Linking Regions and Central Governments*, *op.cit.*

Although the need for enforcing grants conditions can be significantly reduced by involving the beneficiary through negotiation or contracting, there is still need for *credible* formal sanctions to enforce the arrangements. In the absence of formal sanctions, a lower level may be tempted to waste or misappropriate the allocated grant funds, especially where moral hazard comes into play.

Sanctions must be evoked with care since they inflict upon trust and a productive relationship between governments, which, necessarily, is to stay for long. It requires adopting an intermediary conflict-resolution procedure that involves both parties at par, which may be facilitated by external experts, mediators, or the judiciary. But in the end, sanctions must be applied to render conditioning credible, which is a pre-requisite for it to work in the first place. So if a lower-tier authority is found to waste or misuse funds, and passing a conflict-resolution procedure was futile, the grantor must reclaim the funds or at least cut the funding in subsequent periods.

Nevertheless, politicians shun the adoption of financial sanctions for reasons of an non-reflected “diplomacy” or political considerations. There is an apparent lack of political will to impose sanctions within government. For instance for the EU Cohesion Fund there is a limited element of sanction in that payments can be suspended at some stage of the Excessive Deficit Procedure (EDP). But because this requires a discretionary decision, it has not been evoked for political reasons. Unfortunately such considerations seriously undermine the working of conditioned funding more generally, and must therefore be reproved.

The credibility of financial sanctions for enforcing conditioned grants or performance contracts can be enhanced through automaticity. For instance the sanction is triggered and activated automatically when a procedural blockage occurs<sup>87</sup> or an objective benchmark is violated. It shifts the political blame to the procedures or the definition of appropriate indicators, which may be a general rule of the game or established *a priori* through negotiation. Where moral hazard can be excluded, the imposition of *ex ante* rules benefits from the rational, non-discriminatory, fair and evenhanded Rawlsian “veil of ignorance”.

An alternative is changing the political weights in the enforcement procedure. For example, the donor’s burden of proof of a violation could be converted into the recipient’s burden of proof of non-violation; enforcement could be transposed to the courts, for instance to the EU Court of Justice for the verification of the balanced budget rule; or voting procedures could be changed, for instance Council decisions relating to the excessive deficit procedure become directly enforceable unless opposed by a qualified majority. The EU has in fact embarked on this new approach to policy enforcement in her recent Treaty on Stability, Coordination and Governance (TSCG).

## **1.8 Pre-requisites for the good working of conditionalities**

The satisfactory working of grant conditionalities hinges on assuring certain pre-requisites even before a law is enacted or a performance contract signed. These pre-conditions fall into two groups: those linked to the political, institutional and regulatory environment in which coordinated policies are to be implemented; and those linked to the quality of procedures for implementing a cofunded activity at lower tiers of government.

As to the political and institutional environment at the central level, it is decisive that there is strong domestic leadership and political support for the program; that policies are designed to complement and

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87. For example, the EU’s de-commitment (N+2) rule constitutes a procedural sanction that is triggered automatically. It decommits “any part of a commitment which has not been settled by the payment on account or for which it has not received an acceptable payment application ... by the end of the second year following the year of commitment.” (Article 31.2 of Regulation 1260/1999).

sustain lower tiers efforts rather than supplementing them; that local preferences and capacities for implementation are respected; that the senior government creates the structural preconditions for a successful policy implementation; and that the senior government provides administrative support and technical assistance where appropriate. It is the senior government's responsibility to draw up overarching investment strategies that may be cast into a National Development Plan or the like. Consistency with the strategy or plan will then become a pre-requisite for funding subnational public activities.

At the subcentral level of government, it is decisive that politicians accept joining in a common strategy with the senior government; that they are committed to sharing the objectives underlying the conditioning of funding ("ownership"); that they implement necessary structural reforms where these are needed; and that they prepare cofinanced projects thoroughly through independent feasibility studies and cost-benefit analyses. Structural reforms in areas of joint decision making or financing can also become part of the grant conditionality, but it is crucial that such reforms are carried out of own accord. The reform objectives must be entrenched in the recipients' own objective function rather than being imposed from above. Issues of ownership and accountability are thus critical preconditions for the conditioning of grants.<sup>88</sup>

Structural reforms may be needed both at national and the subcentral levels and the timing and synchronization of such reforms will be essential for a successful cofunding arrangement. Moreover the central government must be prepared to address the costs of structural policy changes imposed on some subcentral government where these exceed their regular budgets, especially for those with specific disadvantages. As an example, the funding of primary and secondary education to be implemented at lower tiers must produce feeble results where there is no coherent and purposeful national education strategy on the one hand. On the other it is subcentral authorities that have to labor the ground for this policy to become fertile, which may need extra funding for structural adjustments. As another example, the senior government might follow an economic growth and innovation strategy based on small-scale business enterprises. Yet the funding of this strategy through conditioned grants must necessarily fail where the local regulatory framework is hostile to innovation, for instance by maintaining barriers to market entry or clientelism, and local officials are reluctant to reform.

When it comes to the pre-conditions linked to the quality of procedures for implementing a cofunded activity, the policy adequacy of a conditioning scheme clearly takes the most prominent place. Second comes the credibility of the conditions. In order to render grant conditions credible, not only is there need for effective conflict resolution mechanisms, but also the political willingness to impose sanctions in the case of non-compliance. It needs fairly extensive *ex ante* and *ex post* evaluations of the conditions and the implementation of policies.

What is desirable as a pre-condition for integrating conditions into a subcentral authority's "own" policies, establishing intrinsic motivation for compliance, and hence rendering them more effective is a process of negotiation and contracting based on performance criteria rather than imposing conditions top-down. What is desirable for enhancing the acceptance by the recipient's constituency is to raise awareness about the ultimate objectives of the conditions through citizens' coparticipation in the process. Ultimately donor and recipient governments need to assure the taxpayers that their financial contributions are being used efficiently and effectively.

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88. See also World Bank, *Review of World Bank Conditionality*, Operations Policy and Country Services, The World Bank, Washington, D.C., September 2005.

## PART II: MODES OF INTERAGENCY COOPERATION AND COORDINATION

### 2.1 General overview

The coordination of policies within multilayer government through conditioned grants is just one, albeit important, instrument to establish effective governance structures. As said, performance contracting often goes hand in hand with the conditioning of grants, which will definitely enhance their policy effectiveness. However this may not be sufficient where longer-term policy objectives are at stake. This calls for more institutionalized forms of joint planning and cooperation, for instance for the formation of public infrastructure and regional development.

In practice there is a host of intergovernmental agreements; platforms and processes; agencies and cooperative mechanisms; and coordinative institutions that aim at enhancing the transparency in public decision-making, the adjudication of potentially conflicting policy objectives, and the orderly implementation of policies to the benefit of society as a whole. These operate both between levels of government (“vertical coordination and cooperation”) and among public authorities at a given level of government (“horizontal coordination and cooperation”).

In the following a number of selected examples are examined that may serve as references or guide posts for institutionalized forms of coordination and cooperation among governments. The study first looks into vertical coordination among layers of government examining the Council of Australian Governments and its Reform Council in Australia; and the role of the *Bundesrat* and other forms of vertical coordination and cooperation in Germany, notably the instrument of joint tasks.

It then inspects horizontal aspects of coordination and cooperation with special attention given to two examples in Germany, the Region Hannover and the regional bodies for the Greater Frankfurt area; and the ongoing reforms of local governments in France, in particular their territorial reorganization and intermunicipal cooperation.

The study concludes with two timely trends for fiscal policy coordination: Domestic Stability Pacts (DSPs) and Fiscal Responsibility Legislation (FRL); and the challenge of intergovernmental macroeconomic management and arbitration with special regard to the European Union.

As an overview, the following Table 3 may serve to shed some light on the various objectives that are relevant for coordination and cooperation among governments; the main instruments used for achieving them both vertically and horizontally; and the main policy risks that are associated with these mechanisms. It also emphasizes the importance of contractual design and enforcement procedures that must accompany intergovernmental coordination and cooperation in order to become effective.

**Table 3: Critical Coordination Mechanisms for Better Multi-level Governance**

Lever	Why is it important?	What instruments?	What happens if mechanisms are weak?
<b>Vertical Coordination</b>	<ul style="list-style-type: none"> <li>To account for regional and local specificities</li> <li>To ensure regional and local investments contribute to national plans and growth</li> <li>To identify and maximize intergovernmental synergies/avoid conflicting or overlapping policies which result inefficient investments</li> <li>To minimize vertical coordination costs</li> </ul>	<ul style="list-style-type: none"> <li>Intergovernmental transfers</li> <li>Intergovernmental contracts</li> <li>Intergovernmental platforms and process for public investment decision-making</li> <li>Regional planning process and engagement of local government bodies</li> </ul>	<ul style="list-style-type: none"> <li>Information asymmetries</li> <li>Contradictory or not complementary policies across levels of government</li> <li>Fiscal gaps</li> <li>Region's collective interest undermined by sectional interests</li> <li>Un-coordinated action by different parties compromises collective interest</li> <li>Regional policies not in synch with relevant national policies</li> <li>Lack of synergy between national and regional development plans.</li> <li>Central Grant conditions fail to take adequate account of regional specificities</li> <li>National and regional infrastructure investment plans poorly aligned</li> <li>Transport Infrastructure not integrated with international, national and other regional infrastructure</li> <li>Failure to meet national conditions undermines reputation and influence of regional government</li> </ul>
<b>Horizontal Coordination</b>	<ul style="list-style-type: none"> <li>To achieve critical mass at a functional level and economies of scale in investment projects</li> <li>To ensure coordination of investment projects at the regional and local levels</li> <li>To ensure coordination of public investment across borders</li> </ul>	<ul style="list-style-type: none"> <li>Regional development agencies</li> <li>Intermunicipal coordination mechanisms (e.g., financial incentives for mergers and/or cooperation, contractual agreements, specially created bodies, and advisory services)</li> <li>Local and regional government associations</li> <li>Cross-border agreements and cooperation platforms</li> </ul>	<ul style="list-style-type: none"> <li>Failure of achieve proper economies of scale for investments</li> <li>Proliferation of small or uncoordinated investment projects</li> <li>Presence of contradictory investment projects/strategies with unintentional, negative consequences</li> </ul>

Lever	Why is it important?	What instruments?	What happens if mechanisms are weak?
<b>Contractual Design and Enforcement</b>	<ul style="list-style-type: none"> <li>• To design effective agreements (contracts)</li> <li>• To enforce commitments and to hold parties accountable for outcomes (minimize renegotiation)</li> <li>• To require and incentivize the implementation of public investment strategies in a specific way</li> </ul>	<ul style="list-style-type: none"> <li>• Contracting among levels of government</li> <li>• Intergovernmental platforms for the design and enforcement of contracts</li> <li>• Ex-ante conditionalities to be achieved in order to release investment funds</li> <li>• Performance conditions to be achieved to ensure continued disbursement of funds in a present or subsequent funding cycle</li> </ul>	<ul style="list-style-type: none"> <li>• Poor contract design leads to inefficient allocation of resources and possible (undeserved) rewards or sanctions for realisation of objectives</li> <li>• Weak enforcement mechanisms leads to unnecessary contract revisions, or shirking</li> <li>• Ex-ante or performance conditions are weakly related to contract outputs or objectives, causing an inefficient allocation of resources (time, people, and money)</li> <li>• Gaming</li> </ul>

Source: Unsigned OECD Internal Document, Conceptual Framework for Multi-level Governance of Public Investment, Paris, 2011.



## 2.2 Vertical coordination through the COAC in Australia

The Council of Australian Governments (COAG), established in 1992, is the peak intergovernmental forum in Australia, comprising the Prime Minister (chair), State Premiers, Territory Chief Ministers and the President of the Australian Local Government Association (ALGA). The role of COAG is to initiate, develop and monitor the implementation of policy reforms that are of national significance and which require cooperative action by Australian governments.<sup>89</sup> Its operation is now based on the Intergovernmental Agreement Federal Financial Relations of July 2011 and works through National Agreements and Partnerships Agreements.<sup>90</sup>

The objectives of the COAG are far reaching. They comprise

“collaborative working arrangements, including clearly defined roles and responsibilities and fair and sustainable financial arrangements, to facilitate a focus by the Parties on long term policy development and enhanced government service delivery; enhanced public accountability through simpler, standardised and more transparent performance reporting by all jurisdictions, with a focus on the achievement of outcomes, efficient service delivery and timely public reporting; reduced administration and compliance overheads; stronger incentives to implement economic and social reforms”

as well as provisions relating to tax sharing and inter-State equalization.<sup>91</sup> The Standing Council for Federal Financial Relations, within the framework established by the COAG, will oversee the operation of the Agreement. It clearly emphasizes the key role of financial arrangements, which also explains that the Treasurer of the Commonwealth holds the chair of the Standing Council.

The agreements for coordinating intergovernmental relations in Australia are a typical expression of “contract federalism”<sup>92</sup> which, since they involve only executives, has also been dubbed “executive federalism” by some scholars.<sup>93</sup> These arrangements do not dispossess parliaments at national or subnational levels, but it is clear that voting against an intergovernmental agreement established among executives will be more difficult and needs to be explained.

The more recent COAG Reform Council was set up by the COAG, but is independent of individual governments reporting directly to the COAG. It is the key institution within this framework for enhancing the accountability of governments to the community for the outcomes achieved under the various intergovernmental agreements. Its role includes<sup>94</sup>:

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89. COAG Reform Council’s Charter as of 30 September 2011, p. 4.

90. A National Agreement comprises “the objectives, outcomes, outputs and performance indicators, and clarifying the roles and responsibilities, that will guide the Commonwealth and the States and Territories in the delivery of services across a particular sector.” A Partnership Agreement is devoted to “the delivery of specified projects, to facilitate reforms or to reward those jurisdictions that deliver on national reforms or achieve service delivery improvements.” (Schedule A of the COAG Charter).

91. Intergovernmental Agreement on Federal Financial Relations, Council of Australian Governments, July 2011.

92. See footnote 2.

93. Ronald L. Watts, *Executive Federalism: A Comparative Analysis*, Institute of Intergovernmental Relations, Queen's University, Kingston, Ont., 1989.

94. COAG Reform Council’s Charter, p. 6.

- reporting on the performance of governments under National Agreements, highlighting contextual factors, providing a comparative analysis of the performance of governments, and reporting on progress under National Partnerships that support the National Agreements;
- reporting on the performance of governments under various National Partnerships with reward payments assessing the adequacy of such payments;
- other reporting such as on Water Management Partnerships; and the consistency of capital city strategic planning with national goals; etc.
- advising COAG on options to improve performance reporting frameworks;
- highlighting examples of good practice and performance; and
- implementing an effective public accountability regime.

The COAG Reform Council's mandate is hence mainly advisory, with the exception of the implementation of an effective public accountability regime.

Reform initiatives and actions remain in the hands of the COAG itself, whose track record is too short to be assessed at this time. Given a highly imbalanced vertical attribution of taxes, the States' main interest is to increase their revenue shares, while the central government is to insure that the money is spent adequately and effectively. This has led to certain antagonisms between the Parties. In particular Western Australia, that has been benefitting from a tremendous resources boom, as well as New South Wales and Queensland have expressed fears that the arrangements would lead to a diminishing role of the States. They also fight up to the central government for controlling larger resources.

Whatever the antagonism within the COAG, its Reform Council has certain political clout, given its independence from individual governments, through its analytical powers and its ability to identify and underline deficiencies in policy making. For instance in a recent two-year report card on capital city strategic planning systems, the Reform Council identified a number of shortcomings in investment and innovation; urban design and architecture; performance measures; and consultation and engagement, for instance in Southern Queensland.<sup>95</sup> But the chairman of the COAG Reform Council has also criticized the central government by warning „that Canberra's proposals for health, education, national disability and skills appeared to impose more curbs on the states, undoing previous deals intended to increase state autonomy.“<sup>96</sup>

It remains to be seen how cooperative federalism through agreements within the COAG will evolve. But the institutional setting is promising, especially given the independence and informational power of its Reform Council. After all there is a precedent of a powerful independent institution in Australia that makes recurrent recommendations in the area of intergovernmental finances: the Commonwealth Grants Commission. Whatever criticism of its work may be, its overall track record is largely considered successful.

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95. “Capital city planning at 'watershed point'“, *Brisbane Times*, April 2, 2012.

96. “COAG challenge to federal 'attitude'“, *The Australian*, April 3, 2012.

### 2.3 Vertical policy coordination and “Joint tasks” in Germany

Vertical policy coordination between the Federation on the one hand and the States (*Länder*) and their municipalities on the other mainly relies on the Second Chamber of Parliament, the *Bundesrat*, and on intense interagency cooperation among bureaucrats. The *Bundesrat*, despite being part of the legislature, consists of non-elected representatives of the States, which is another phenomenon of “executive federalism”. The *Bundesrat* has only specific legislative powers as it rules on federal legislation only in those matters that affect the interests of the States directly. Its main functions are therefore to defend the interests of the *Länder vis-à-vis* the Federation and the European Union<sup>97</sup> and to ensure that the political and administrative experience of the *Länder* is incorporated in federal legislation and administration; and in European Union affairs.<sup>98</sup>

Like the other constitutional organs of the Federation, the *Bundesrat* bears its share of the overall responsibility for the Federal Republic of Germany. Its working has a mixed record however: Whenever the coalition forming the federal government had no majority in the *Bundesrat*, the latter tended to block federal legislation for political reasons. True, there is a reconciliation committee (*Vermittlungsausschuss*) that attempts to overcome such conflicts, but it was not always successful, which led to a stalemate in federal legislation. The federalism reform of 2006<sup>99</sup> attempted to lower this conflict potential by disentangling some joint responsibilities between the two layers of government, which somewhat reduced the number of law that are subject to *Bundesrat* approval.

The role of the German *Bundesrat* is general purpose. There are however other modes of cooperation among levels of government for specific responsibilities. For instance in the domain of regional planning, the federal minister and State ministers for regional planning form a Standing Ministerial Conference to establish a common framework for regional policy including cross-border issues and the cooperation with neighboring countries.<sup>100</sup> Similar arrangements exist in education where the States assume primary responsibility, but the Federation has some limited functions in continuous education, financial support for students, and the support of research and progress of technology. But education is also an area for which the Constitution foresees a specific form of vertical cooperation: “joint tasks”. According to Article 91b (1) of the Constitution (*Grundgesetz*) the Federation and the States can cooperate in matters of national importance in projects of scientific research outside of universities and in constructing research buildings for universities. Projects of science and research at universities also fall in this category, but they require unanimity among all States.

Joint tasks are not confined to education alone. The Federal Government participates in the performance of State duties where these are important for society as a whole and where federal participation is required to improve the living conditions. Specific areas are the upgrading of the regional economic structure; the enhancement of agricultural structures; and coastal preservation and protection (Article 91a *Grundgesetz*). These joint-task projects are integrated into the national framework for regional policy and the Federation then carries at least half of the respective expenditures. Financial assistance by the Federation is however differentiated by region, integrates the funding from the European Structural Fund (ERDF), and is limited to structurally weak regions with the objective to improve their economic conditions through infrastructure development.

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97. *Gesetz über die Zusammenarbeit von Bund und Ländern in Angelegenheiten der Europäischen Union (EUZBLG)* of March 1993 as amended on 22 September 2009 (Bundesgesetzblatt, Part I p. 3031).

98. From [www.bundesrat.de/cln\\_117/nn\\_10940/EN/funktionen-en/funktionen-en-node.html?\\_\\_nnn=true](http://www.bundesrat.de/cln_117/nn_10940/EN/funktionen-en/funktionen-en-node.html?__nnn=true).

99. 52. *Grundgesetzänderungsgesetz* vom 28.08.2006, BGBI. I 2006, 2034 ff.

100. See § 26 *Raumordnungsgesetz* of 22.12.2008 (BGBI. I S. 2986).

The implementation of joint tasks is exclusively assigned to the States (Article 30 *Grundgesetz*). To coordinate the policies between the Federation and the States, a Coordinating Committee (*Koordinierungsausschuss*) is formed that establishes a framework for coordination and financing. This Committee comprises the federal minister for economics and technology (chair), the federal minister of finance, and the economics ministers or senators of the States. Decisions of the Committee require the consent of the federal government and of a majority of States. The Committee cannot decide on the amount of financial assistance and cofinancing, which is part of the normal budget process, but it can decide on the distribution of funding onto individual States.<sup>101</sup>

The joint task regional economic development has a long tradition of evaluation, which was developed in close partnership with academic institutions both as to content and methodology. Numerous components of a comprehensive performance review were applied and implemented empirically. There is wide agreement that the joint task regional development has had a positive impact on regional policy objectives and that it significantly contributes to reducing regional disparities in Germany.<sup>102</sup>

## **2.4 Horizontal coordination and cooperation among local governments**

### ***The integration of horizontal economic spillovers and economies of scale***

As said in Section 0 of this study, specific grants aim at integrating vertical, but also horizontal spillovers to provide incentives for efficiency and address economies of scale. These can be achieved through interagency cooperation or through the formation of “optimal” spatial units for public service delivery. This is particularly relevant for metropolitan areas where jurisdictional fragmentation can easily lead to a waste of public resources through overlapping competencies and fiscal competition among governments. Apart from relatively loose modes of interagency coordination, for instance through municipal associations, it could require institutionalized forms of intermunicipal coordination and cooperation that go beyond the working of a grant system.

This study examines regional and intermunicipal cooperation in two countries, Germany and France. While the decentralization strategy in France is comprehensive and all-inclusive based on national legislation, the institutionalized forms of intermunicipal cooperation vary from State to State and from region to region in Germany. Within Germany, a comparison is made between two metropolitan areas, Hannover and Frankfurt, one resulting in success, the other in failure. As to the results of the French institutional reforms they are inconclusive given that they are still being implemented.

### ***Regional coordination and cooperation in Germany: Hannover and Frankfurt***

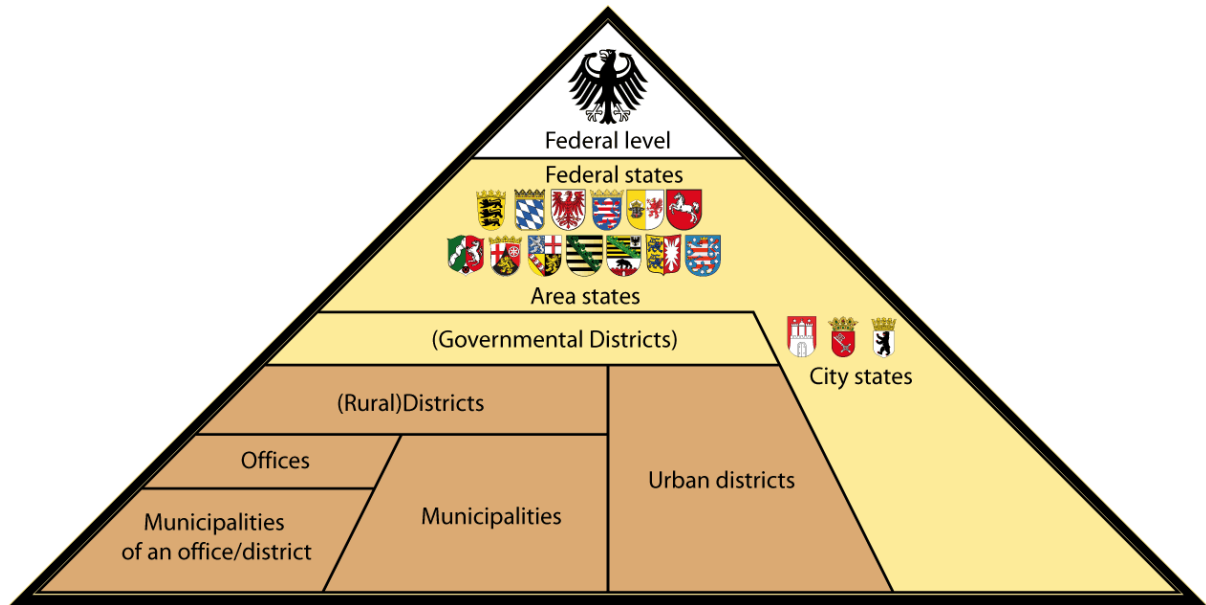
In order to understand the way municipalities interact in Germany, a brief outline of the administrative structure of German governments may be useful (see Figure 2).

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101. For a comprehensive explanation of the working of the joint task for regional development, see: *Koordinierungsrahmen der Gemeinschaftsaufgabe “Verbesserung der regionalen Wirtschaftsstruktur” ab 2009*, Deutscher Bundestag, 16th Term, Print Matter 16/13950 (8th September 2009).

102. *Koordinierungsrahmen ...*, op.cit., p. 7.

Figure 2: The Administrative Structure of Government in Germany



Source: David Liuzzo, [http://commons.wikimedia.org/wiki/File%3AAdministrative\\_divisions\\_of\\_Germany.png](http://commons.wikimedia.org/wiki/File%3AAdministrative_divisions_of_Germany.png).

Below the federal level, there are two types of States (*Länder*): Area-States and City-States. The latter also perform municipal functions together with State functions, so they are better able to integrate regional spillovers and to realize economies of scale than other metropolitan agglomerations. The Area States possess regional outlets for policy implementation, the governmental districts (*Regierungsbezirke*), but these do not form part of the local sector.

The local sector falls into two categories: urban districts (*kreisfreie Städte*) and rural districts or counties (*Landkreise*). The rural districts or counties are composed of smaller self-governing municipalities with own resources, including State grants, which they partly use to fund the county through upward oriented grants (*Kreisumlage*).<sup>103</sup> But municipalities are free to create offices or leagues (*Gemeindeverbände*) according their needs as own legal subjects<sup>104</sup>.

The city of Hannover (*kreisfreie Stadt*) and the surrounding counties (*Land-kreise*), with the support of the *Land* Lower-Saxony, have amalgamated their resources and policies by creating, in 2001, the “Region Hannover” at the highest district level. This league of municipalities was also given certain State responsibilities that were formerly exercised by the local Governmental District (*Regierungsbezirk*) of Lower-Saxony.

103. The determination of the district levy (*Kreisumlage*) is up to the district council, and the municipalities, towns and cities of the district have no right of participation. Where they consider the levy to be too high, they have to go to the courts.

104. In addition there are various forms of specific purpose offices (“*Zweckverbände*”) through which municipalities cooperate in specific areas such as water management, wastewater disposal, health (regional hospitals), mass transportation or tourism, for instance. These are not relevant in this context.

The Region Hannover is based on State legislation<sup>105</sup> and operates through a regional assembly (*Regionsversammlung*) with elected members, and a regional president (*Regionspräsident*) that correspond to the municipal assemblies and mayors for other municipalities. The legal construct of Region Hannover as a cooperative local institution is unique in Germany. It comprises 21 municipalities and cities, including the State capital Hannover, and 1,1 million inhabitants. The Region assumes responsibilities in the area of mass transportation, waste management, local social protection, schools and hospitals as well as regional planning, recreation, economic, environmental and employment policies. Its creation and performance is widely regarded as successful.<sup>106</sup> The administration describes itself as „powerful, close to citizens, non-bureaucratic, modern and cosmopolitan”.<sup>107</sup>

On the other hand, the region of Frankfurt, one of the fastest growing regions in Europe, has made various attempts to consolidate public decision making within the region. In 1975 the State created the regional Umlandverband Frankfurt (UVF), which was expected to become the main vehicle for intermunicipal policy coordination. The UVF had wide-reaching competencies in policy planning and implementation for many specific-purpose functions at the local level.<sup>108</sup> Membership of the 43 cities and municipalities with about 1,6 million inhabitants was compulsory by law. The parliament (*Verbandsammer*) of the UVF consisted of non-elected delegates from member governments.

The UVF was indeed successful in promoting economic integration in certain areas. For instance in 1990 it proposed a new expanded transport association Rhein-Main, and thus paved the way for the Rhine-Main Transport Association (RMV) that still exists today.<sup>109</sup> However the construct had a number of deficiencies from the outset. For political reasons the territory of the league was too narrow to incorporate the economic and social interests of the larger Frankfurt area (*Rhein-Main-Gebiet*). This was important because the UVF had no competencies beyond its territory, which excluded important suburban areas. Also, over time, the rural districts rather than the metropolis dominated collective interests. In particular the extension of the airport led to continuing political conflicts that could not be resolved within the UVF. It was for this and other reasons that the UVF was finally dissolved in 2001. It was widely regarded as a failure.

The successor organization of the UVF, the Planungsverband Ballungsraum Frankfurt/Rhein-Main (PBF) comprised a larger number of members, 75 cities and municipalities, but was less strictly organized and bestowed only with partial responsibilities that were mainly confined to regional planning. The rural districts that had dominated decision making in the UVF were excluded this time. But equally excluded were important urban centers such as the State capital of Wiesbaden, or neighboring Darmstadt. Again the decision-making body of the PBF, the Regional Council, consisted of delegates from the different member governments, not elected parliamentarians as in the case of the Region Hannover.

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105. Originally the Region was ruled by the Gesetz über die Region Hannover, now by the Niedersächsische Kommunalverfassungsgesetz of 2011.

106. Henneke, Hans-Günter, „Eine kritische Würdigung der Regionsbildung“, in: Niedersächsische Landeszentrale für politische Bildung (ed.), *Die Region Hannover: Eine erste Bilanz*, 2003, p. 41-50.

107. “Leistungsfähig, bürgernah, unbürokratisch, modern und weltoffen.”  
[http://www.hannover.de/de/buerger/verwaltungen/rh\\_dez\\_fb/index.html](http://www.hannover.de/de/buerger/verwaltungen/rh_dez_fb/index.html).

108. *Gesetz über die Bildung des Umlandverbands Frankfurt (UFG)* of 11 September 1974.

109. The creation of this association, the *Verkehrsverbund* for mass transportation in the region, was however facilitated by federal transfers through the *Gemeindeverkehrsfinanzierungsgesetz*. See also footnote 53.

Since 2011, a new Regionalverband FrankfurtRheinMain (RVF) governs the region. In addition to the competencies for land use and landscape planning of its predecessor, the RVF now has a role in strategic management and coordination for the development of the region. The former Regional Council was dissolved and replaced by an expanded regional board, which includes, in addition to three full-time board members, a maximum of eight honorary councilors and mayors of the urban districts and the rural councils of the districts.

In contrast to the Region Hannover, which has adopted a larger territorial approach and thrives on citizens' coparticipation in public decision-making, the greater Frankfurt region has embraced political convenience and non-democratic forms of decision-making. Of course this can be explained – and the expansion of Frankfurt airport remains a controversial issues – but it is doubtful whether this constitutes a sustainable basis for coordinated arbitration of interests and for regional cooperation in the long run.

### ***Regional coordination and cooperation in France***

During 2008-2014 the subnational public sector in France was/is being subject to significant transformations and reforms. These reforms aims at simplifying and consolidating a highly fragmented subnational public sector along two lines, one emphasizing the region (*départements-régions*), the other local government (*communes-intercommunalité*). The strategy followed for the region is to move from a highly centralized system based on the *département* as administrative outlet of State power to a participatory approach based on *régions* with elected officials (*conseillers territoriaux*), while retaining the traditional departments but reassigning the competencies between the *département* and the *région* by 2015.

More interesting for this study is the strategy adopted to consolidate the local government sector. In fact this sector with more than 36.000 municipalities (*communes*) is extremely patchy. Yet, even before the reforms, municipalities had the right to establish various forms of intermunicipal cooperation (*Établissements publics de coopération intercommunale*, EPCI) on a voluntary basis. At present there are five types of such EPCI according to the number of inhabitants and/or proximity to urban centers.<sup>110</sup> For political convenience the reform of Grand Paris (*Île-de-France*) has been adjourned for later legislation.

It is interesting to note that the various forms of voluntary intermunicipal cooperation have been highly attractive in France. In 1999 only one municipality of two was regrouped in an EPCI with own fiscal rights; ten years later the EPCIs with own fiscal rights included already 93,1 percent of all municipalities that represented 89,7 percent of all inhabitants.<sup>111</sup>

However despite these favorable trends, there are a number of deficiencies related to the voluntary amalgamation process:<sup>112</sup> (i) often the territorial delineation of the EPCIs is either inappropriate or too narrow for fiscal reasons or factors such as political affinity; (ii) there are still isolated municipalities whose integration into EPCIs is difficult; (iii) a number of EPCIs is based on ill-defined or “virtual”

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110. These are the communauté de communes (CC), the communauté d'agglomération (CA), the communauté urbaine (CU) and (since 2010) the métropole and the pôle métropolitain. There are also older forms of intermunicipal cooperation, the syndicats d'agglomération nouvelle (SAN) and the structures intéressées, which will be transformed into new forms of EPCI. Moreover there are specific-purpose bodies for intermunicipal cooperation in particular areas such as water, electricity or schools (syndicats intercommunaux à vocation unique (SIVU), and syndicats intercommunaux à vocations multiples (SIVOM)) that do not possess fiscal rights however.

111. Projet de loi de réforme des collectivités territoriales: Étude d'impact, Document joint au projet de loi, Paris, 2009, p. 58.

112. *Op.cit.*, p. 63.

competencies, especially where the common interest is established restrictively; and (iv) the internal transfer of own resources is sometimes insufficient, especially for smaller municipalities in rural areas.

In order to implement the decentralization reforms by 2014, and the new structures of EPCIs in particular, the law mandates the prefects (*préfets*) to elaborate departmental schemes for intermunicipal cooperation in the *Département* to be deliberated and decided, with a two third majority, by the Departmental Commission for Intermunicipal Cooperation (*Commission départementale de coopération intercommunale* CDCI).<sup>113</sup> The prefect will then have to implement its decisions and possibly redraw the boundaries of existing EPCIs through mergers and dissolutions.

So the strengthening of intermunicipal cooperation in France is essential based on a territorial reform, which is achieved through negotiations without necessarily liquidating the existing local jurisdictions, in particular municipalities. Nevertheless the prefect has the power to absorb all enclaves and discontinuous entities into an EPCI with fiscal powers and to regroup and, possibly, dissolve syndicates and to transfer their competencies onto an existing EPCI. These decisions are subject to a review by the CDCI, but will be irrevocable once adopted.

The objectives of these reforms are manifold, in particular the elaboration of common programs and projects for a better organization of area space, economic development and urban management. Moreover one expects better intermunicipal service dispositions, efficacy and rationalization of unified common services through economies of scale, improved human resource management, the mutualization of means and services as well as a clearer definition and delineation of competencies.

It remains to be seen what these reforms will mean for horizontal intermunicipal cooperation in France. Positive traits are that the new EPCI will operate on democratic principles, unlike regional government in Frankfurt, and that there are provisions to avoid financial downgrading. Undoubtedly the structure of local government will be significantly consolidated and simplified. However the fact that the competencies of the new EPCI still have to be defined by legislation in 2014 is somewhat unfortunate. Moreover the fact that the new structures will supersede the existing structure of municipal governments without fully absorbing them will provide an interesting laboratory for intermunicipal cooperation that might not always be without failure.

## 2.5 Macroeconomic policy coordination

Macroeconomic conditionality “reflects a logic similar to the broader version of structural reform conditionality”.<sup>114</sup> But there are clear limits to convey macroeconomic conditionality through the grants system domestically, let alone at a supranational level. It easily collides with the challenges discussed in Section G.1: respect for sovereignty and autonomy. Moreover it need more elaborate forms of information exchange that can only be achieved by institutionalized forms of intergovernmental coordination and cooperation. The recent economic and financial crises have put the limelight on the deficiencies of achieving macro-fiscal stability in a multi-government environment – whether within the domestic economy or from an international perspective.

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113. These CDCI, which play a major role in the process of decentralization and amalgamation, are given extended powers. They are composed of representatives from the municipalities (40 percent), from EPCIs and syndicats (40 percent), from the departmental *conseil général* (15 percent) and the regional *conseil régional* (5 percent).

114. William Tompson, *op.cit.*



### *Domestic Stability Pacts and Fiscal Responsibility Legislation*

In the Member States of the European Union the move toward domestic mechanisms for macro-fiscal policy coordination in decentralized government was triggered by supranational agreements. In particular the EU's Stability and Growth Pact (SGP) provides that the public deficit of a Member State may not exceed 3 percent of its GDP and consolidated public debt may not exceed 60 percent of GDP.<sup>115</sup> Although these criteria are indicative, their consistent negation and violation may lead to an "excess deficit procedure" by which a Member State government may face sanction in the form of fines.

The need to comply with criteria defined for consolidated general government as a whole raises the problem of how to coordinate autonomous public budgets in a decentralized setting, and how to enforce these global limits for all governments. In fact many EU Member States have responded by concluding domestic stability pacts (DSP) between the national government and subcentral authorities. The DSP is essentially a rule that imposes deficit reduction on subnational authorities.

There are basically two different strategies for DSPs found in EU countries:

- Consensual agreements and formalized cooperation (e.g., Austria, Germany, Belgium, Denmark); and
- Fiscal rules and administrative controls (e.g., France, Greece, Italy, Spain, Sweden, United Kingdom).

It is no coincidence that the former type of arrangements is found primarily in federations, while the second is more typical for unitary states.

Consensual agreements are more difficult to reach and they can work only through institutionalized forms of cooperation, which many DSPs tend to shun. The Financial Planning Council (*Finanzplanungsrat*) represents such an institution in Germany, for instance.<sup>116</sup> Moreover, there must be enforcement mechanisms that are usually deficient, especially in federations, except perhaps in the case of an effective EU sanction, which would raise the question of how to allocate that sanction among governments. However consensual agreements can be highly effective where there is political consensus on maintaining good fiscal governance and budget discipline (e.g. Austria or Germany).<sup>117</sup>

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115. Public deficit or surplus is defined as the net borrowing or net lending of the general government (defined to include the central government, local governments and social security funds) in accordance with the European System of Integrated Economic Accounts, and it encompasses all public expenditures, including infrastructure financings.

116. According to § 51 of the Law on Budget Principles (*Haushaltsgrundsatzgesetz* of 1969) the task of the Financial Planning Council is to coordinate financial planning of federal, State and local authorities. Since 2002, when a DSP was formed, the Financial Planning also plays a central role in maintaining the fiscal discipline of public finances in the framework of the European Economic and Monetary Union.

117. In fact fiscal rules are often thought to be superfluous where budget procedures are sufficiently transparent and there are effective mechanisms for democratic control, for instance in Skandinavian countries.

More recently however the strengthening of fiscal governance based on quantitative rules has become more prominent – even before the financial crisis.<sup>118</sup> Various countries have adopted DSPs not only to reign-in subcentral levels of government, but also spendthrift parliaments by calling upon self-discipline. For instance Italy, in 1998, passed a law, which made subnational entities (regions, provinces and municipalities) subject to public expenditure and deficit limits. As a result, local entities must participate in the efforts to reduce the public deficit implied in the EU framework. The Budget Law for the year 2005 amended some of the principles of this DSP, and some new commitments for local entities with respect to investment expenses apply since then.

The principles governing the DSP in Italy are significantly different from the rules of the EU Stability Pact however. In fact, the main obligation of local authorities is not based on an expenditure/GDP ratio, but on the prohibition of local expenditures to exceed certain thresholds. These are independent from the growth of GDP, i.e. the DSP subjects local governments to absolute expenditure thresholds. In addition, the expenditure limits applied to local entities did not take investment outlays into account initially. However the budget law for 2003 provided that as from 2005, investment expenses will also be counted. This new provisions have a strong impact on infrastructure decisions by local governments and regions.

Although Italy (as other EU countries) may have a DSP with harsh sanctions on paper, this is poorly monitored and not enforced. Moreover there were frequent changes in the targets, some spending (health, education) was ring-fenced and hence protected, and the DSP cash balances did not correspond to the EU relevant balances. Most importantly, the DSP was increasingly considered to become an instrument of centralized control – in conflict with the objectives of decentralization. After an initial period of successful performance where 90 percent of subnational entities complied with the rules, subnational budget targets have been disregarded more recently.<sup>119</sup>

In a similar vein the United Kingdom and Poland have put a cap *on total* local government borrowing, which, once reached, restricts even those local governments whose public debt is low or nil. In principle this may be considered both unfair and potentially ineffective because it allows the spend-thrifty to expand their borrowing at the expense of the fiscally responsible. In particular it cannot prevent moral hazard behavior and local government insolvencies, which generates pressures for political bailouts even under such tight macro-fiscal conditions. Such variants of DSPs are hence more symbolic, and possibly need a mechanism for allocating budget risks internally, however, so far, this symbolism seems to have worked reasonably well in both countries. Again the DSP works better where there is a solid fiscal-governance “culture”.

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118. The EU maintains a site on fiscal governance in EU Member States that comprises information about national numerical fiscal rules, independent fiscal institutions, and medium-term budgetary frameworks. [http://ec.europa.eu/economy\\_finance/db\\_indicators/fiscal\\_governance/index\\_en.htm](http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm).

119. Ian Lienert, *Should Advanced Countries Adopt a Fiscal Responsibility Law?*, IMF Working Paper, Fiscal Affairs Department, International Monetary Fund, Washington D.C., 2010, p. 24.

Potentially the most comprehensive institutional device for incorporating macroeconomic conditions into intergovernmental coordination to strengthen the fiscal sustainability of decentralized government is a Fiscal Responsibility Law (FRL)<sup>120</sup>. The FRL concept was pioneered by New Zealand and has found worldwide acknowledgment. In 2004, New Zealand's FRL was consolidated into a revised and more-comprehensive Public Finance Act.<sup>121</sup> Several Latin American countries, or India, have adopted FRL legislation with the aim of promoting enhanced fiscal policies. OECD countries that have adopted legislation in the spirit of FRL are Australia, New Zealand, the United Kingdom, Mexico and Hungary.

There are a number of general aspects that characterize a FRL:

- A medium-term strategy that specifies the path of fiscal aggregates and relates the medium-term to the annual budgeting process for attaining the chosen fiscal objectives.
- Numerical targets (or limits) on fiscal indicators, e.g., rules such as requirements for overall balance or current balance, or limits on the overall deficit, primary expenditure, change in debt stocks, public sector wage bill, and so forth.
- Fiscal transparency requirements, e.g., requirements for comprehensive timely, frequent, and detailed reporting on budget execution; a well-defined medium-term macroeconomic budget framework, including the underlying macroeconomic assumptions, all of which are essential for showing the current budget in the context of a sustainable perspective; and information of tax expenditures, and potential fiscal risks as part of the annual budget exercise<sup>122</sup>; a special annual report on compliance with the law may also form part of the FRL.
- A small number of escape clauses to be invoked in a discretionary manner in the event of unforeseen exogenous shocks; e.g., national catastrophes or periods of negative economic growth.
- Enforcement mechanisms (usually through the audit office or the legislature) to enhance compliance, along with a system of sanctions and penalties for violations of the FRL.

It is essential that the FRL is comprehensive and *mandatory for all levels of government*. The effective monitoring of macro-fiscal behavior in a multi-government setting also asks for harmonized budgeting rules and reporting as well as an effective institution for effective monitoring. Moreover a coordinative institutional mechanism involving all layers of government must be in place for imposing possible sanctions that need a high degree of political legitimacy.

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120. Lienert, op. cit., p. 5, defines an FRL as follows: "A 'Fiscal Responsibility Law' is a limited-scope law that elaborates on the rules and procedures relating to three budget principles: accountability, transparency and stability." He then adds that "laws that elaborate on *individual* responsibility for budget program management" [such as the US Government Performance and Results Act of 1990, for instance] „are not considered to be FRL-type laws. In contrast, laws that elaborate on the government's *collective* responsibility to parliament for macro-fiscal management are FRLs."

121. For details see: New Zealand Treasury, *A Guide to the Public Finance Act, August 2005*. [http://www.treasury.govt.nz/publications/guidance/publicfinance/pfaguide/11.htm#\\_toc](http://www.treasury.govt.nz/publications/guidance/publicfinance/pfaguide/11.htm#_toc).

122. It includes an analysis (stress testing) of potential effects produced by external shocks, policy risks, debt risks, the operations of subnational governments, public-private partnerships and state-owned enterprises, natural disasters, and fluctuations in the value of government assets.

An effective FRL also requires involving parliaments at any one level of government.

“Fiscal rules, if incorporated in a FRL, could be ignored by parliament if it avails itself to the FRL’s exception (or “escape”) clauses to circumvent the intent of the legislation. In this context, about half of the OECD countries’ parliaments have unlimited powers to amend a government’s draft budget.<sup>123</sup> Such powers could potentially derail a government’s proposed fiscal consolidation plan for fiscal deficits and debt.”<sup>124</sup>

Moreover, to be successful, the implementation of a FRL needs to go hand-in-hand with strengthening macro-fiscal analysis; institutional and managerial capacities of subnational entities, in particular municipalities; corroboration of the judicial system and fiscal control institutions; and sound financial management systems at all levels of government.

The pioneers of FRL, New Zealand and Australia<sup>125</sup>, initially put the emphasis on transparency and accountability, not so much on macro-fiscal stability – although the former policy objective does support the latter. As said, macro-fiscal objectives are easier to reach where “budget procedures are sufficiently transparent and there are effective mechanisms for democratic control”.<sup>126</sup> There was some short-lived FRL-type legislation in the United States and in Japan where the focus was clearly on macro-fiscal stability.<sup>127</sup> But in both instances legislation was confined to the national budget, not incorporating subcentral public entities. By contrast the more recent FRL of the United Kingdom<sup>128</sup> focuses on total public sector net borrowing expressed as a percentage of gross domestic product, so there is an implicit imposition of rules on the local sector, which is yet to be specified. Mexico has an FRL that also applies to the finances of the States, but excludes the local government sector.<sup>129</sup>

The use of FRL legislation is mainly confined to emerging economies<sup>130</sup>, but relatively rare in OECD countries. The reasons may be that the economically more advanced countries had adopted sound budgeting principles for long and did not see the need for a specific FRL.<sup>131</sup> As said, Germany has a Law on Budget Principles, including subnational entities, which was adopted in 1969 already. The French Constitution (Article 40) limits the parliaments’ power to amend the budget (although being silent on

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123. OECD, *Budget Practices and Procedures Survey*, Paris 2007/08, <http://webnet4.oecd.org/budgeting/Budgeting.aspx>.

124. Ian Lienert, *op.cit.*, p. 10.

125. *Charter of Budget Honesty*, Australian Government, Canberra, 1996. <http://www.budget.gov.au/1996-97/honest.pdf>.

126. See footnote 117.

127. These were the US Budget Enforcement Act of 1990 and the Balanced Budget Act of 1997, which have since expired; and Japan’s Fiscal Structural Adjustment Law 1997.

128. *Fiscal Responsibility Act 2010*, 10<sup>th</sup> February 2010.

129. *Ley federal de presupuesto y responsabilidad hacendaria* of 2006, which was complemented by a General Law on Budgeting in 2008 (*Ley General de Contabilidad Gubernamental*). <http://www.diputados.gob.mx/LeyesBiblio/pdf/LFPRH.pdf>.

130. For an evaluation of experiences of FRL in emerging economies, see: Lili Liu and Steven B. Webb, *Laws for Fiscal Responsibility for Subnational Discipline - International Experience*, The World Bank, Policy Research Working Paper 5587, Washington, D.C., 2011. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1792244##](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1792244##).

131. The trend of twisting legislation toward more pertinent macro-fiscal stability aspect is relatively recent and was spurred by the economic and financial crises.

subnational entities) and has an Organic Budget Law since 2001<sup>132</sup>. In France the budget performance of the *collectivités territoriales* is regulated *via* instructions and contracts with the national government. As said the need a formal fiscal rule may be felt less urgent as long as fiscal transparency and good public debate is able to ensure prudent fiscal policy.

Assessing the results of FRL based on preliminary evidence, Ian Lienert concludes: “The FRL successfully tilted the balance of fiscal decision-making away from short-term economic and policy considerations towards strategic and long-term fiscal objectives.”<sup>133</sup> However “the achievement of the fiscal stability objectives of FRLs has been mixed. When targets are realistic and there is political willingness and consensus for taking the necessary revenue and/or expenditure measures for achieving them, FRLs have been successful.”<sup>134</sup> This underlines, again, the importance of entrenched principles of good fiscal governance and the willingness of politicians to comply with sound budgeting principles.

### ***EU macro-fiscal coordination up to the European Fiscal Compact***

In 1997, the European Union adopted a Stability and Growth Pact (SGP) among its 27 members. Its aim is to establish fiscal discipline based on two “convergence criteria”: public debt and deficits. These criteria are defined comprehensively and encompass all levels of government as well as social security. They mainly serve as benchmarks, but meeting them is compulsory for those members that wish to join the Euro zone. There is even a formal mechanism for sanctioning treaty violations, the multiple-steps “Excessive Deficit Procedure” (EDP), which was evoked against Germany (2002) and France (2003) but did not entail sanctions,<sup>135</sup> while punitive proceedings were started (but fines never applied) in the case of Portugal (2002) and Greece (2005). These political considerations, together with deficiencies in the definition of the criteria in the first place<sup>136</sup>, undermined the credibility of the SGP.

The sovereign debt crisis resulting from the recent economic and financial upheavals has re-emphasized the need to take collective action for securing macro-fiscal stability and enhancing the fiscal governance of EU Member States more generally. At the end of 2011, 23 out of 27 Member States were in the EDP.<sup>137</sup> Under its impression the EU Member States signed, in March 2011, a “Euro-Plus Pact” (EPP) within the EU’s Open Method of Coordination (OMC)<sup>138</sup> that commits Member States to a set of political reforms intended to foster competitiveness and employment; to enhance the sustainability of public

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132. *Loi organique relative aux lois de finances, LOLF*, 2001. This law puts the emphasis on performance-oriented budgeting, not so much on macro-fiscal stability.

133. Ian Lienert, *op.cit.*, p. 15.

134. *Op.cit.*, p. 16. Similarly, “FRLs can help coordinate and sustain commitments to fiscal prudence, but they are not a substitute for commitment and should not be viewed as ends in themselves.” (Lili Liu and Steven B. Webb, *op.cit.*, p. 31).

135. In fact the SGP was relaxed in 2005 as it became obvious that the pact could not be enforced against powerful members such as France and Germany.

136. The deficit criterion does not account for variations due to the business cycle, for instance. The debt criterion does not account for productive assets of the public sector. Both criteria are related to GDP while average tax revenue is likely to be more appropriate as the denominator.

137. European Commission, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>.

138. The “Open Method of Coordination” (OMC) is a form of EU soft law, a process of policymaking, which does not lead to binding EU legislative measures nor require Member States to change their law. The open method of coordination (OMC) aims to spread best practices and achieve greater convergence towards the main EU goals and was initially used for employment policies and the European Social Dialogue. <http://www.eurofound.europa.eu/areas/industrialrelations/dictionary/definitions/openmethodofcoordination.htm>.

finances (including through national fiscal rules); to reinforce financial stability; and to engage in a structured discussion on tax policy issues. Not all EU Member States signed this treaty criticizing it to infringe on their sovereignty in certain aspects.<sup>139</sup>

### **Box 1. Macroeconomic Imbalance Procedure (MIP)**

The MIP is a surveillance mechanism that aims to prevent and correct macroeconomic imbalances within the EU. It relies on an alert system that uses a scoreboard of indicators and in-depth country studies, strict rules in the form of a new Excessive Imbalance Procedure (EIP) and enforcement in the form of financial sanctions for euro area Member States which do not follow up on recommendations.

#### **Preventing and correcting macroeconomic imbalances**

Over the past decade, the EU has registered serious gaps in competitiveness and major macroeconomic imbalances. A new surveillance and enforcement mechanism has been set up to identify and correct such issues much earlier: the Macroeconomic Imbalance Procedure (MIP), based on Article 121.6 of the Treaty. It will rely on the following main elements:

**An early warning system:** an alert system is established based on a scoreboard consisting of a set of ten indicators covering the major sources of macroeconomic imbalances. For each indicator, alert thresholds have been set to detect potential imbalances. ...

**Preventive and corrective action:** The new procedure allows the Commission and the Council to adopt preventive recommendations under article 121.2 of the Treaty at an early stage before the imbalances become large. There is also a corrective arm in more serious cases, and an excessive imbalance procedure (EIP) can be opened for a Member State. In cases of serious imbalances, the Member State concerned will have to submit a corrective action plan with a clear roadmap and deadlines for implementing corrective action. Surveillance will be stepped up by the Commission ...

**Rigorous enforcement:** A new enforcement regime is established for euro area countries. The corrective arm consists of a two-step approach:

- An interest-bearing deposit can be imposed after one failure to comply with the recommended corrective action
- After a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP)
- Sanctions can also be imposed for failing twice to submit a sufficient corrective action plan.

The decision-making process in the new regulations is streamlined by prescribing the use of reverse qualified majority voting to take all the relevant decisions leading up to sanctions. This semi-automatic decision-making procedure makes it very difficult for Member States to form a blocking majority.

Source: EU Commission:

[http://ec.europa.eu/economy\\_finance/economic\\_governance/macroeconomic\\_imbalance\\_procedure/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm).

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139. Four members opted out of the EPP: Hungary, the Czech Republic, Sweden and the United Kingdom.

On 13th December 2011, a reinforced Stability and Growth Pact (SGP) entered into force with a new set of rules for economic and fiscal surveillance. These new measures, the so-called "Six-Pack", are made of five regulations and one directive proposed by the European Commission and was approved by all 27 Member States and the European Parliament. Member States in excessive deficit procedure are to comply with the specific recommendations the Council addressed to them to correct their excessive deficit. In case a euro area Member States does not respect its obligations, the Council, on the basis of a Commission recommendation, can impose a financial sanction unless a qualified majority of Member States votes against it („reverse qualified majority“).<sup>140</sup> The surveillance mechanism established is also known as the Macroeconomic Imbalance Procedure“ (MIP).<sup>141</sup> The MIP resembles indeed provisions of a FRL.

Finally, an intergovernmental treaty, the Fiscal Compact was signed on 2 March 2012 to become effective from 2013 on.<sup>142</sup> It requires all parties introducing national legislation to bring consolidated national budgets in balance or in surplus, similar to the „debt brake“ that has become part of the German Constitution. The “structural deficit” (adjusted for the business cycle) must not exceed 0,5 percent of GDP – except for countries with a debt/GDP ratio that is significantly lower than 60 percent. The rules have to be incorporated into national legislation at constitutional or similar level. It must also provide automatic correction mechanisms for readjustments in the case of deviations. Member States in EDP must submit an economic partnership program (to be endorsed by the Commission and the Council) that details the necessary structural reforms to ensure an effectively durable correction of excessive deficits. The European Court of Justice is acknowledged as an arbiter, and as judge in the case of applying fines.

True, the Fiscal Compact and in particular the enforcement procedures of the Six-Pack have strengthened the awareness of the importance of fiscal discipline. Even if formal sanctions are not applied, political and reputational effects will matter under these circumstances. However the experience with the SGP demonstrates that the decisive point may still be the political will, or lack thereof, to apply sanctions, especially *vis-à-vis* sovereign states, which is decidedly counterproductive in the wake of an economic and fiscal crisis of a country. It remains to be seen whether the Fiscal Compact and MIP will be more successful in establishing fiscal discipline than its predecessor.

Moreover the concomitant initiatives to support flagrant budget deficits through collective funding instruments such as the European Financial Stability Facility (EFSF), the European Financial Stabilization Mechanism (EFSM) or the European Stability Mechanism (ESM) all run counter the idea of financially sanctioning violations of the Fiscal Compact. Even worse: they may provide incentives for moral hazard. Financial discipline is always and everywhere achieved only where the issuer of new debt has to bear its costs “at the margin”. This marginality principle is put on its heads by some of the institutional arrangements and proposals intended to resolve the present sovereign debt crisis.<sup>143</sup>

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140. European Commission, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>.

141. See the Box on the previous page.

142. Among the 27 Member States of the EU, only the Czech Republic and the United Kingdom abstained from signing.

143. For instance the German Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (Jahresgutachten 2011/12 „Verantwortung für Europa wahrnehmen“, November 2011), has recently proposed a Eurobond on a pool of sovereign debt that exceeds the 60 percent of GDP margin. This would “socialize” excess deficits. Yet only the reverse complies with the marginality principle: Debt up to 60 percent of GDP (or corresponding tax base) could be pooled into a common first-class Eurobond while all excesses would have to be financed as 2<sup>nd</sup> and 3<sup>rd</sup> class tranches of a specific country.

Finally, the Fiscal Compact requires national government to reconsider their financial relations with subnational authorities and to assure that the macro-fiscal signals are appropriately transmitted to, and incorporated in, subnational fiscal policy making and budgeting. This must revive the interest of national governments in mechanisms such as DSPs, or comprehensive legislation such as FRL.

## **MAIN POLICY CONCLUSIONS**

This section will be finalised following the OECD workshop on “Effective Public Investment at Sub-National Level in Times of Fiscal Constraints: Meeting the Co ordination and Capacity Challenges”, 21 June 2012.



## APPENDIX: MAINTENANCE OF EFFORT CONDITIONING IN THE FIELD OF EDUCATION IN THE UNITED STATES<sup>144</sup>

### What is Maintenance of Effort (MOE)?

Maintenance of Effort (MOE) is a federal requirement that requires grant recipients and /or sub-recipients to maintain a certain level of state/local fiscal effort to be eligible for full participation in federal grant funding. Grant recipients or sub-recipients not meeting MOE requirements face loss of a portion of their federal funds.

#### *Sec. 9521. Maintenance of Effort*

(a) **In general.** A local educational agency may receive funds under a covered program for any fiscal year only if the State educational agency finds that either the combined fiscal effort per student or the aggregate expenditures of the agency and the State with respect to the provision of free public education by the agency for the preceding fiscal year was not less than 90 percent of the combined fiscal effort or aggregate expenditures for the second preceding fiscal year.

#### (b) **Reduction in case of failure to meet.**

1. **In general.** The State educational agency shall reduce the amount of the allocation of funds under a covered program in any fiscal year in the exact proportion by which a local educational agency fails to meet the requirement of subsection (a) of this section by falling below 90 percent of both the combined fiscal effort per student and aggregate expenditures (using the measure most favorable to the local agency).
2. **Special rule.** No such lesser amount shall be used for computing the effort required under subsection (a) of this section for subsequent years.

(c) **Waiver.** The Secretary may waive the requirements of this section if the Secretary determines that a waiver would be equitable due to—

1. exceptional or uncontrollable circumstances, such as a natural disaster; or
2. a precipitous decline in the financial resources of the local educational agency.

### How does the Department of Public Instruction monitor the MOE requirements?

DPI monitors MOE requirements by accessing the Annual Report data for the most recent two years that school districts have submitted online to the Bureau for School Finance. The chart of accounts is reviewed each year to determine what costs are appropriate, as per the requirements (see blank copy of MOE worksheet). The net expenditures for each year are divided by the membership count for that year to arrive at a per pupil MOE annual expenditure amount.

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144. Source: Wisconsin Department of Public Instruction <http://www.dpi.wi.gov/esea/moe.html>.  
See also <http://www.familiesusa.org/assets/pdfs/health-reform/maintenance-of-effort.pdf>.

ESEA requires each Local Educational Agency (LEA) to maintain financial support at least at a 90% support level. If state/local support falls below 90% on both an aggregate expenditure basis and the per pupil expenditure basis, then the LEA is cited for a MOE violation. Each LEA in violation is notified in writing and given 30 days for response. If after the 30 days no response is received, then the LEA's ESEA cover program entitlements are reduced proportionally by the percentage of the lesser percentage of the aggregate expenditure basis, or the per pupil expenditure basis, that falls below 90%. Then, when computing MOE for the subsequent year, the LEA is required to maintain support at least at the 90% level as if they would have met the minimum support level for the current MOE calculation.