OECD Multi-level Governance Studies

Rethinking Regional Development Policy-making

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Foreword

This report offers guidance on how to improve the design and delivery of development programmes for regions and cities. Building on frontier economic theory and country experiences, it identifies how supra-national, national and subnational governments can provide better incentives to achieve effective results.

The success of regional development efforts depends inherently on the actions of multiple levels of government—local, regional, national and often supranational. Regional development programmes also often involve intermediary organisations such as banks and non-profit organisations. The challenge is to align the diverse incentives of these actors so that, together, they best support the economic, social and environmental development of different regions across a country. Given the increasing pressure for more efficient and effective regional policies, the instruments and governance arrangements used to implement them undergo constant adjustment. For this, it is necessary to take a step back in order to understand how countries are implementing regional policies and programmes, what makes some practices particularly successful, and how others can be improved.

The report highlights lessons arising from a series of seminars organised by the OECD and the European Commission in the framework of the project Designing Better Economic Development Policies for Regions and Cities that mobilised leading academics, practitioners and country experts. It discusses some of the main trades-offs faced by policy makers that recent theoretical advances and practical experience can help overcome. It provides nine cross-cutting lessons to overcome those trade-offs and identifies the pitfalls that policy makers should avoid. It also underlines potential avenues to increase the impact of regional development policies. The report also provides key insights on how to reinforce the focus on policy results and how to better introduce performance frameworks. It explores how to strengthen and facilitate the uptake of financial instruments; how to better design conditionalities; and finally, how behavioural science can provide useful insights to enhance the efficiency of regional policies.

This work is part of the Series OECD Multi-Level Governance Studies and supports the implementation of the OECD Recommendation of the Council on Effective Public Investment across Levels of Government. The initial seminar findings were discussed at the 37th Session of the Regional Development Policy Committee on 19 May 2017 and an earlier version of the report was discussed at the 38th Session on 8 December 2017. The final report was approved by written procedure on 9 March 2018 [CFE/RDPC(2017)8/REV1].

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Executive summary

Better governance tools to face new challenges in cities and regions

To face complex challenges such as globalisation, climate change, or disruptive technologies, policy makers need to rethink the design of regional development policies. More efficient regional development policies require a management architecture that combines different results-oriented instruments which facilitate managing the different trade-offs faced by policy-makers: how to ensure that regional development policy instruments are sufficiently flexible while also ensuring policy stability and accountability? How to strike a balance between performance, compliance and administrative costs? To manage these trades-offs and to develop innovative policy approaches, it is necessary to combine recent developments in economic theory with practical country experiences.

Key messages

What works there might not work here

Instruments used to promote regional development in regions and cities should reflect territorial specificities and be adapted to different contexts, such as the degree of subnational autonomy, market conditions, or institutional capacities. Avoiding one-size-fits-all policy responses is crucial. More flexible policy mechanisms can respond more effectively to different needs, thereby ensuring that resources are more efficiently used. To achieve this, policy makers need to balance the degree of flexibility of policy instruments and the need for control and accountability. Higher degrees of autonomy for subnational governments to decide on investments, for example, might work where corruption levels are low, but would likely be less appropriate where corruption levels are high. This flexibility can be achieved at different stages of the policy implementation. For example, deadlines for achieving certain goals can vary across regions depending on different context.

Capacities first

Capacity gaps directly impact regional development and inequalities across regions. Governments should put more efforts to build capacities at all levels of government to design and implement better regional policies. Targeted technical assistance can, for example, increase the uptake of financial instruments to diversify financing of regional policies. Yet, capacity building should not be restricted to the reinforcement of skills and abilities; it should also target institutional and financial capacities. Capacity building needs also to be understood as a “learning-by-doing” process in which governments should limit excessively complex administrative procedures and constant changes in the rules.

Keep it simple

When reducing administrative burden, policy makers also risk diminishing subnational government fiduciary control and accountability in an environment with low levels of trust. Still, simplifying procedures is crucial to increasing the effectiveness of regional policies, in particular where capacities are low. Simplicity comes with the need for greater flexibility that allows adapting programmes to local circumstances and development needs. Stability in the rules can be a source of simplicity, in particular when rules for programming and managing policies are complex.

It is the quality of relationships that counts

Developing a strong, trusting, and cooperative relationship among sectors and levels of government can facilitate the alignment of objectives and incentives. It also helps clarifying what is expected from the different parties. Such relationships are often built and maintained through co-ordination and collaboration mechanisms. Yet, formal co-ordination and collaboration procedures may imply some transaction costs, at least in the short term. Policy makers need to balance these costs with the long term benefits that consistent and regular cooperation brings. Regular dialogue on regional development and investment priorities can foster trust and generate citizen involvement. Simplicity of information and feedback, credibility, and transversal engagement are important ingredients for an effective dialogue.

Ownership matters

Policy ownership is crucial to facilitate the better use of public spending and investments for regional development. At its basis are the reputation of the parties involved and the trust between them. Or put differently, ownership cannot be achieved in isolation. Ownership is a process that evolves over time and through constant interaction between supra-national, national and subnational governments during the implementation of regional policies. Ownership is particularly relevant when using conditionalities: subnational governments are more likely to comply when they "own" policy objectives. Greater simplicity, greater flexibility, and better relationships between stakeholders are all elements that help create a feeling of ownership.

Be aware of biases

Regional development policies inherently involve multiple stakeholders at all levels of government and are defined by a long-term horizon. These characteristics may create important biases and asymmetries of information among those responsible for their implementation. Insights derived from the behavioural and social sciences can be used as a public policy tool to address those biases. For example, instead of imposing rule compliance from higher to lower levels of governments, policy practitioners could be "nudged" to influence their decision-making in a particular direction. Behavioural insights can also help improving "group decision-making"; they can enhance communication and stakeholder engagement. They can also be used to improve collaboration among actors, to make a more efficient use of data and to improve the uptake of policies by better understanding the use of rewards or incentives.

Get the incentives right

While incentives need to be linked to rewards, and not only sanctions, governments should be aware that rewards may transform into a negative reinforcement, thereby

"crowding out" intrinsic motivation. Autonomous motivation can be bolstered, for example, by encouraging trusting relations and partnerships among people. To encourage engagement and better performance, goals need to be challenging, specific and accepted by practitioners. The relationship between inputs, outputs, and outcomes needs to be clear, known, and measurable. A limited number of indicators must capture performance that is under the control of the actor in the timeframe being measured.

Keep trying and testing

A process of constant and adaptive learning is beneficial for the long-term efficiency of policy instruments. Yet, while using a "trying and testing" approach, policy makers need to avoid the risk of perpetuating regional differences and inequalities. Developing a culture of trial-and-testing permits a better definition of objectives, as well as an easier identification of barriers or bottlenecks to policy implementation, be they technical or political. Testing policy options also helps policy makers design interventions that will be more effective and sustainable in the long run.

Begin with the goal in mind

Setting monitoring and evaluation systems for regional development policies in the early stages of the policy design process is necessary to increase efficiency. Evaluations help policy makers learn from experience and adapt policies to better fit the needs of regions and cities. They also allow officials to allocate the resources necessary for defining evaluation methodologies and producing relevant data. Setting up independent evaluation institutions, can be beneficial for policy credibility, trust, and enforcement, and may help increase the uptake of monitoring and evaluation results.

Chapter 1

Designing better economic development policies for regions and cities: Lessons from theory and practice

This chapter summarises cross cutting lessons on how to improve the design and implementation of regional development policy discussed during a series of 2017 seminars organised by the OECD and the European Commission. It highlights the main seminar lessons, bringing together frontier economic theory and country practices regarding performance frameworks, financial instruments, policy conditionalities, contractual arrangements and behavioural insights in regional policy. Nine lessons are derived from the latest theoretical developments and practical examples to design and use regional development policy instruments more effectively. It highlights pitfalls that policy-makers should avoid and proposes potential practical solutions to improve the management of economic development programmes.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

OECD and European countries have a long tradition of using different sets of mechanisms to ensure public spending and investments contribute to regional development as effectively as possible. These mechanisms include, among others, the extensive use of monitoring and evaluation systems, the definition of conditionalities when assigning grants, the use of financial instruments for regional development policies to complement grants, or the design of contracts to create partnerships between different levels of governments.

At a time of increasing pressure on public finances in which all budgets – regional, national and European budgets – are under close scrutiny, it is crucial to continuously enhance the effectiveness and efficiency of regional policy instruments to add value to public spending and investment. With an increased focus on results, the introduction of a performance framework, a reinforced focus on facilitating the uptake of financial instruments, and the introduction of policy conditionalities, among others, the EU's Cohesion Policy is at the forefront of the modernisation of regional development policy instruments. Many other OECD countries are also experimenting with these types of mechanism to improve the accountability, effectiveness and responsiveness of their economic development policies for regions and cities.

The performance of these mechanisms is varied and context specific. Nevertheless, it is clear that both the challenges that policy must address, and the efficiency and effectiveness of policy, can only grow in scope and scale over the coming years. It is thus necessary to take a step back to understand how countries have been implementing these mechanisms, why some practices have been successful, and how others can be improved. In summary, are policies achieving what is intended or needed?

This is why the OECD and the European Commission have partnered to organise a series of seminars entitled Designing Better Economic Development Policies for Regions and Cities. During these seminars, researchers and practitioners discussed, from a theoretical and practical perspective, lessons that can be drawn in the implementation of responses to a range of policy challenges. These included:

- Performance and incentives: How to best apply the principles of performance based budgeting and develop performance frameworks in the context of public investment at national and subnational levels? How can the design of incentive structures be optimised to balance innovation, performance, compliance and administrative costs?
- Flexibility/adaptability: How to reconcile the need for a long-term investment framework with the capacity to respond to emerging economic and social challenges? What are the roles of different actors in the definition of objectives, allocation of resources, accountability and political oversight?
- Conditionalities: How can conditionalities be used to improve policy outcomes and encourage the alignment of the objectives of principals and agents involved in economic development programmes? How can potential trade-offs between effectiveness, ownership and administrative burden be addressed?
- Incentivising the use of financial instruments: For which types of investment is the use of financial instruments particularly effective? What are the limits to their use? How can the shift from grants to loans be encouraged?
- Behavioural insights: How and to what extent can we use behavioural insights to increase the effectiveness and efficiency of economic development programmes?

This report takes stock of these discussions and identifies opportunities to improve the design and delivery of regional development policies by understanding how the management of economic development programmes can be improved. This report is of interest to all policymakers striving to improve the efficiency and effectiveness of territorial policies. It will serve as a manual for policy makers on theoretical approaches and practical experiences to better design public expenditure and investment programmes for the development of regions and cities.

After providing some contextual elements, the first chapter of this report summarises the main cross-cutting lessons discussed during the seminars on ways to improve regional development policy instruments. The following chapters summarise the seminar's discussions for each of the aforementioned topics.

Setting the scene: Challenges for regional development

Boosting development in all regions

During the last two decades, inequality between countries has decreased in the world. However, while this picture seems promising, a deeper analysis on territorial inequalities shows increasing gaps among regions within countries that are often larger than those across countries (OECD, 2011, 2014, 2016c, 2016d). The gap within countries between the top 10% regions with the highest labour productivity and the bottom 75% has grown on average by almost 60% over the last two decades, from USD 15 200 to USD 24 000. These interregional differences are wider when considering multi-dimensional measures of living standards instead of income alone (OECD, 2016c).

Encouraging productivity growth in all regions is crucial for well-being. Greater productivity can indeed have a positive impact on income and jobs and a number of non-material dimensions of well-being such as health, access to services, etc. This is why policy makers around the world are concerned by figures showing that one out of four people in OECD countries live in regions that are falling behind in productivity growth (OECD, 2016c). Regional development policies need to mobilise regional catching-up potential in order to promote growth and inclusion in all places.

Strategic investments in productivity drivers can help to unlock the potential of regions and cities. Investments that facilitate the diffusion of innovation and best practices across sectors and firms can help boost productivity in all regions (OECD, 2016c).

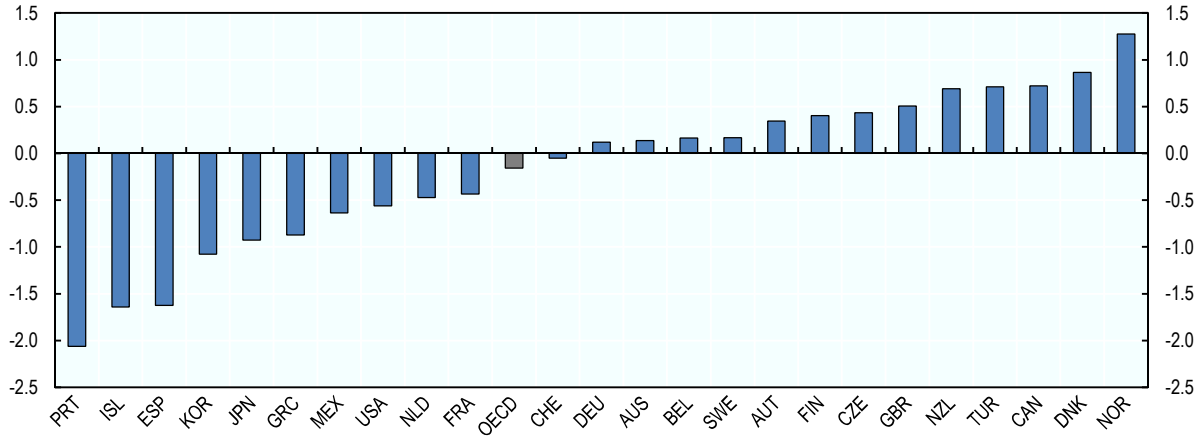
Various studies by the OECD, IMF and the World Bank show that public investment spending has a high-multiplier effect. In 2015, the IMF showed that an unanticipated increase of investment expenditure as a percentage of GDP by 1 percentage point led to a 0.4% boost in output in the same year (IMF, 2015a). The OECD showed that the effect of public investment is the highest in fields that are associated with large externalities (such as research and development or health). It is the lowest in countries, such as Japan, where the public capital stock is already high (OECD, 2016). Overall, it is total investment and the capital stock that matter for growth.[1]

Encouraging investment in a time of fiscal consolidation

Public investment in OECD countries has been strongly affected by fiscal consolidation strategies and austerity packages that followed the crisis; the share of public investment to GDP has still not reached its pre-crisis level. In nearly half of OECD

countries, the share of public investment to GDP has fallen relative to pre-crisis levels (OECD, 2017) (see Figure 1.1).

Figure 1.1. Percentage points difference in public investment between 2015 and the average over 2000-07

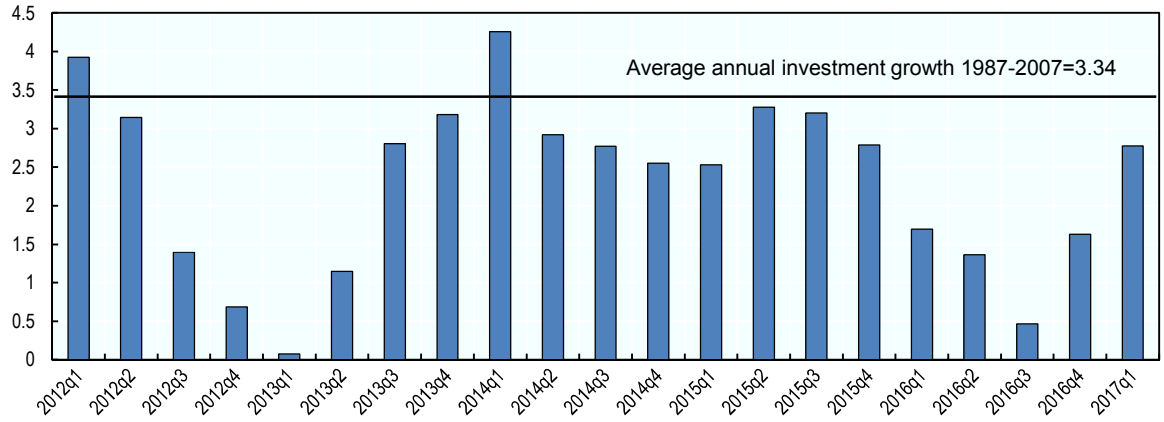


Note: For Korea, the last available year is 2014.

Source: OECD (2017a), *Economic Policy Reforms 2017: Going for Growth*, OECD Publishing, Paris, http://dx.doi.org/10.1787/growth-2017-en.

The global financial crisis has also had a strong impact on private investment. Corporate investment declined much more rapidly than output during the 2008 crisis and has struggled to recover since then, especially following the intensification of the crisis in Europe in 2011. This decline has depressed productivity growth, and one area of particular attention is infrastructure investment (OECD, 2017b). However, there are some positive signs regarding future private investment. Global GDP growth has picked up since mid-2016, with a rebound in industrial production, global trade and investment (Figure 1.2). Surveys conducted by the OECD also show that businesses intend to invest particularly in technology-embodied capital. Still, projected investment rates remain too low to sustain the acceleration of activity, in particular to face new global challenges (OECD, 2017b). Government investment as a share of GDP is projected to remain below pre-crisis levels in several euro area countries, as well as in Japan and the United States, and most OECD countries are not expected to increase this rate in 2017-18. Evidence suggests that even with the observed capital upgrading, a much stronger recovery in investment and expansion in the capital stock will be needed to help strengthen productivity growth substantially (OECD, 2017b).

Figure 1.2. OECD real investment growth



Source: OECD (2017c), *OECD Economic Outlook, Volume 2017 Issue 1*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_outlook-v2017-1-en.

1. These trends put a strong pressure for the future development of regions and cities. The latest report published by the McKinsey Global Institute regarding infrastructure gaps shows that to support currently expected rates of growth, the world needs to invest an average of USD 3.3 trillion annually through 2030 in economic infrastructure, land use and energy systems. When bringing the UN Sustainable Development Goals into the equation, investment needs are multiplied by three. The latest figures from the OECD Investing in Climate, Investing in Growth report (OECD, 2017c) suggest that annual global investment of around USD 6.9 trillion over the period 2016 to 2030 may be necessary to put emissions on a pathway in line with a 2°C scenario. To cope with these global challenges efforts are needed from both the public and the private sector. A comprehensive and collective policy response is needed to make growth stronger and more inclusive and to manage risks (OECD, 2017b).

Better governance for better regions

To enhance sustainable productivity potential in all regions, good and sound governance practices are needed. Place-based policies complementing productivity growth are necessary to ensure that benefits reach different groups and places. These place-based policies require governance arrangements that facilitate co-ordination and integration of sectorial policies, provide them on the relevant scale and bring together relevant public, private and civil society actors. Multi-level governance mechanisms play a key role as, among other roles, they align objectives across different levels of government. Good governance is indeed associated with higher levels of productivity and catching-up dynamics (OECD, 2016c) and can help promote strategies for inclusive growth.

Governance arrangements are also crucial to increase the impact of regional development policies in regions and cities. Regional development policies will need to be more productive and efficient because of greater investment needs and fiscal constraints in a majority of OECD countries. Some estimates show that it is possible to generate savings of some 40% on infrastructure projects by making project selection, delivery, and the management of existing assets more effective (McKinsey Global Institute, 2013, 2016). The IMF, and its Public Investment Index assessment, also points out that around 30% of

the potential gains from public investment are lost due to inefficiencies in public investment processes (IMF, 2015b).

Assuming that public budgets across the OECD remain tight for some time to come, improving the management of regional development policies, and particularly in public investment, could lead to substantial savings and enhanced productivity (OECD, 2015, 2013; IMF, 2015; WB, 2014; McKinsey Global Institute, 2013, 2016). Evidence suggests that institutional quality and governance processes affect the expected returns on public investment and the capacity for public investment to leverage private investment, rather than crowd-out such investment. In the EU, some research has shown that, beyond a certain threshold of investments in cohesion and regional development, the quality of the regional government becomes a vital factor in determining the extent to which a region grows. The most efficient way to achieve greater economic and social cohesion is by improving the quality of government; otherwise, improvements in economic growth would require massive amounts of additional investment (Rodríguez-Posé and Garcilazo, 2012).

The Seventh Cohesion Report also points out that quality of life, and quality of governance and institutions is a fundamental precondition for growth at the subnational level. The report finds that improvements in the quality of institutions appear to be consistently important factors underlying economic growth in EU regions. One conclusion is that bringing about such improvements – by tackling widespread corruption, introducing measures aimed at making government decisions more efficient and transparent, or supporting relevant reforms – is important for regional development.

Box 1.1. Major challenges associated with investments across levels of government

Regional development and public investments are, by their very nature, a shared responsibility, where different sectors and levels of government intervene. This implies major governance challenges: appropriate co-ordination of efforts both vertically and horizontally among sectors and levels of government can make public investment more effective (OECD, 2014). While this co-ordination is necessary, it is difficult in practice.

The 2014 OECD Recommendation on Effective Public Investment Across Levels of Government identified 12 Principles that can help governments overcome major challenges linked to investments across levels of governments. The Recommendation addresses three main challenges that typically arise: co-ordination challenges, capacity challenges, and challenges related to framework conditions:

- **Co-ordination challenges** may arise across sectors, across levels of governments, or across jurisdictions. Co-ordination across several actors may be difficult, in particular as their interests may not be aligned. Co-ordinated planning is essential in order to identify investment opportunities, potential externalities and bottlenecks, allocate efficiently the limited resources available, etc. Sectoral coordination also has multiple benefits. It allows positive externalities to be identified from one sector to another, or economies of scale to be generated.

- **Subnational capacity challenges** occur when the capacities of subnational governments to design and implement investment strategies are too weak. These challenges may prevent policies from achieving their objectives. Capacity-building programmes that provide studies, research and expert recommendations to subnational government staff and national agencies can help bridge the capacity gap, and ultimately lead to better investment choices.

Box 1.1. Major challenges associated with investments across levels of government *(continued)*

- **Challenges related to framework** conditions may arise from poorly designed budgetary, procurement or regulatory practices. These practices may not be consistent across levels of government, or even within a single level of government. In particular, local fiscal arrangements are a key determinant of local public investment. The level and stability of capital transfers received by subnational governments from national or supra-national bodies have a direct impact on their levels of capital expenditure. The stability of the local fiscal framework is also crucial in order to plan for future expenses generated by investments and reduce uncertainty. Regulatory frameworks across levels of government should be consistent and stable, with no divergent, overlapping or contradictory regulations.

Source: OECD (2014), "Recommendation of the Council on Effective Public Investment Across Levels of Government", OECD Better Policies for Better Lives, Paris, www.oecd.org/regional/regional-policy/Principles-Public-Investment.pdf.

Governance tools to boost development in all regions

The use of an integrated place-based approach to regional development requires a management architecture that combines a set of results-oriented instruments. OECD countries use different sets of mechanisms that allow and facilitate a better governance of regional development policies. Different mechanisms can serve multiple and complementary objectives; determining which of them to use and combine will strongly depend on the political and cultural context, the capacities of national and subnational governments, the degree of path dependency of existent policies, the objectives pursued, etc. In the end, it is a suitable combination of different mechanisms that will help countries to improve the institutional environment and the way in which the public budget is spent and invested.

The set of instruments used by governments to implement regional development policies combine top-down and bottom-up approaches. From the national or supra-national perspective, a key question is how to better assign grants to subnational governments or how to make the most of loans to effectively enhance regional development.

When regional development policies are financed by loans, which have been used by different countries at a considerable scale in different formats, there are challenges in contract design to ensure adaptation to contextual characteristics. For instance, incentives need to be set up to facilitate the uptake of financial instruments. However, the literature on the effectiveness of financial instruments is not conclusive. While in general scholars recognise that financial instruments may have less impact on firms incentives than government grants – which might create important distortions – if designed poorly financial instruments can also generate distortions. If contracts are well designed and financial instruments are well articulated with grants, they can generate sizeable benefits. Financial instruments, as well as grants, are generally more effective if they create opportunities for new investments to be undertaken instead of merely replacing financing from other market sources.

When it comes to the design of grants provided by supra-national or national governments, more variables enter into the equation and the picture becomes more

complex. Contracts and conditions attached to aid or transfers that, among other things, enable the alignment of priorities and encourage parties to co-operate and negotiate actions, are two of the main mechanisms used to strengthen the link between grant support and specific outcomes. These mechanisms can also serve to guarantee, for example, a stronger alignment with supra-national priorities and the introduction of linkages to macro-fiscal policies and structural reforms. Finally, performance-based budgeting, or more broadly, performance systems, provides the general framework in which conditions and contracts are designed.

Recently, governments from different parts of the world have focused their attention on integrating behavioural insights into the policy-making process to make public policies work better. This analytical stream has gained relevance on the international scene: the 2017 Nobel Prize was awarded to Richard Thaler for his contribution to behavioural economics and its links with public policy. In this area, several OECD countries like the US or the UK have created a behavioural department or have set up a behavioural insights team within government. While evidence of its effectiveness is not yet conclusive, there are many positive examples in diverse policy areas: consumer protection, education, energy, environment, finance, public service delivery, among others (OECD, 2017a). These experiences show that behaviourally-informed policies have become commonplace in the way we think about public policy and are likely to play an important role moving forward.

Integrating behavioural insights can shape the way in which regional development policies and investments are designed. Indeed, when deciding the conditions to be included in a contract or which indicators should be considered to evaluate performance, a better understanding of the behaviour of policy makers or policy-implementers can make a significant difference in the quality of outcomes. Behavioural insights can help frame thinking about public investment and regional development policies, where different instruments are interdependent and cannot be seen in isolation.

In order to prepare the evidence base for future work in regional development, it is therefore necessary to i) build on recent advances in public management theory, fiscal federalism, performance-based budgeting and behavioural economics and ii) draw lessons from the application of these principles in practice at the regional and local levels in research and innovation, public infrastructure, enterprise support, human capital and institution building. When deciding on regional development policy instruments policy makers are faced with numerous trades-offs that recent theoretical advances and practical experience can help to overcome. The following section highlights some of these key trade-offs faced by policy makers and summarises some key cross-cutting lessons for regional development from theory and practice to overcome them.

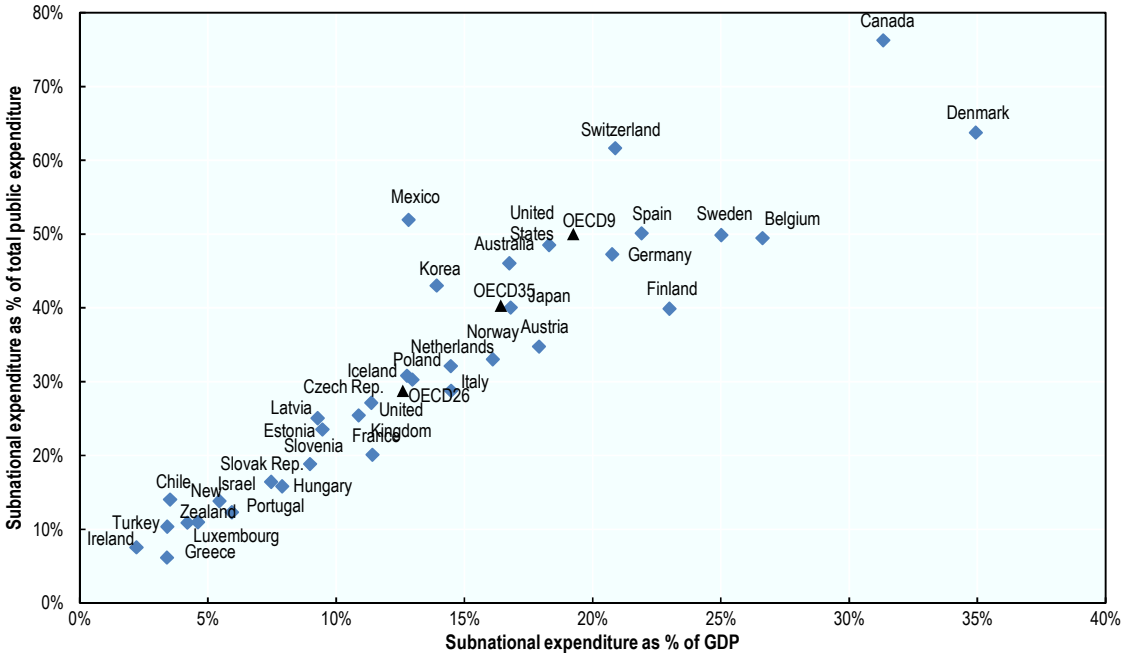
How to improve regional development policy instruments: Cross-cutting lessons from theory and practice

What works there might not work here

In the OECD, subnational governments differ greatly in their degree of autonomy, the types of responsibilities they have, their aggregate productive capacity, their institutional capacities, etc. Instruments used to promote regional development in different regions should reflect these specificities and adapt to different contexts. Place-based policies that combine policies across different sectors to unlock regions' growth potential need to take the local context, i.e. the local "eco-systems", into account (OECD, 2011).

Different institutional characteristics will thus intervene in this equation; the degree of decentralisation or autonomy of subnational governments being one of those. When looking at the decentralisation of expenditure, at one extreme there are countries where subnational governments are responsible for over 60% of total public expenditure like Switzerland, Denmark or Canada; in contrast, in countries such as Turkey, Greece or Portugal subnational expenditure represents less than 20% of total public expenditure (see Figure 1.3). Regardless of whether they are federal or unitary countries, subnational governments have also strong difference in their revenues sources (see Figure 1.4).

Figure 1.3. Degree of decentralisation varies largely in OECD countries

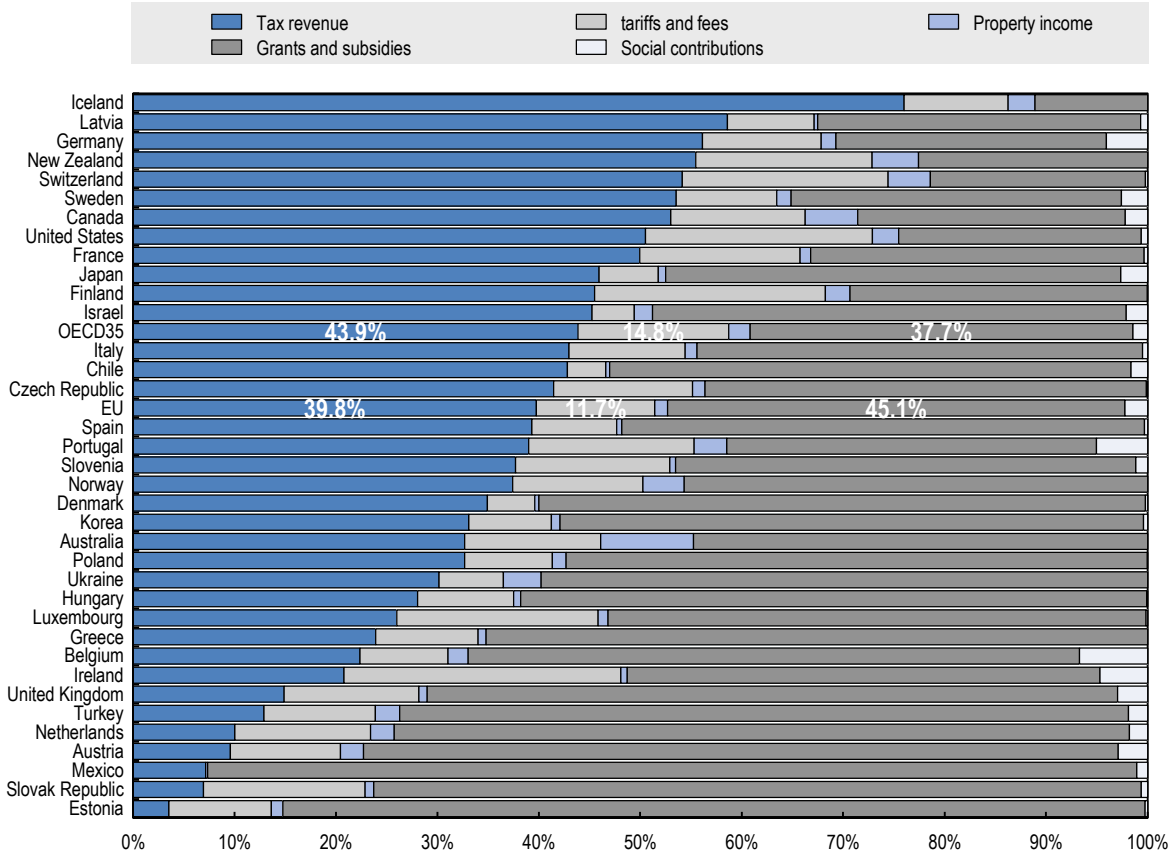


Note: 2014 data for Japan and 2014 data used to calculate general government ratio for New Zealand.

Source: OECD (2016e), "Subnational government structure and finance (Edition 2016)", OECD Regional Statistics (database), http://dx.doi.org/10.1787/876958d5-en.

Figure 1.4. The structure of subnational governments' revenue varies greatly across countries

Revenue sources for subnational governments (%, 2015)



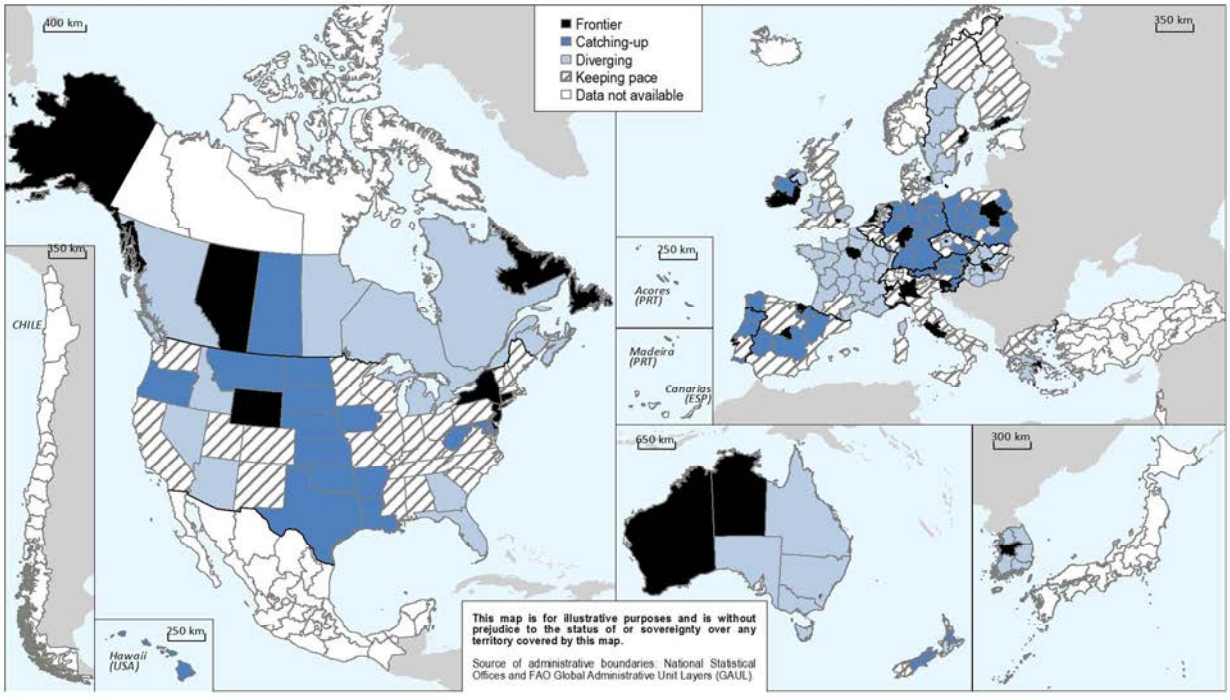
Note: 2014 data for Japan.

Source: OECD (2016e), "Subnational government structure and finance (Edition 2016)", OECD Regional Statistics (database), http://dx.doi.org/10.1787/876958d5-en.

Regions are also different in terms of aggregate productivity. Beyond the urban-rural split, the OECD has identified four types of regions depending on their aggregate levels of productivity: frontier regions, catching-up regions, keeping-pace regions, and diverging regions (see Figure 1.5). One of the key lessons of the 2016 Regional Outlook is the need to adapt policy responses to each type of region considering its interdependencies and specificities when defining regional development policies. (OECD, 2016c).

Figure 1.5. Patterns of catching up and divergence differ across countries

Classification of TL2 regions according to their labour productivity growth relative to their country's frontier, 2000-2013



Notes: The period covered is 2000 to 2013 (or closest available year) and countries included are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Korea, Netherlands, New Zealand, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, United Kingdom and United States. For New Zealand TL3 regions and for Belgium, 10 provinces and the capital city region instead of TL2 regions are used. Exclusions of OECD countries are due to missing data or due to data only being available for a single region.

Source: OECD (2016c), *OECD Regional Outlook 2016: Productive Regions for Inclusive Societies*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264260245-en.

The intervention of different actors and layers of government makes regional development policies, from their design to their implementation, particularly complex in terms of interaction and co-ordination. The degree to which different stakeholders collaborate depends, among other things, on culture and behaviours rooted in the public sector that create path dependency. Northern countries, for example, tend to collaborate in a more informal way than countries with weaker levels of interpersonal trust. Contracts tend to be less common in societies in which mutual trust is more widespread, which facilitates informal mutual adaptations to changes and external shocks (Brousseau, 2017).

Another key difference across places is the government's capacity to implement regional development policies. Big cities, for example, tend to have higher levels of capacities than more rural distant areas. The quality of governance, including the level of corruption, will also vary significantly depending on the region and the country and might be correlated with the capacity level. All these factors can determine the degree of success or failure of certain conditions or the compliance with performance indicators. A high degree of autonomy when setting conditions, for example, might work in a place with low levels of corruption but would likely fail in a context with higher levels of corruption.

As there is no one-size-fits-all solution to regional development, a major challenge that policy makers need to address is balancing the degree of flexibility of policy instruments and the need for control and accountability of those instruments. Policy makers tend to design one-size-fits-all policy responses in order to address the need for accountability of public spending; an homogeneous policy design can also be less costly in terms of the capacities to mobilise resources, at least in the short term. However, more flexible policy mechanisms can ensure that resources are used in a more efficient way by responding more effectively to different needs. Flexibility can be built in at different levels: flexibility in the policy areas that are supported (e.g. support may be provided flexibly to a range of policy areas, including to new areas, if new challenges emerge); flexibility across time (this covers for instance issues such as the length of programming) and processes. If more flexibility can help in reducing the costs associated with the administrative burden of accountability processes; there is, however, always a trade-off with ensuring accountability on the one hand and with providing structural responses on the other hand.

In addition to the institutional setting, the effectiveness of regional development policies also depends on market conditions – and the associated risks – that determine the appropriateness and effectiveness of instruments that support socially desirable investments by private and public actors. Market failures – that depend on the degree of interactions among other factors – might prevent markets from providing optimal amounts of financing to businesses and public organisations.

Beyond moral hazard and adverse selection challenges, different market failures can determine the use of regional policy instruments, notably, monitoring costs to overcome the information gaps, costs of due diligence that occur due to legal requirements, thin markets, etc. These market failures together with investments and business needs that differ across regions will partially determine the need for financial instruments. For example, thin or incomplete markets represent a particular challenge in remote locations where only few businesses and lenders operate or in highly specialised market segments. Thus, a thorough understanding of the market situation – identifying where shortfalls in access to finance exist and what market failures are responsible for them – is a precondition for a successful public intervention using financial instruments. In the same vein, national governments play a crucial role in promoting an institutional setting that creates a pro-innovation or pro-business environment in which private actors are willing to invest.

Assessing contextual elements is also important when defining objectives, setting up monitoring processes and setting performance indicators. Location, capacity level, actors involved, among others, will also determine how behavioural insights can provide some useful information to define which data should be used and the way to present it to allow for a monitoring by policy makers. What may work with a targeted group in one environment or culture may not work in another. Using behavioural insights to "nudge" an individual versus an organisation may require setting very different baselines and incentive structures to achieve stated goals (see section "It is the quality of relationships that count").

Depending on the context, the conditions that should be attached to grants or loans will also vary. National or supra-national institutions can decide from a wide array of conditions (*ex ante*, policy, macro-economic conditionalities, etc.) and their use should follow a "match follows function" logic in which conditions are appropriate with the issue and circumstances at hand.

In order to adapt to different contexts, countries are increasingly exploring asymmetric decentralisation arrangements. This means that subnational governments have varying degrees of responsibility, depending on their capacity, their population (urban or metropolitan areas), certain characteristics like identity or geographic characteristics (islands for example). While this is not a new trend, asymmetric forms of decentralisation have been gaining in importance during the last few decades (Allain-Dupré, 2018 forthcoming). A clear advantage of such differentiated governance is that it can foster gradual learning-by-doing (see section "keep trying and testing"). Yet, asymmetric arrangements also have risks, such as creating institutional complexity and a lack of accountability. Nevertheless, these risks can be attenuated with appropriate multi-level governance instruments.

Capacities first

The use of different techniques and mechanisms to guide, co-ordinate, and align priorities for regional development require the existence of certain capacities at the different levels of government involved in the investment cycle. These capacities are not restricted to skills and abilities; they also refer to financial and institutional capacities (see Box 1.2). The capacity gap at all levels of government, but especially at the subnational level, is indeed a constant concern of policy makers in all contexts. The lack of technical capacities, which is often attributable to an overlap or duplication of responsibilities and administrative burden among other things results in ineffective public actions, as well as inefficient public investment. This affects the ability to boost regional growth, address inequalities and improve social and environmental conditions.

The question of capacities arises as a major impediment or facilitator for the adequate use of the different regional development policy mechanisms analysed throughout this report. As networks of relationships become more intertwined – which is the case for regional development programmes – the ability to pinpoint and meet the demand for necessary skills and abilities, as well as institutional capacity, of administrative staff becomes harder. Given major differences in the capacity level across regions, regional development policies risk benefitting the most developed places while underserving subnational governments that have fewer capacities.

Box 1.2. Which subnational capacities are important?

The OECD has identified 15 subnational capacities needed for the different stages of the investment cycle. In many ways, these capacities represent an ideal. In practice, subnational governments face daunting challenges in various areas – although national governments and subnational governments differ in their views of the relative importance of the different challenges.

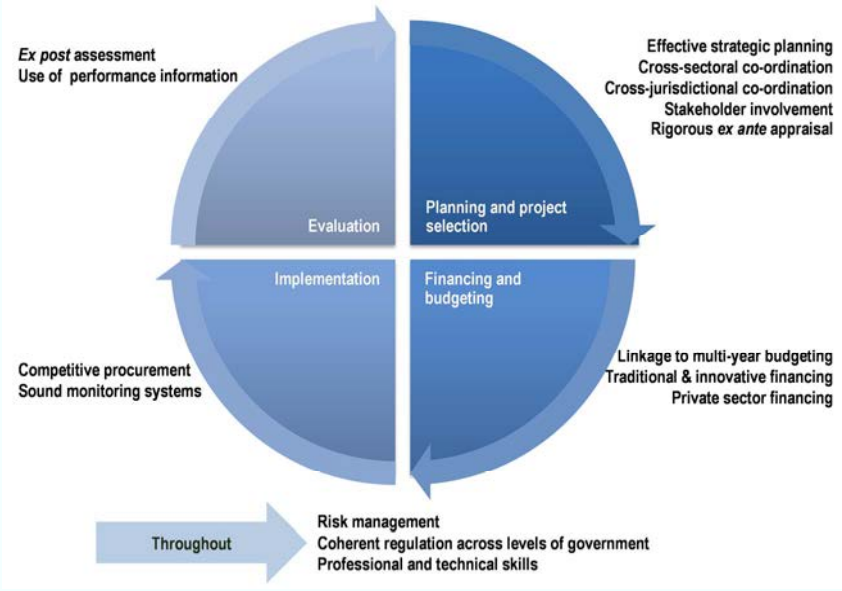
It is worth noting that the term "capacities" can refer to a myriad of concepts, including professional competences and skills but also institutional arrangements or resources. In the context of public investment, capacities here refer to best practices in terms of the institutional arrangements, technical capabilities, financial resources, and policy practices that can help subnational governments achieve important goals at different stages of the investment cycle.

Strengthening subnational capacities can potentially help to improve the efficiency and effectiveness of public investment. In some cases, by enhancing capacities, the quality of the investment choices may improve (i.e. more growth-oriented, better tailored to subnational specificities as a result of enhanced strategic planning efforts or more rigorous *ex ante* appraisal). In other cases, capacity development may lead to efficiency gains as subnational

Box 1.2. Which subnational capacities are important?
(continued)

governments tap unexploited economies of scale (e.g. through cross-jurisdictional co-ordination) or reduce costs (e.g. through more competitive procurement or e-government tools).

Capacities needed throughout the investment cycle



Source: Mizell, L. and D. Allain-Dupré (2013), "Creating Conditions for Effective Public Investment: Sub-national Capacities in a Multi-level Governance Context", *OECD Regional Development Working Papers*, No. 2013/04, OECD Publishing, Paris, http://dx.doi.org/10.1787/5k49j2cjv5mq-en.

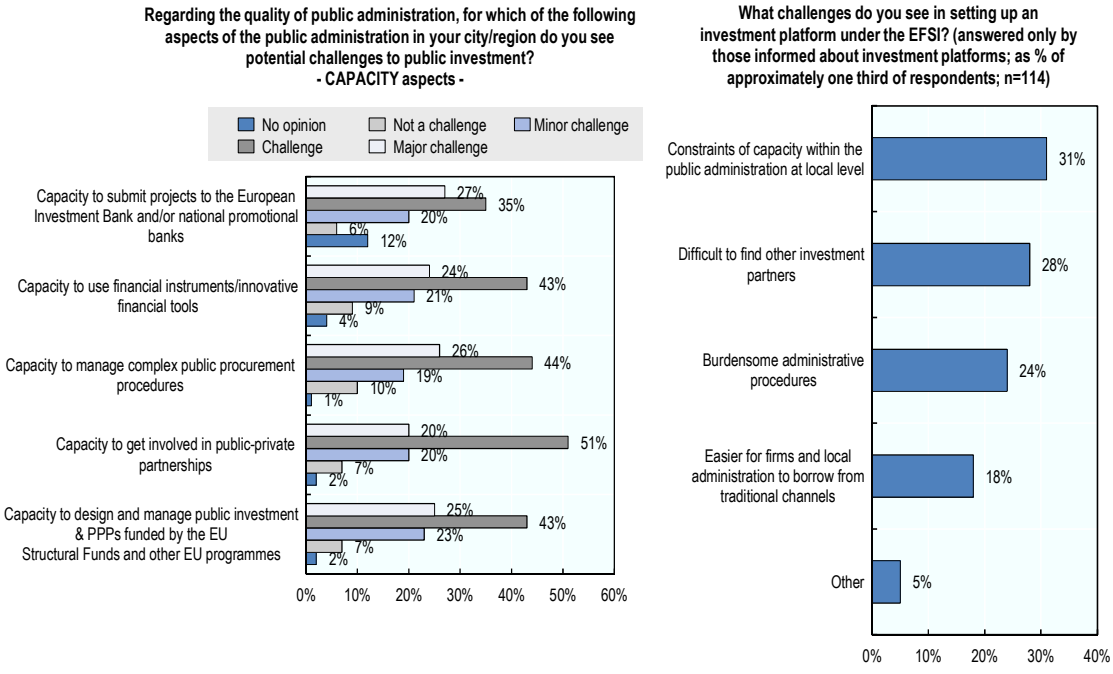
When asked to identify the main challenges with respect to strategic planning and implementation of infrastructure investments, 65% of subnational governments in the EU identified the lack of long-term/strategic planning capacity as an important challenge; in turn, 56% of subnational governments mentioned that the lack of adequate own expertise to design projects represents an important bottleneck for infrastructure investments (OECD CoR, 2015). For this reason, designing strategies in the areas of regional innovation and transport for example was made a precondition for funding for the EU's Cohesion Policy for the period 2014-2020. In order to build the necessary capacity, technical assistance was provided to support strategy development. Cities and local governments are limited by their capacity to use funding tools, to combine different streams of financing and funding and by the existence (or lack thereof) of appropriate skills to design and manage public-private partnerships (see Figure 1.6).

Spending more time on building capacities – at the subnational but also at the national and supra-national levels – is a first step towards achieving the desired results. To effectively improve the operationalisation of development policies, this process need to be complemented by the transfers of appropriate financial resources. This is why, for example, Canada in the 1980s refocused its regional development policies: regional development was no longer about diminishing disparities between leaders and laggards

but rather enabling regions facing particular challenges to realise their full potential, not by focusing on needs but developing assets and building capacities (Bradford, 2017).

Capacity constraints at all levels of government affect the uptake of conditionalities (Mizell, 2017) and financial instruments. A certain capacity level is needed at the subnational level to fulfil conditions but also higher levels of government to prioritise, design, and monitor conditionality. A combination of conditions and technical assistance can therefore contribute to improve the institutional and administrative capacity of public institutions (Berkowitz et al, 2017).

Figure 1.6. Results of the CoR survey 2016



Source: Committee of the Regions (CoR) (2016), "Results of the CoR online consultation on obstacles to investments at local and regional level", Secretariat of the Commission for Economic Policy (ECON), Unit C2, http://cor.europa.eu/en/events/Documents/ECON/results-survey-obstacles.pdf.

The capacity challenge can be seen in the evaluation of 216 programmes on structural conditionality conducted by the IMF: while overall compliance reaches 54%, this average is reduced to less than one-third for conditions linked to the deepest (structural depth) and more difficult reforms (Independent Evaluation Office, 2007). Capacities issues arise in the United States and active pursuit of waivers by states for the No Child Left behind Programme. In South Africa, subnational governments, particularly smaller municipalities, consistently demonstrate capacity constraints in managing conditional grants by under-spending funds (Mizell, 2017). In Europe, the case of Greece exemplifies the difficulties of trying to implement reform in the context of a public administration already facing serious and highly-publicised capacity constraints (Mizell, 2017). There has, therefore, been a strong focus on providing technical assistance to address these capacity constraints.

An adequate level of capacities is needed to develop an appropriate framework that incentivises good performance and results (skills, knowledge, abilities and institutional

capacity). Indeed, not every performance problem is a motivational problem. Performance schemes meet more effectively their objectives if they are accompanied by technical assistance to ensure the quality of data and information collection. While requiring a basic level of capacities to be in place, performance schemes can also promote institutional capacity building.

This is why, for example, Economic Development Administration (EDA) of the U.S. Department of Commerce is currently developing a performance measurement framework that aims to capture the impact of its non-infrastructure programs, including Technical Assistance, on select capacity outcomes associated with long-term desired economic outcomes. In order to collect the appropriate information, EDA is communicating the relationship between program inputs, outputs, and outcomes through the economic development logic model by making it available to any prospective or current grantee online[2]. Additionally, through its performance and programme evaluation webpage, EDA, not only communicates its current evaluation practices and objectives, but provides a variety of resources such as the Technology Readiness Level (TRL) Guidelines[3] regional data sources, and Comprehensive Economic Development Strategies (CEDS) library to enhance capacity for planning, performance measurement, and evaluation of any regional economic development initiative.

Capacity building is also a "learning-by-doing" process in which supra-national, national and subnational stakeholders learn by repeated interactions. Contracts are known, for example, as tools enabling dialogue and capacity building across levels of government. In France, according to the evaluation of contracts between the State and Regions, *Contrats de Plan État Région*, (CPER) carried out in 2014 by the Court of Auditors (Cour des comptes, 2014), contracts led to gradual capacity building in regions. Contracts contribute to build local capacity, by valorising the role of local decision makers, their proximity to problems and resources and therefore their capacity to better target the initiatives and use untapped development potential (Charbit and Romano, 2017). Contracts can empower subnational authorities to develop new capacities and gain greater autonomy in dealing with regional development policies (Charbit and Romano, 2017). Certain types of contracts can serve not only to build "traditional" capacities, but also to develop capacities needed to face new global challenges. On an experimental basis, they can serve to build administrative capacities in response to new shared competencies, including responsibilities related to new global challenges such as climate change and environmental protection.

Understanding that capacities are built on a daily basis through practice is a reason to limit excessive administrative procedures and constant changes in the rules. Indeed, governments can learn by repeating interactions. It also provides the basis to gradually provide more autonomy to subnational governments in the accomplishment of their tasks by decreasing rules and procedures and increasing monitoring and *ex post* evaluations. However, this "learning-by-doing process" needs to go hand in hand with differentiated and targeted capacity building activities and technical assistance. Evidence suggests for example, that to increase the uptake of financial instruments, technical assistance is necessary. This process might need a differentiated approach to specifically target different needs in different types of regions.

Keep it simple

A striking concern that has been largely reported and appears as a central challenge when discussing regional development policy tools is the burden on administrations and project

managers that procedures might cause. The complexity of administrative procedures has been clearly identified as one of the major obstacles for regional development policies in general. A key issue for policymakers is to balance the accountability and fiduciary requirements linked to spending public resources with the capacity of regional administrations to effectively spend budgets.

An excessive amount of legislation and guidance or the proliferation of multiple conditions coupled with weak capacities may lead to an inefficient or low use of regional development funds by subnational governments. Over-regulation can also make it difficult for policy makers to take ownership of their responsibilities (see section "Ownership matters"). If the administrative burden exceeds the expected benefits of regional policy outcomes, project beneficiaries might not even bother to apply for central grants or financial instruments to fund their initiatives. It is thus crucial to compare the administrative burden with the expected policy benefits to avoid an excessive amount of guidance and legislation.

However, policy makers are confronted with a difficult trade-off: reducing the administrative burden might diminish subnational governments' fiduciary control and accountability. Indeed, the excessive administrative burden partly stems from the need to align priorities and compliance requirements, in an environment with low levels of trust and confidence (Euro Cities, 2017). This is particularly challenging when diverse actors from different levels of government need to co-ordinate and collaborate or when regional policies are operating in areas with low governance capacity or risks of corruption. Simplifying administrative procedures requires, among other things, the various actors involved in the process to trust one another.

Administrative burden combined with unequal capacities within countries, risk deepening pre-existing inequalities. Subnational governments with higher capacities might benefit more from funding opportunities – like competitive grants, external financing, PPPs – than their peers. For example, in Chile, like in many other countries, the system of financing subnational investment, often based on open competition, creates some disadvantages for small municipalities that do not have the technical or "relational" capacity to cope with the administrative procedures and compete in a bidding process. Bigger municipalities, or those with better technical capacities to develop projects, are in a better position to attract more investment resources (OECD, 2017e).

It is generally ineffective to include a large number of conditionalities aimed at addressing performance deficiencies and capacity limitations (Mizell, 2017). *Ex ante* conditionalities often require additional workload and costs; if too many conditions are in place, their implementation becomes unworkable. When faced with capacity constraints at the subnational level and an excessive technical language to communicate, the challenge becomes even greater. There is therefore an important trade-off to be assessed between the volume and detail of conditionalities, and the capacity of a region to deliver them. Likewise, an excessive number of conditions in contractual arrangements might make contracts unworkable; instead, by building trust among parties, contracts might focus on different ways to ensure compliance like reporting arrangements.

Simplicity comes with the need for greater flexibility to adapt programmes to specific local circumstances and development needs. This simplicity acquires greater importance in the context of new global challenges and uncertainty. Indeed, a more simple and flexible procedure to re-programme or adapt programmes is needed to address more efficiently new challenges or unforeseen urgencies (Euro Cities, 2017). This must be balanced with the need to achieve long-term objectives. A good level of flexibility allows

reprogramming when necessary, while keeping a long-term approach and avoiding the burden and uncertainty of continuous changes.

Simplicity therefore also means maintaining the rules of the game. When subnational authorities need to deal with constant changes, administrative procedures might rapidly become overwhelming, especially for subnational governments with low capacities. Stability may therefore also be a source of simplicity, in particular when rules for programming and managing policies are complex.

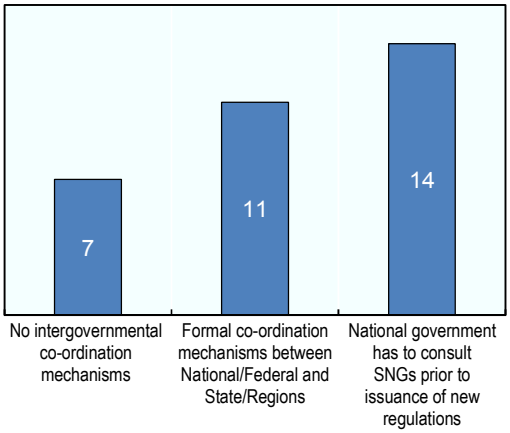
Figure 1.7. Indicator of regulatory co-ordination across levels of government

Regulatory co-ordination across levels of government

The country has mechanisms to co-ordinate regulations across levels of government

a. No intergovernmental co-ordination mechanisms
b. Formal co-ordination mechanisms between National/Federal and State/Regional Governments
c. The National government has to consult subnational governments prior to issuance of new regulations that concern them

The regulatory framework across levels of governments has to be consistent and stable with no divergent, overlapping or contradictory regulations. While establishing investment plans, local governments should analyse regulations in vigour to identify potential obstacles to efficient investment. Mechanisms to coordinate regulatory policies across levels of government can help achieve a coherent regulatory framework; Such mechanisms may include intergovernmental platforms for dialogue, mutual recognition policies among governments, regulatory harmonisation agreements, and strict regulatory uniformity agreements (OECD, 2009).



Source: OECD, (2017), Implementation of the OECD Recommendation on Effective Public Investment across levels of Government", Unpublished material, presented at the 37th session of the Regional Development Policy Committee, OECD Paris.

Simplicity is also a guiding principle in the design of performance frameworks. An excessive number of indicators can be counterproductive to encouraging better results. Indeed, the risk is that the framework becomes an administrative 'checklist' or a mere 'box-ticking' exercise. The key is to find the right balance of indicators to address the trade-off between simplicity and comprehensiveness of the evaluation. This is particularly true for small subnational governments that can be disproportionately affected by the administrative burden (Mizell, 2008). This is for example, what motivated the creation of the "Lifting the Burdens Task Force" in the United Kingdom set in 2008 to examine how the red tape burden for local governments could be minimised. Mechanisms for minimising burden could include, among others, co-ordinating data reporting requirements, guidelines, and submission frequencies across sectors and programmes where possible, enhancing the capacity to submit information electronically, reducing the overall number of indicators to be monitored to those deemed essential for achieving national (or local) priorities (Mizell, 2008).

Simplicity has also been identified as a key factor for success when looking at behaviour. Keeping instructions as clear, succinct, and convenient as possible might help to improve participation and reduce errors. Some case studies have revealed that, for example, where appropriate, pictures can help explain instructions more effectively than text. Visually showing users how to complete the steps of an action or initiative can indeed be more effective than writing lengthy instructions. The main lesson is thus to

simplify and shorten the rules and regulations wherever possible (see section "It is the quality of relationships that counts").

The use of financial instruments can encourage alignment between public management of funds and private sector investment activities. Indeed, some financial instruments are comparatively easy to administer. For instance, loans and credit guarantees can be easy to use, as their distribution can be outsourced to financial intermediaries or specialised funds. A greater use of financial instruments, in turn, can help in attracting and encouraging businesses with better investment projects, leading to better investments decisions. In parallel, it can reduce grant dependency by encouraging business models that are viable without public support. Yet, it is important to note that this benefit depends crucially on how financial instruments are implemented. In itself, their use does not guarantee a simplified administration.

It is the quality of relationships that counts

An ongoing dialogue can facilitate the alignment of objectives and set the basis for a win-win situation in which all parties can benefit. The need for dialogue and collaboration among parties in regional policies has been widely recognised by OECD countries. Either through contractual arrangements, formal or informal dialogue fora, inter-ministerial committees, etc., governments look at promoting dialogue between different levels of government to produce outcomes that are aligned and sufficiently clear for all actors. A majority of countries have indeed set up formal or ad hoc platforms to foster dialogue on regional development and investment priorities (see Figure 1.8). Through this, dialogue can generate ownership, trust and a sense of fairness, thus enhancing citizen involvement. In the end, if conditions are met and the quality of the relationship is good, dialogue is a two-way virtuous circle enabling better policy outputs and outcomes in the long term.

Figure 1.8. Co-ordination across levels of government in the OECD

Multi-level dialogue to define investment priorities for regional development

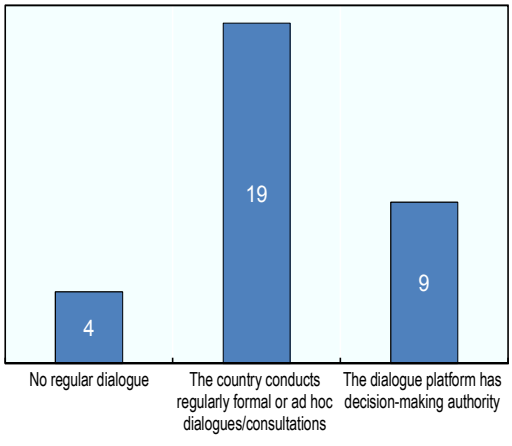
The country conducts regular dialogue(s) between national and subnational levels on regional development policy including investment priorities

a. No platform to conduct regular dialogue

b. Formal or ad hoc platforms to dialogue on regional development and investment priorities

c. The platform for dialogue has decision-making authority

When a dialogue is convened on a regular basis, co-ordination across levels of government is likely to be more successful. A dialogue platform or consultation forum that activates this dialogue needs to produce outcomes that are sufficiently clear for all actors involved to implement without difficulty. When the platform has decision-making authority, co-ordination across levels of governments can be further ensured.



Source: OECD, (2017), Implementation of the OECD Recommendation on Effective Public Investment across levels of Government", Unpublished material, presented at the 37th session of the Regional Development Policy Committee, OECD Paris.

Australia, for example, has an Intergovernmental Council (COAG) that gathers representatives of subnational entities and equivalent ministries at the level of the federal government. The Council includes the leaders of the Commonwealth and State and Territory governments and the Australian Local Government Association. By convening key stakeholders, the COAG drove national micro-economic reforms in the mid-1990s, which have been have been credited with improving the flexibility and efficiency of the national economy. Following the crisis, the leaders gathered in the COAG agreed economic stimulus measures in an attempt to make the economy more resilient in the face of the crisis. One of the key issues for its success has been the regularity of engagement that has generated trust between parties and has made it easier to work together (Bennet, 2017).

When incentivising dialogue and co-operation, policy makers need to balance short-term costs that the institutionalisation of this collaboration may imply with the long-term benefits that the regularity of these dialogues can bring in terms of ownership and trust. Continuously developing strong, trusting, and cooperative relationships can be very effective in improving the performance and compliance of all levels of governments (Shepard, 2017). In the end, opportunities for genuine dialogue may reduce the need for formal agreements between parties.

Governments, through dialogue and evidence-sharing, gain insight into which interventions work best, where to implement them and under what conditions (especially in the context of pilot projects). However, the sole creation of permanent inter-governmental and cross-sectoral national fora that facilitate structured dialogue, strategic action, and sustained learning, do not ensure an effective dialogue. Some mutually-dependent conditions that can facilitate an effective dialogue are:

- **Simplicity of information and feedback**: as mentioned previously, presenting information in a simple way helps all sides engage in a fruitful dialogue. Complexity can only create needless barriers, putting the involved parties in asymmetric positions. Behavioural science can offer some key insights in this respect (see section "Keep it simple").
- **Transparency:** it is important that all parties understand the rules and their consequences in a transparent and fair way. If people do not understand the rules or their consequences, they are less likely to comply with policies.
- **Transversal engagement**: developing approaches where different stakeholders are involved, especially citizens, through bottom-up approaches, can result in parties with a more positive and satisfied perception.
- **Ownership:** commitment to and ownership of the recipients of support are critical. Ownership can in turn be facilitated by an inclusive dialogue (see section "Ownership matters").

Transparency is key in establishing long-term trusting dialogues. A good example of the importance of trust is given by agreements set up among governments during the global financial crisis. Those agreements were characterised by strong asymmetries among the parties around the table. As a result, most of the conditions to set up a self-enforcing agreement were not met and many parties did not trust the resulting final agreement (Brousseau, 2017).

The different conceptual approaches to conditionality highlight the complexity of donor-recipient relations as a key issue for their effectiveness. The multitude of

stakeholders with different interests involved on both sides makes relations between donors and recipients complex and often conflicting. All theoretical approaches predict sub-optimal outcomes unless the design of assistance mitigates the perverse incentives faced by various stakeholders in these repeated interactions (Shah, 2017). In this respect, credibility, partnerships, collaboration, etc., are key elements to improve aid effectiveness (see Table 4.1 in Chapter 4).

Dialogue and transparent information sharing are also key elements to build better performance systems. At the same time, performance frameworks also serve as tools to strengthen the relationship between parties by instilling greater transparency and accountability, especially through the budget process. Indeed, accountability and transparency are again cited as the two most effective outcomes of performance budgeting. Here incentives play a key role; it is important to design performance frameworks that favour collective work instead of individual efforts. If communication and collaboration channels are in place, but sanctions or rewards are based on individual efforts, effective collaboration is relatively unlikely (Foster, 2017).

Some of the lessons learned in the United States and New Zealand are, for example, the need to select goals based on inter-agency dialogue in order to increase commitment, and the need to make targets available to the public, with regular updates on both implementation plans and metrics. In New Zealand, the goals were written primarily for a public audience and were visible enough to capture interest from the media, making them difficult to abandon (Moynihan, 2017). In the European Union, data on progress on expenditure and outputs for cohesion policy are published on an open data platform.

Trust is also both a condition for an effective dialogue and a long-term outcome of collaboration. For example, on the one hand, trust is key for the implementation of contracts. In a society characterised by mistrust, third parties can be responsible for triggering renegotiations or making unilateral decisions. In contrast, when strong social networks favouring cooperative relations exist, the intervention of third parties is less necessary. On the other hand, contracts can be envisaged as instruments with the long-term perspective of building trust. For this, attention needs to be paid to unilateral decisions to adapt to circumstances that might, in the short-term, create distrust and under-performance with long-term costs (Brousseau, 2017).

An important approach to build better relationships between parties is to find the right balance between top-down and bottom-up approaches. In contractual arrangements, for example, the consultation phase is crucial as it encourages contribution from different parties and clarifies shared policy objectives. It also allows priorities to be established in a consensual manner by assessing regional development needs and impacts on different people and places (Charbit and Romano, 2017).

Ownership matters

As has been mentioned previously, policy ownership[4] is crucial to facilitate a better use of public spending and investments for regional development. The different mechanisms discussed in this report can be strengthened if countries, regions and relevant stakeholders "own" them. Ownership cannot be achieved in isolation. Greater simplicity, greater flexibility, better relationships between stakeholders and levels of government, etc., are all elements that help in creating feeling of ownership. Ownership is a process that evolves over time in which repeated interactions can help in facilitating reputation and trust – two basic elements for ownership to be in place. This is turn can result in a win-win relationship.

Ownership has, indeed, been identified as a crucial element for project success, particularly in the use of conditionalities as an important facilitator or inhibitor of compliance (Mizell, 2017). The political economy theoretical approach to conditionalities focuses on designing conditions to forge recipient ownership and commitment to reform. Ownership increases the effectiveness of the conditions attached to grants or loans provided by public or private actors (international institutions, supra-national or national governments, banks, etc.) or contractual arrangements between different levels of government. However, development assistance is often faced with important trade-offs between effectiveness, ownership and administrative burden, especially when conditions are input-based or related to processes, reporting and accounting requirements. These types of conditionalities can undermine recipient ownership imposing important administrative burden for countries to meet requirements (Shah 2017).

Recent literature suggests that conditionalities are most likely to be implemented by governments that are already willing to reform (Mizell, 2017). This is why international organisations and supranational governments – notably the IMF, the World Bank, and the European Commission – have in recent years put a stronger emphasis on advancing local ownership of conditions set out in aid assistance (see Box 1.3). Indeed, an emerging consensus on a new conditionality paradigm – at least from the theoretical perspective – perceives conditions as a mechanism to encourage mutual accountability and alignment of incentives rather than a means of financial leverage and input controls (Berkowitz, 2017; Shah, 2017). In this perspective, ownership – which is dynamic and often fragile (IMF, 2003) – needs to be sustained by regular dialogue between partners that should agree on a particular set of conditions adapted to different needs through a bottom-up approach. Yet, in practice, greater flexibility in the setting of conditions is harder to achieve and has a direct impact on the willingness of recipients to comply (Berkowitz, 2017).

Box 1.3. Conditionalities: A focus on ownership

The use of conditions by the IMF, World Bank and the European Union is a widely used tool for development policies. These instruments and conditionality have evolved over time. After witnessing weak compliance and conditions with little structural depth, the IMF for example, streamlined its conditionality in 2009, and changed the focus to the area of own competency; the requirement to achieve macro-economic programme goals was also reinforced. More recently, income inequality and unemployment concerns led the IMF to emphasize the "macro-social" criticality of its loan conditions (Shah, 2017).

While the World Bank continues to follow traditional conditionality in its investment project assistance, their lending instruments and associated loan conditions have undergone profound changes over the last 50 years. Both institutions have integrated greater flexibility and have put a stronger emphasis on local ownership.

In the context of the European Union, *ex ante* conditionalities have been jointly agreed between the European Parliament and Member States on the basis of the Commission's proposal in the regulatory framework for regional policy. Since these are based on a common agreement on potential regulatory, administrative or strategic bottlenecks to effective implementation of support, local ownership has generally been higher than in traditional development assistance.[1]

1. A recent study by the European Commission "Support by the European Structural and Investment Funds (ESI Funds) regarding the implementation of the Country Specific Recommendations in Member States" suggest that *ex ante* conditionalities contributed to initiating structural reforms in 18 Member States.

Source: Shah, A. (2017), "Development assistance and conditionality: Challenges in design and options for more effective assistance", Background paper prepared for the seminar "Conditionalities for More Effective Public Investment", 28 April, OECD, Paris.

In this new paradigm, ownership can be one of the criteria used for selectivity of assistance. If countries "own" reforms and policy conditions, then donors could even explore providing countries with unconditional assistance and budget support with which to finance reforms (Shah, 2017). This is indeed one of the crucial questions surrounding conditionalities and ownership: is ownership by country recipients of aid or grants a crucial element for conditions to work? Or, instead, does ownership by countries render conditions unnecessary as the country would implement policy conditions either way? The literature concludes that, when ownership exists, then conditionalities offer a supportive framework for governments whose preferences for reform are in line with (even if not identical to) what is being asked by the donor (Mizell, 2017). By reducing adoption costs ownership can help in increasing the uptake of conditions. Indeed, the fulfilment of conditions may be facilitated by a combination of external pressure and support, particularly given the complex array of interests involved in governments' implementation of economic development policies.

Ownership represents an important challenge as, regardless of how it is defined, it should not be restricted solely to government ownership. Government ownership does not necessarily imply citizens' ownership or legislative buy-in (Shah 2017). When referring to ownership scholars put particular emphasis on the need for it to be transversal, in particular from citizens; otherwise, government ownership can be too fragile. A "citizen-centric" ownership can be more effective in helping to ensure that development effectiveness objectives are fulfilled. If this criterion is not met, the so-called country ownership is a necessary – but not a sufficient – condition to guarantee equity in public service provision (Shah, 2017). Emphasis on citizen engagement can in turn help mitigate existing trade-offs between effectiveness and accountability. This can be achieved by output-based conditionality being subject to broader citizen-based monitoring and evaluation, as well as citizen empowerment for oversight of government operations.

The literature has identified different mechanisms that can be used to create, facilitate or promote country ownership:

- **Selection:** "selecting" countries that are already committed to implementing reforms or policy conditions facilitates ownership. Indeed, reduced effectiveness of conditionalities might be explained by government's unwillingness to change policies or undertake the necessary reforms (Berkowitz, 2017). Research suggests indeed that conditionalities work best as facilitators rather than instigators of reform. However, by rewarding countries already committed to change, this approach may entail some important risks: the selection bias could lead to aid assistance going to countries in lesser need (Shah, 2017).
- **Persuasion and learning:** ownership can also be created or strengthened by intervening in a "soft" way to cultivate local demand for change through persuasion and learning (Mizell, 2017). For this, reforms can be implemented via either a "social learning" approach or a "lesson-drawing" approach. The former suggest that governments adopt reforms if they are persuaded of their appropriateness; the latter suggests that governments will adopt reforms if they perceive they can effectively solve domestic problems (Mizell, 2017). Multi-level governance instruments that promote co-ordination and dialogue are crucial. In addition, it is important to develop an observable evidence-base that makes it possible to verify results both during and after the process (Berkowitz, 2017).

- **Output and outcome-based conditionality**: ownership can be facilitated by building consensus on outputs and outcomes to be reached by countries. These types of conditions, contrary to input-based conditionalities, can provide governments with more autonomy and flexibility in policy-design – while still holding them accountable – to choose the 'best fit' strategies to reach the agreed objectives (Mizell, 2017).

The dissemination of monitoring and evaluation results can also help in enhancing ownership by enabling credibility and trust (see "Begin with the goal in mind" section). Transparency of evaluation processes is indeed crucial to strengthen relations between governments and citizens. As a starting point, it is important to build consensus around the goals of regional development policy and embed these in the multi-level governance mechanisms that link actors at different levels. By creating this "ownership" it is more likely that actors at different levels make use of the information generated by monitoring policies and performance mechanisms as an ongoing process of adaptive learning.

Be aware of biases

Over the last 5-10 years, the use of behavioural science to increase effectiveness, efficiency and compliance in policies and programmes has drawn attention of governments and public institutions. Although its use in regional development policies has not been deeply explored, behavioural sciences offer a series of insights and tools worth considering when designing regional development policies. This can be done by "nudging" whole organisations via the people inside of them and via the policies and procedures defined to get results. "Nudging" people responsible for the design and implementation of regional development policies refers to the effort that can be made to modify their behaviour by influencing their decision-making as opposed to doing so through compliance-oriented measures.

Behavioural insights can provide some guidance regarding ways to make instruments more effective and overcome trade-offs that often arise between short-term costs and long-term benefits. Behavioural insights can help provide guidance about how to define conditions that can be effectively met, how to design contracts that better nudge the parties to collaborate, and how to better design performance incentives that nudge people to pursue the desired results. In this respect, the starting point is to define, as precisely as possible, which is the question that can be answered using behavioural insights: which behaviours are we expecting to change?

In the context of regional development policies, stating that the behaviour expected to change is a "better administration of funds" is sometimes a good place to start. However, a more detailed analysis specifying which specific objectives are being targeted for behavioural change is necessary (Foster, 2017). Using behavioural insights as a guide, some of the questions that can help shape the definition of more precise objectives in regional development policies are:

- According to whose interests and towards which goals are we nudging?
- How and when are decisions within subnational governments made?
- Are we nudging for the goals of the supra-national/national/subnational authorities or for a particular objective?

The multi-organisational and multi-stakeholder nature of regional development policies adds complexity to the challenges at hand. The long-term horizon that is inherent

in regional development policies is also an underlying factor that may create important biases. All these challenges can be seen through behavioural lenses: behavioural insights can explain biases linked with communication problems, engagement challenges, priority misalignment, funding gaps or misallocations, among others. A key step forward in regional development policy design is assessing and responding to those biases by integrating possible solutions provided by behavioural theory when deciding who to engage, which activities to fund, and how to assign that funding.

Some of the key dimensions in which behavioural insights can be taken into account when designing regional development policies are:

- **Better use of funds and selection of projects**: improving organisational or "group decision-making" can significantly improve allocation of project funds by, for instance, factoring in biases related to underestimating resource needs. At the same time, using behavioural insights might help to improve the effectiveness and transparency in the use of funds by using fair procedures to select projects and due processes.
- **Improve co-ordination and collaboration among actors**: behavioural insights can offer techniques that improve communication between parties and facilitate engagement of stakeholders. Behavioural insights can also provide useful information on how to align individual and organisational goals across levels of governments. Collaboration can be enhanced through the use of behaviourally-informed tools and products that aid them in the process. It is thus possible to encourage interested parties that can benefit the most from the programmes to participate in their design and engage actively in their implementation. This in turn can also improve sense of fairness, which is crucial for collaboration and engagement. At the same time, they can provide insights into how to best involve the private sector in development policies and investments and help, thus, to create successful partnerships.
- **Simplification of procedures**: behavioural insights have proven to be a successful tool in areas where the use of traditional forms of regulation is no longer effective. Nudging principles can be applied in interventions that aim to simplify processes within an organisation, for example, in relation to public procurement or grant applications. As mentioned previously, the use of plain language, or even visual instructions can be more effective than lengthy instructions. Also, an important potential of nudging behaviours is that, ultimately, they can become routines rooted in the organisation's daily work. Building routines and habits by simplifying procedures can thus generate a virtuous circle: habits can in turn make the procedure simpler.
- **More effective use of data**: behavioural science can also make sense of data by helping to answer the following questions: how can the available data be used better? How can the data be presented to different stakeholders involved in defining regional development policies with a view to increasing uptake? Which data should be used, provided to or asked of subnational governments in order to align objectives? Which data can be more effective to reward, monitor or evaluate performance? In this sense, open data from the European Commission or the OECD can help, for example, to create reference classes for milestones achieved, costs per unit of output in particular policy or programme categories. All these, in

turn, could contribute to improving the uptake and the efficiency in the use of funds.

- **Improve performance and uptake**: behavioural insights can contribute to a better understanding of the use of rewards or incentives in organisations, structuring rewards and measuring performance in line with intended outcomes. They can also help build a culture of risk-taking to encourage and stimulate innovation (see section "Get the incentives right"). A key lesson from case studies is the need for exploring rewards and not only sanction mechanisms to reinforce the capacity of subnational governments to propose effective projects and create incentives to adopt best practices across subnational governments.

Citizens also tend to have lower trust in self-reported government data, than non-public sources of information (Moynihan, 2017). This is why setting up independent evaluation institutions can be beneficial for credibility, trust, and enforcement. Involving third parties in evaluation processes can facilitate access to information and transparency of the results, putting stronger pressure on the consequences (see section "Begin with the goal in mind".

Get the incentives right

Designing incentives in a way that effectively encourages the expected behaviour always represents a significant challenge for policy makers, especially when those incentives should be aligned across levels of government. When designing performance incentive frameworks, policy makers need to balance the need for control and accountability from the central to lower levels of governments, and the risk of crowding out intrinsic motivation due precisely to this excessive control.

This trade-off is illustrated by the "making managers manage" approach for contracting used by New Zealand and the "letting managers manage," practiced in Australia, Sweden and the US. While both approaches provide flexibility to public managers to improve performance, they differ in the reliance on incentives and competitive spirit in the first, and goodwill and trust in the latter. These two approaches take different perspectives on how to reward public servants. Performance-based contracts reward the chief executive financially if the organisation reaches its performance targets. According to the empowerment approach, public servants are more motivated by the intrinsic rewards of public service than material benefits (Shah, 2017).

While theoretical approaches regarding incentives are well developed, in practice defining which incentives, for whom, and how is difficult. The "folly of rewarding A, while hoping for B" (Kerr, 1995) is a matter that policy makers have to deal with on a daily basis. The well-known example that governments reward real expenditure by allocating budget based on the previous year's expenditure is a clear sign that policy makers are struggling with getting the incentives right. With this allocation rule, public institutions are indeed encouraged to spend as much money as possible instead of managing resources in an efficient manner.

Examples of incentives that encourage unexpected outcomes can be easily found in a wide range of policy areas. In practice, performance measures need to be based on "objective criteria" that can often be misleading. It also results from the need for simplicity: it is certainly easier to allocate a budget based on actual expenditure than define performance criteria for its allocation. The 2016 OECD Performance Budgeting Survey shows, for example, that when performance is not met by the institution being

evaluated, consequences are generally linked to management issues (performance results being made public, increased monitoring for the next period, etc.) instead of financial issues like budget increases or decreases. Moreover, "no consequences" is the second most likely scenario.

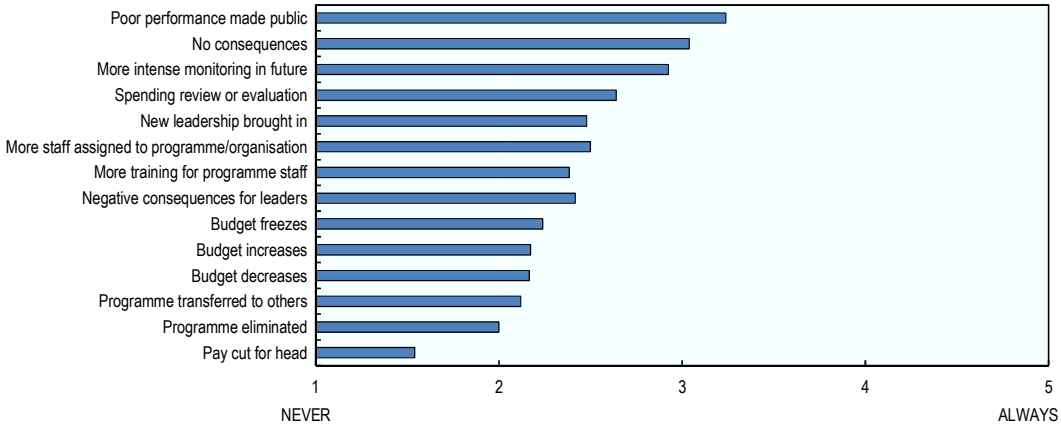
Setting incentives is not only a question of which incentives and for whom; it is also a question of what will be the consequences of compliance (or non-compliance) when setting those incentives. Consequences are indeed part of the incentive and the strength of incentives depends on how information will be used and by whom (Charbit and Romano, 2017).

To make the most out of incentives, a large part of the behavioural literature has focused on their design, linking behavioural insights with performance schemes. Behavioural insights have proven to be successful at diagnosing problems with incentive models and providing alternatives to align incentives and promote innovation. For this, some key questions that need to be addressed are: what kind of incentives will help engage the target group? If the target group is not engaging with an intervention, how can they be incentivised to do so? What tools do they need in order to take the appropriate steps in an intervention to achieve the policy or program objective?

Incentives need to be linked to rewards, not only sanctions. Rewards, which may not necessarily be financial, can be successful when they are aligned with desired outcomes and when they balance potential risks with innovations, while bearing in mind the behavioural consequences of going too far in either direction. It is also important to ensure incentives are properly targeted and do not further incentivise unintended outcomes. This was reflected in the European Cohesion Policy 2014-2020, which monitors progress with respect to defined targets in terms of financial/input, output, and, in certain cases, result/outcome indicators. The focus here is on ensuring that the achievement of targets is within the control of project beneficiaries and programme managers. This requires indicators that are relatively unaffected by outside factors. This tight link forms the basis for the allocation of a performance reserve (6%), which aims to reward good performance in the implementation of programmes or sanctions otherwise.

Figure 1.9. Responses to performance evaluation

If performance targets are not met by line ministries/agencies,
how likely is it that any of the following consequences are triggered?



Source: OECD (2016), 2016 OECD Performance Budgeting Survey (database), Q28, https://qdd.oecd.org/subject.aspx?Subject=90B147D4-005C-462A-9678-4CF7A931A4CA.

Extrinsic rewards can work as positive reinforcement but they also may involve some risks in the long term. Some recent findings in the economic and psychological literature point out some of the risks of extrinsic motivation tools. In the long term, rewards may become negative reinforcement as people conceptualize their motivation to perform a task only in external terms, "crowding out" intrinsic motivation (Foster 2017). External rewards need to be bolstered by autonomous motivation; otherwise, a system that relies only on external motivational factors might be unsustainable. For this, some basic conditions in the work environment might be needed: provide a degree of autonomy, foster relations with other people, challenge them, promote ownership and task significance, and define explicit responsibility over results, among others (Foster 2017).

Developing the appropriate conditions to stimulate intrinsic motivation applied to regional development policies can be a difficult task. A good starting point would be to assess if there are any intra- or inter-institutional barriers that are impeding or stifling self-motivation (Foster, 2017). It can also be fruitful to assess the degree to which planning or monitoring policies are generating or impeding conditions for policy makers to feel autonomous or to generate ownership over policies. It could be also beneficial to assess whether the appropriate communication channels are in place to effectively communicate good results or to ensure that policy makers understand the connection between their responsibilities and the overarching objectives.

From the theory and practice in contract and conditions compliance, as well as performance budgeting and behavioural science, some of the key issues to get the incentives right are:

- Develop good feedback mechanisms and build partnerships and trust across stakeholders (see section "It is the quality of relationships that count")
- Setting goals is complex as not all goals are equally motivating. Setting goals with those who have to accomplish them is crucial. These goals need to be challenging, specific, accepted by the worker and accompanied by progress reports.
- Clearly define the relationship between inputs, outputs, and outcomes. This relationship should be known and measurable. This is the case, for example in the European Cohesion Policy 2014-2020, where a clear intervention logic is set out in programmes for the different areas of intervention.
- Indicators associated with incentives must capture performance that is under the control of the actor in the timeframe being measured. Rewarding outputs instead of outcomes might help to attenuate the influence of external factors that may determine outcomes (time lag, external influences, etc.). However, it is important to make sure that the outputs being rewarded are linked to outcomes; otherwise, policy makers might be 'held hostage' by indicators with no real impact on the outcome.
- Be cautious when tightening monetary rewards as it can make policy makers work for indicators instead of working for results.
- Assess spillovers and externalities, conducting interviews with stakeholders to identify and understand the unexpected benefits.
- Motivation goes beyond monetary rewards.
- Some mix of hard and soft incentives is most likely to be effective.

Keep trying and testing

A process of adaptive learning within regional development can offer a set of benefits for the long-term efficiency of policy instruments. Through pilot experiences (e.g., pilot contracts with some regions for specific purposes or pilot indicators to promote certain behaviours) policy makers can learn from actual successes and failures. Yet, while using this "trying and testing" approach, policy makers need to avoid the risk of perpetuating differences and inequalities across places.

Mirroring the increasing trend towards asymmetric decentralisation in different countries, pilot experiences in the devolution of responsibilities to subnational governments are also a growing tendency. In Sweden for example, two successful pilot experiences on asymmetric decentralisation were established in the end of the 1990s (regions of Skåne and Västra Götaland) to transfer the responsibility of regional growth from regional state agencies (County Administrative Boards) to regional political bodies (elected regional councils). Since then, step by step, the responsibility has been transferred from regional state agencies to regional political bodies in other counties as well (to County Councils and County Cooperation Bodies). This policy might be rolled out to the entire country based on the pros –that outweighs the cons- of its implementation. These approaches might allow a better match between policies and local needs without going through radical administrative or constitutional reforms (Allain-Dupré, forthcoming). Indeed, pilot experiences allow policy makers to experiment and learn while avoiding subnational governments with low capacities from becoming overwhelmed by new responsibilities.

Ensuring flexibility in implementation and enabling pilot experiences in specific places/regions makes it possible to make permanent adjustments through learning-by-doing. They can indeed be a powerful way to operationalise regional development policies, test which indicators might facilitate the assessment of performance, implement specific contracts in subnational governments with particular characteristics (metropolitan areas for example), etc. In Canada, for example, pilot experiences are at the core of the place-based regional development policy to promote learning and community capacity-building (Bradford, 2017). Pilot policies are one of the tools chosen by Canada to operationalise the hybrid contracts that are the prime instrument of the Canadian regional governance system – or the so-called meta-governance. The Community-Based Regionalisms (CBR) are learning pilots and demonstration projects to tackle "wicked problems" (those that are deep-seated and localized in their expression and therefore resistant to off-the-shelf solutions) through the generation of new knowledge and a problem-solving strategy. They represent laboratories for policy, launched by the federal government to emphasise project experimentation and learning evaluation. Lessons learned in these pilot projects aim at addressing local gaps in technical expertise or organisational capacity as well as bringing experiential knowledge and network expertise to upper level administration (Bradford, 2017).

Developing a culture of trial-and-testing is important for developing a practical body of knowledge. This form of experimentation is an important part of studies on behavioural insights. For example, a randomized controlled trial in England found that making public data on a local government's performance compared to other localities had a positive effect on citizens' perceptions of the government's performance and they were more satisfied with that performance compared with citizens who are shown no such information (Shephard, 2017). But experimentation in this field does not end with randomised controlled trials. Testing can also be accomplished by using a variety of

methodological tools, including, systematic reviews, quasi-experimental studies, non-experimental evaluations, cohort studies, surveys, amongst others. Indeed, the methodological toolbox when applying behavioural insights to institutions and organisations encourages the use of "of multi-level, longitudinal field experiments, experience-sampling studies, and intervention studies to allow for the evaluation of motivational and behavioural variability as a function of time, work events, the individual's history, and the social context of action" (Foster, 2017).

The define-diagnose-design-test approach can be useful in implementing and testing behavioural nudges at the organisational level. Clearly defining objectives, soliciting input from experts and stakeholders, identifying barriers or bottlenecks, and then addressing these objectives and evaluating the interventions can be very valuable in ensuring that these interventions remain effective and sustainable in the long run.

Begin with the goal in mind

Setting evaluation processes for regional development policies is necessary to increase their efficiency, learn from experiences and adapt policies to better fit cities' and regions' needs. Evaluating policy implementation does not only refer to *ex post* evaluations of programmes, it also refers to technically sound project appraisals and effective investment monitoring systems that monitors policy performance during the entire cycle, from its design to its execution. There is now a broad consensus that evaluation mechanisms need to be defined when designing policy. Indeed, monitoring and evaluation have an important role to play in linking policy objectives and outcomes.

Evaluation and monitoring criteria need to be defined in the early stages of the policy design and techniques to monitor and evaluate should not be limited to merely budget execution. Integrating evaluation early in the planning process also allows officials to allocate the resources needed to define the evaluation methodology and produce the appropriate data for this purpose. Defining the theory of change of different policies – in which the outcomes to be reached need to be set at the beginning –can help policy makers to better understand policy objectives, better define key concerns to be addressed, better define indicators to operationalise the outcomes, and better assess the relationship between indicators and outcomes. Yet, setting evaluation standards and using their results in future interventions is not always easy. Beyond the capacity needs it involves, policy monitoring and evaluation imply additional costs that need to be balanced with the need to pursue effectiveness.

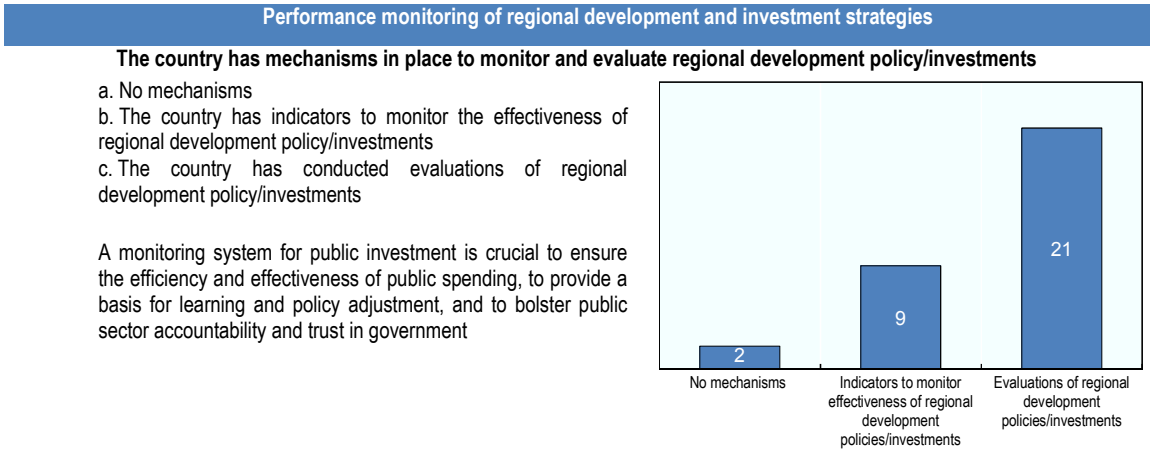
Evaluation is crucial to enhance the effectiveness of contracts across levels of government. To start with the goal in mind, evaluation should be a key component of contracts themselves; they can help to improve the terms and implementation of the contract in the next period and more efficiently allocate shared tasks across levels of government (Charbit and Romano, 2017). The evaluation process is also a fundamental piece of pilot projects, since without evaluation, pilots lose their leitmotiv. Evaluations make it possible to learn from success stories and failures and adopting best practices in different contexts. To reach their learning potential, pilot projects require new evaluation tools to be developed that value equally policy experimentation, experiential knowledge, and results-based accountability (Bradford, 2017).

Alongside regular monitoring, evaluation has an important role to play in the successful implementation of financial instruments. Evaluation results are sparse because specialist knowledge is required to evaluate the impact of financial instruments. Like for all instruments analysed throughout this report, evaluation plans should be drawn up at

the outset as part of the programming of financial instruments, to ensure that the effective use of public funds can be accounted for. This can also help with the management and targeting of the funds on an ongoing basis. Evaluation can also provide guidance on future needs and funding strategies (Wishlade, 2017).

Given its relevance, it is not surprising that the majority of OECD countries declare having some mechanism to monitor or evaluate regional development policies and investment in place. As shown by Figure 1.10, considering the 30 countries that have developed indicators to monitor the effectiveness of regional development policies or investments, at least 21 one of them have put in place some form of evaluation. However, while this indicator reveals an important effort to set up evaluations, it does not provide information on how countries design those evaluations or their effectiveness. Moreover, the mere existence of evaluation does not guarantee that results are used in practice to modify or adapt policies, or the degree of independence of those evaluations.

Figure 1.10. Indicator on performance monitoring

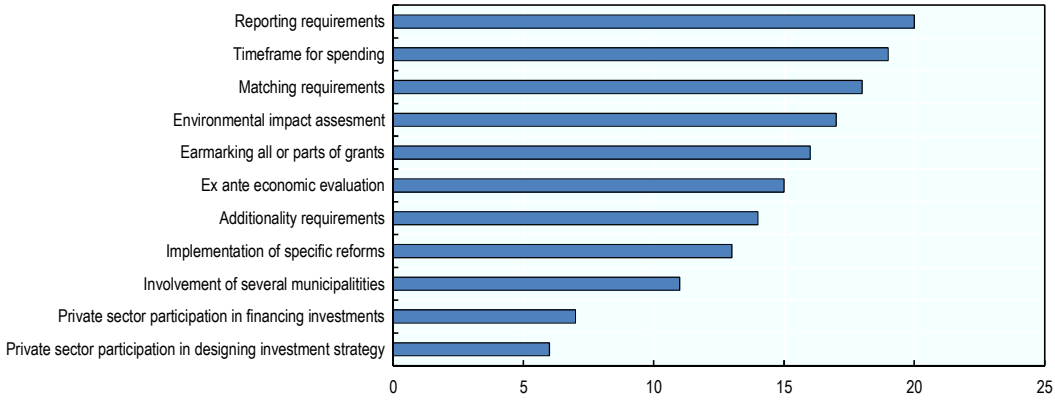


Source: OECD, (2017), Implementation of the OECD Recommendation on Effective Public Investment across levels of Government", Unpublished material, presented at the 37th session of the Regional Development Policy Committee, OECD Paris.

Canada, for example, through its Regional Development Agencies sets monitoring and evaluation conditions when defining policy objectives. While defining contribution agreements between the Regional Development Agencies (RDA) and private businesses, non-profit organisations, or other levels of government, the different parties involved negotiate the core objectives, the activities to be funded, the expected outcomes, the performance measures that will support programme management, programme evaluation procedures, and external reporting. If monitoring reveals non-compliance with the obligations set out in contribution agreements, the RDA can withhold payments (Bradford, 2017).

The existence of *ex ante* appraisals is a characteristic often used by supranational or national governments or aid agencies while defining conditions for grants. In the 2012 OECD survey on public investment across levels of government, around half of respondents declared that some of the conditions attached to funding were environmental impact assessments and *ex ante* economic evaluation (Figure 1.11) (OECD, 2013). However, conducting those evaluations is not sufficient by itself; information that emerges from monitoring and evaluation systems should feed into decisions regarding investment in subsequent investment cycles.

Figure 1.11. Types of conditionalities attached to public investment funds



Source: OECD (2012), "Multi-Level Governance of Public Investment", National and regional case study questionnaires, www.oecd.org/regional/effectivenessofpublicinvestmentatsub-nationallevelintimesoffiscalconstraints.htm.

The Devolution Deals in the United Kingdom meet both the upfront definition of an evaluation procedure, as well as the independency of such evaluation. These cross-government arrangements between central government and local areas, which involve the devolution of powers and resources from the central government, require putting in place an extensive programme of evaluation, agreed at the outset with HM Treasury (Local Government Association, 2016). An independent panel, commissioned by the central government and the local areas will assess if investment funding meets objectives and contributes to national economic growth (Charbit and Romano, 2017).

Monitoring performance and conducting evaluations also entail important challenges and risks. First of all, excessive attention to output indicators – that should be linked to outcomes – to monitor and evaluate programmes can encourage governments to 'game' the system by focusing solely on the achievement of those indicators. As mentioned previously, focusing on particular outputs can also lead to indicator-driven policy-making…and losing sight of the big picture. Beyond the opportunistic behaviours that it can engender, it is crucial to consider that true impacts are often only visible in the long term and the *ex post* evaluation is performed too early; evaluation needs to be carried out in a consistent timeframe, while also considering the time lags with the production of relevant information. Evaluation also needs to take into consideration the unidentified or unintended outcomes of different policies. It is essential to disassociate evaluations with rewards or sanctions attached to compliance or non-compliance.

Setting up independent evaluation institutions can be beneficial for credibility, trust, and enforcement (see "Be aware of biases" section). Indeed, citizens tend to have lower trust in self-reported government data, than non-public sources of information (Moynihan, 2017). For example, independent agencies overseeing contractual processes help to legitimise contracts and can be responsible for both the collection and publication of information relevant to the *ex post* assessment of contractual performance and the supervision of the negotiation process (Brousseau, 2017). In general, independent evaluations can also help limit the path dependency of certain programmes that prevent them from being wound down and eliminated, even though they are negatively evaluated.

The dissemination of monitoring and evaluation results enhances credibility and trust (see "Ownership" section). Citizen-based monitoring and evaluation could be a powerful

tool to strengthen relations between governments and citizens. For this, transparency in the use of information is crucial. A good example for this is Chile's National Investment System, which enjoys a high degree of transparency. The various methodologies and processes for undertaking social evaluations are published on a specialised website, as are the *social prices* used in those evaluations. An online Integrated Project Database provides information relating to the status and costs of all public investments, thereby enabling civil society, the private sector and the general public to monitor investments across sectors in different regions (OECD, 2017f). This system, which combines rigorous processes, independent review and a high degree of transparency, has undoubtedly contributed to the relatively high quality and efficiency of Chile's infrastructure investments over the past 20 years (OECD, 2017f).

Beyond monitoring and evaluation systems, it is important to build consensus around the goals of regional development policy and embed these in the multi-level governance mechanisms that link actors at different levels. This is likely to increase the likelihood that actors at different levels make use of the information generated by monitoring policies and performance mechanisms as an ongoing process of adaptive learning.

Table 1.1. Summary table

Pitfalls to avoid and potential solutions when designing economic development policies for cities and regions

PITFALLS TO AVOID	POTENTIAL SOLUTIONS
☞ **What works here might not work there**	
• Apply one-size-fits-all policy instruments by overestimating the need for accountability • Design regional development policies without considering regional characteristics such as: degree of decentralisation/autonomy of subnational governments, productivity level, degree of corruption, capacity gaps, etc. • Underestimate the role of market and institutional conditions when choosing support instruments	• Ensure flexibility in policy design to adapt to different contexts • Consider the context to establish good references when defining objectives and showing comparable data • Explore with asymmetric arrangements and differentiated and targeted pilot projects • Ensure a degree of flexibility to programmes to specific local circumstances and development needs and to adapt to emerging challenges • Take into account the quality of governance and support to make the context more conducive to delivering results
☞ **Capacities first**	
• Ignore that capacities consist of more than just skills and abilities: capacities are also financial and institutional • Give sole responsibility for the design and implementation of regional development policies to subnational governments that have a substantial capacity gap • Ignore that capacity-building is a learning-by-doing process where subnational governments learn from practice • Assume that poor performance is due to a motivational problem when it is often related to capacity shortfalls	• Spend more time building capacities and bolster regional development policies with technical assistance • Repeat interactions with subnational governments (with the same rules) to build capacities in practice • Use a differentiated approach to building capacities in order to respond to different needs and different types of regions
☞ **Keep it simple**	
• Apply over-detailed regulations and procedures to address fiduciary and accountability concerns • Use excessively technical language to communicate • Change and adapt too frequently the rules, instructions, and legislation for the implementation of regional policies by subnational governments	• Compare the administrative burden with the expected benefits of regional policy outcomes to avoid an excessive amount of guidance and legislation • Use plain language and images to communicate • Keep instructions clear, succinct, and convenient to improve participation from interested parties and reduce errors • Strengthen dialogue and trust to align priorities • Maintain stability of rules and regulations over a long period of time to facilitate compliance • Design simple performance frameworks by reducing the number of indicators • Co-ordinate data reporting requirements, guidelines, and submission frequencies across sectors and programmes.
☞ **It is the quality of the relationship that counts**	
• Undervalue dialogue and co-operation tools • Focus on formal arrangements without considering their real effectiveness and the motivation of actors • Ignore that developing strong, trusting, and cooperative relationships is a virtuous circle that starts with practice • Underestimate the role of informal dialogues and social networks that favour cooperative relations	• Develop formal fora to encourage dialogue and build trust by focusing on the: – Simplicity of the information and feedback communicated – Transparency of rules and its implications – Comprehensive stakeholder engagement and bottom-up approaches • Use formal instruments (like contracts) to build trust between parties • Avoid unilateral decisions without consultation • Find the right balance between top-down and bottom-up approaches

PITFALLS TO AVOID	POTENTIAL SOLUTIONS
☞ **Ownership matters**	
• Ignore that ownership is a process that evolves over time • Concentrate on government ownership while underestimating citizens' ownership and legislative buy-in	• In order to build ownership, put in place different, complementary mechanisms: simplicity, flexibility, dialogue, etc. • Ensure repeated interactions to facilitate building reputation and trust, i.e. two basic elements required for actors to take ownership of initiatives • Design conditions as a mechanism to encourage mutual accountability and alignment of incentives rather than focusing on financial leverage and input controls. • Use a citizen-centric ownership approach: output-based conditionality with greater citizen-based monitoring and evaluation, and citizen oversight • Agree on *ex ante* conditions through a greater bottom-up approach – build consensus on outputs and outcomes to be reached by countries • Use ownership as a selectivity criterion and use conditionalities as a supportive framework for countries whose preferences are in line with the lender/donor • Strengthen ownership by intervening in a "soft" way to cultivate local demand for change through persuasion and learning ("social learning" approach or "lesson-drawing" approach)
☞ **Be aware of biases**	
• Ignore the most common biases when designing conditionalities, contracts, performance frameworks, etc. (e.g., risk aversion, cognitive biases when assessing staffs/organisations, ignoring or not noticing pertinent information or opportunities, developing incorrect mental models, etc.) • Underestimate the complexity of the multi-organisational and multi-stakeholder nature of regional development policies	• Design mechanisms to reduce biases that may explain communication problems, engagement challenges, priority misalignment, funding gaps or misallocation • Start by defining the question(s) that can guide the use of behavioural insights in regional development policies • Encourage "group decision-making" to improve, for example, funding allocation • Use behavioural insights to: – Improve communication and facilitate engagement of stakeholders – Simplify procedures and regulations – Choose which data to communicate and how to do so • Use rewards or incentives
☞ **Get the incentives right**	
• Favour extrinsic motivations (external sanctions and rewards) that may crowd out intrinsic motivation • Reward A when expecting B • Disassociate evaluations with rewards or sanctions attached to compliance or non-compliance • Attach consequences to policy outcomes instead of policy outputs	• Systematically take into account the incentives created by rules • Use behavioural insights to design incentives and performance schemes • Encourage ownership of incentives linked to sanctions and rewards (financial and non-financial) • Develop good feedback mechanisms and build partnerships and trust across stakeholders • Set challenging and specific goals together with the bodies responsible for implementation • Define clear relationship between inputs, outputs, and outcomes • Build performance mechanisms on the basis of outputs to attenuate the influence of external factors; however, make sure that those outputs are linked to the expected outcomes

PITFALLS TO AVOID	POTENTIAL SOLUTIONS
☞ **Keep trying and testing**	
• Be afraid of pilot experiences to test policies in different contexts • Extend indefinitely the "pilot" status and accentuate differences and inequalities across places • Focus only on certain types of pilots to test policies	• Ensure flexibility in the implementation of pilot experiences in specific places/regions to allow for permanent adjustments through learning-by-doing • Develop a culture of trial-and-testing to develop a practical body of knowledge • Test and evaluate policies through different tools like systematic reviews, quasi-experimental studies, non-experimental evaluations, cohort studies, surveys, etc. • Find a balance between trying and testing and continuity of norms
☞ **Begin with the goal in mind**	
• Underinvest in evaluation and policy monitoring to avoid costs • Define policies without defining at the start expected outputs and outcomes and the evaluation techniques to be used • Concentrate too much on *ex post* evaluations ignoring *ex ante* appraisals and monitoring	• Define policy goals collectively • Define evaluation and monitoring criteria in the early stages of the policy design • Define an indicator system according to the expected results • Develop harmonised statistical systems that allow for adequate monitoring and evaluation • Focus on evaluation especially for pilot projects • Use independent evaluation institutions to enhance credibility, trust, and enforcement • Disseminate monitoring and evaluation results, especially ones from independent institutions

Source: Own elaboration.

Notes

1. It is thus important to pay attention to the degree to which a given public investment might "crowd-in" or "crowd-out" private investment.
2. For more information see https://www.eda.gov/files/performance/ED-Logic-Model.pdf
3. For more information see https://www.eda.gov/files/performance/EDA-Technology-Readiness-Levels-Guidelines.xlsm
4. Ownership has been defined in different ways. A definition can be found in IMF (2001, p. 6): "Ownership is a willing assumption of responsibility for an agreed program of policies, by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on an understanding that the program is achievable and is in the country's own interest".

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Chapter 2

Using financial instruments for regional development policies

This chapter discusses the use of financial instruments to support socially desirable investments by private and public actors in order to promote economic development in cities and regions. While theoretical arguments for the use of financial instruments are generally well defined, revisiting theory can help bridging gaps of their practical use. This chapter thus explores, from a theoretical and practical perspective, advantages and disadvantages of financial instruments, and how to promote their use in more effective ways. It identifies factors that make their use particularly effective when compared to grants and highlights, at the same time, circumstances under which they are less appropriate. Finally, it summarises practical considerations for policy makers to make the most of financial instruments.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Introduction

Financial instruments are a politically appealing alternative to grants as a tool to support socially desirable investments by private and public actors that will promote the economic development of cities and regions. Since funds are being repaid, they could have a greater impact than funds used as grants that are not recycled for future projects. However, despite these perceived advantages, financial instruments are not as widely used as could be expected. While theoretical arguments for the use of financial instruments are generally well-defined, in light of the challenges in their use, revisiting the theory can help our understanding of why perhaps in practice there are gaps. This chapter discusses the reasons for the lower than expected use, highlights advantages and disadvantages of financial instruments, and explores possibilities to promote greater use and in more effective ways, considering:

- **For which types of investments are financial instruments particularly effective?** Businesses and public authorities lack access to finance and thus financial instruments can contribute to addressing this financial gap. Different types of financial instruments may be more effective and appropriate depending on the context, and practical examples from across the OECD illustrate this.
- **What are the limits to the use of financial instruments?** There are circumstances under which financial instruments are less appropriate and certain conditions that limit their effectiveness. With certain requirements the use of financial instruments can be more effective.
- **How can greater use of financial instruments be encouraged?** The use of financial instruments is comparatively rare in many OECD member countries, including in national policies as well as in EU policies. As of early 2017, only a small fraction of EU cohesion funds were used for financial instruments in EU member states. This chapter considers some of the institutional framework conditions and complementary policy measures that need to be in place to use financial instruments effectively or to reduce the administrative and financial burden associated with their use.

This chapter draws on background papers for and discussions at the seminar "When to use financial instruments" held 28 June 2017 at the OECD Headquarters in Paris, France. Background papers for this seminar include:

- Brown, R. and L. Neil (2017), "The Theory and Practice of Financial Instruments", Background paper prepared for the seminar "When to use financial instruments" held 28 June 2017, OECD Headquarters, in Paris.
- Wishlade, F. and R. Michie (2017), "Financial instruments in practice: uptake and limitations" Background paper prepared for the seminar "When to use financial instruments" held 28 June 2017, OECD Headquarters, Paris.

Theoretical approach and frontier thinking

What are financial instruments?

"Financial instrument" is an umbrella term that covers a wide range of instruments designed to provide financing to private and public actors. It includes public or subsidised loans, public equity and venture capital, and credit guarantees, but also other less-widely

used forms of support, such as securitisation. When combined with a loan or a guarantee, guarantees fee subsidies or interest rate subsidies can be also classified as financial instruments.

To support economic development in regions and cities, financial instruments, as an alternative to grants (Box 2.1), are designed to overcome market failures experienced by businesses and public organisations. They are used to promote productive investments that would not occur through market interactions alone. In contrast to grants, support provided with the help of financial instruments needs to be repaid, at least partially. Common financial instruments include:

- ***Loans*** are the most widely used source of private finance for SMEs and are offered almost everywhere in domestic and/or co-financed economic development policies. Loans are also widely used by other project promoters, such as local authorities, for upgrading public buildings and spaces and other capital investments. Loans can also be given, for example, to homeowners or landlords to support energy renovation. Loans are comparatively easy to administer from a public administration perspective, to the extent that the implementation of a loan fund can be outsourced. Funds can also essentially be used to increase the volume of finance available through existing commercial sources. Loan products can help address credit rationing, as well as cost-of-credit issues (through interest rate subsidies or easier terms). While loans are often preferred by SMEs because there is no loss of control or ownership, as with equity, this type of financing can sometimes lack the flexibility required by young firms. The use of loans by larger businesses and public entities varies considerably from country to country.
- ***Guarantees*** have the most potential for impact where collateral-based lending is the norm and the business population is not asset rich. The use of guarantees is significant in only a few countries, and the sums covered are, on average often modest, partly because they are frequently combined with loans in microfinance packages for start-ups and young firms. However, where they are used, their reach can be significant, with many thousands of publicly-backed guarantees offered annually in some countries.
- Publicly-backed ***equity*** or venture capital is the least-used of the three typical financial products in most OECD countries. It is often regarded as a niche product for potentially fast-growing innovative firms. Private equity markets vary widely and generally often target larger or fast-growing companies. Equity and venture capital are not prominent sources of finance for SMEs, especially smaller ones. Indeed, across Europe, over 80% of SMEs consider that that "equity is not applicable to my firm" (European Commission, 2013). Equity products can provide significant amounts of medium-to-long-term capital but imply at least some loss of management control by founders and are typically more difficult to manage for public authorities.

Box 2.1. Grants vs financial instruments

From a policy design perspective, financial instruments are an alternative and complementary delivery mechanism to grants. Both instruments can be used to address gaps in access to finance. When deciding over grants or financial instruments to finance projects it is key to answer which delivery mechanism will be most effective and efficient to achieve policy objectives.

Box 2.1. Grants vs financial instruments *(continued)*

In practical terms, financial instruments can be used to finance investments that generate incomes or save costs enabling the initial support to be repaid. This means that where public intervention is justified by the need for public goods, repayable support is unlikely to be well-suited.

There is some consensus in the advantages of financial instruments over grants in three dimensions:

- Sustainability: FIs appear to be more sustainable than grants because funds need to be repaid, creating a legacy to invest.
- Project quality: projects financed through financial instruments seem to have greater quality as private sector appraisals enhances due diligence and repayment obligation encourages project managers to focus on results. There might be also a psychological dimension as both investee and investor share the risk.
- Cost-effectiveness: FIs can make a more cost-effective use of public funds partly because funds may be recycled, but also because of their potential to attract private funds.

Other important benefits of financial instruments are the decrease on grant dependency, the promotion of an "entrepreneurial culture" and a stronger support towards market development (niche). Yet, to encourage and make their use more efficient is important to articulate policies linked to grants and financial instruments. In general, financial instruments are not attractive when grants are available for the same purposes. Financial instruments play an important role in limiting grant dependency, provided that FIs and grants are appropriately dovetailed. To optimise their use it is crucial a comprehensive strategy that complements the use of financial instruments and grants and ensures advice and support through technical assistance, training, audits, etc.

Source: Wishlade, F. and R. Michie (2017), *Financial instruments in practice: uptake and limitations* Background paper prepared for the seminar "When to use financial instruments" held 28 June 2017, OECD Headquarters, Paris.

The rationale for using financial instruments

The use of financial instruments is justified by several types of market failures. In a hypothetical world with frictionless markets, finance would always be provided to the most valuable investments. However, in practice market failures prevent such an efficient outcome from emerging and projects that should receive financing from a societal perspective may not be able to obtain it. In these cases, public policy can intervene through the use of financial instruments (see also OECD, 2015).

First, financial instruments can be used to support the provision of goods and activities that are socially desirable, but that are not supplied in sufficient quantities by a free market. In some cases, they are not sufficiently supplied even when finance for these instruments is available. This includes the provision of merit goods and activities that create positive externalities. Public goods can be supported as long as it is possible to derive revenue streams from them that make it possible to repay the support (see Box 2.2).

Box 2.2. Public goods, merit goods and externalities

Public goods are goods that are non-excludable and non-rivalrous. In other words, a good is a public good if it is not possible to prevent people from using it and the use by one person does not diminish the value of the good for another person. An example of a public good would be an attractive square in a town. Everybody can use it and its value for other people does not diminish if somebody uses it. Because public goods are non-excludable, businesses cannot prevent people from using them and therefore cannot charge for their use. As a consequence, it is difficult to derive revenue streams from public goods and they are rarely provided by a free market. For the same reason, many public goods cannot be supported by financial instruments alone.

Merit goods are goods that are deemed socially desirable, but that are not provided in socially optimal quantities by the market because individuals are not willing or able to pay for them at market prices. An example of a merit good is affordable housing. In many cities, the market does not provide affordable housing for low-income families because it is more profitable to build housing targeted at higher income groups. In such a situation, affordable housing might be considered a merit good if it is in the public interest to build more of it.

Externalities are unintended effects of the activities of one actor on others. Economic theory calls for taxes on activities that have negative externalities and for subsidies on activities that have positive externalities. An example of an activity with positive externalities is research by a company. The company invests in research in order to increase its own profit. However, in the longer term, innovations created by the company will benefit the broader society. As the company is primarily concerned with its own profit and disregards secondary societal benefits of its research activities, it is likely to invest less in research than is socially optimal. In order to encourage the company to invest more in research, public support for private research activities (for example through financial instruments) may be justified.

Source: Based on Musgrave, R.A. (1959), *The theory of public finance: A study in public economy*.

Public support for public goods, merit goods and activities with positive externalities is generally beneficial. However, it is a priori not clear if public interventions should occur through financial instruments, grants or other forms of subsidies. The use of financial instruments could reduce the risk of supporting such activities. If the social benefits of a supported project do not materialise as expected and grants are used for their support, the public funds are lost without any benefit in return. In contrast, if support is provided by financial instruments, the public may recover some or all of the funds used to support the project.

Second, financial instruments can be used to alleviate market failures in the provision of finance to public or private entities. Several reasons prevent markets from providing optimal amounts of financing to businesses and public organisations. In particular, adverse selection and moral hazard – which are among the most common causes of market failures, justify the use of financial instruments. They can occur in the context of various market interactions. In the context of loan provision to businesses:

- **Adverse selection** (colloquially also known as the "market for lemons") occurs when businesses are better informed than lenders about the riskiness of their activities. Lenders would like to charge an interest rate that compensates them for the risk of a loan. The higher the risk of default, the higher the interest rate that is needed to compensate the lender. If lenders do not have good information about the riskiness of specific loans, they can only charge an interest rate across all

loans in their portfolio that compensates them for the average risk of default. However, such an interest rate would be too high for the least risky loans in the portfolio, making it unprofitable for businesses in this category to take out a loan. Thus, only businesses with riskier projects would take out a loan at such an interest rate. Knowing this, lenders would need to raise the interest rate to account for the higher average risk of their portfolio, thus pricing out even more businesses at the lower end of the risk spectrum, which in turn requires even higher average interest rates to cover the risk of default of the loan portfolio. Eventually, the market for loans will break down because lenders would have to charge interest rates at which it makes only sense for businesses with the most risky projects to take out loans.

- **Moral hazard** occurs when a lender has insufficient information about the behaviour of a business after it provides a loan. For example, a lender might provide a loan for a low-risk/low-return project to a business. However, after having received the loan, the business might decide to use the funds instead for a high-risk/high-return project. From the perspective of the business, this behaviour can be rational as a way to maximise expected profit. The higher profit in case the project is successful could more than compensate the higher risk of default. However, from the perspective of the lender, the change in behaviour by the business has negative consequences. As the interest rate of the loan is fixed, the lender will not benefit from the higher profit in case the project is successful but faces a higher risk that the business will default on the loan. Anticipating such behaviour by businesses, lenders would charge high interest rates for all loans. However, this makes it unprofitable for businesses to take out loans for low-risk/low-profit projects, leading to a breakdown in the provision of loans for these types of projects.

Both problems can lead to situations in which private providers of financing withdraw partially or completely from markets. While adverse selection and moral hazard are by far the most prominent problems related to imperfect credit markets, other reasons for market failures can be identified, such as:

- **Monitoring costs** can be too high. In general, private lenders have the possibility to invest in monitoring to overcome the information problems that can lead to adverse selection and moral hazard. However, the costs of doing so may be prohibitively high. In order to recoup monitoring costs, lenders need to charge higher interest rates, which can make it unprofitable for some businesses to take out loans.
- **Costs of due diligence** are conceptually similar to monitoring costs, but occur due to legal requirements associated with the lending process. They too can make the provision of finance unprofitable in some situations.
- **Thin or incomplete market** is a situation in which there are only a few borrowers or lenders. If lenders face a fix cost to enter a market (for example related to the opening of a branch office or to hiring a staff member with expertise in a sector), the fixed cost might outweigh the benefits from entering the market at all. Thus, if too few borrowers exist, lenders might not enter the market at all. If only a small number of lenders enter a market, they enjoy a monopoly or an oligopoly. Due to the inexistent or limited competition in these situations, lenders

might be able to raise the costs of a loan (i.e. the interest rate) to a level that is higher than in a well-functioning market.

- **Demand side failures** can occur if businesses are not able to access finance that is offered by lenders. For example, this can be the case if businesses are unable to provide loan applications that include detailed business plans. Alternatively, owners of businesses might be hesitant to take out loans or access other forms of finance even in cases in which it would make sense from an economic perspective. For example, owners might be hesitant to accept a dilution of their ownership stake or do not like the risk associated with accepting a loan.

Different types of businesses are affected differently by these market failures. For example, information asymmetries are particularly severe for start-ups and innovative businesses as it is difficult for outsiders to assess the degree of risk associated with their activities. For small businesses, the costs of information acquisition and compliance can be a particularly important factor, as they can quickly outweigh the benefits of a small loan or a small venture capital injection. Thin or incomplete markets are especially common in remote locations where only a few businesses and lenders operate, or in highly specialised market segments.

All market failures mentioned above imply that some businesses and public organisations will not be able to obtain financing even though there is an economic case for it. In these situations, governments can use financial instruments to provide financing that the market does not supply. They can fill a financing gap that is created by such market failures.

The economic context and geographic characteristics imply different challenges for the use of financial instruments in cities and regions. Depending on the level of economic development, the administrative and the nature of private investment, governments will draw upon these instruments differently. Within countries, spatial characteristics will also determine the extent to which these instruments are used as they determine the capacity of would-be entrepreneurs to raise their own finance (from family, friends or secured on property), bank lending, business angels and the operation of the venture capital and stock markets (Wishlade and Michie 2017). Complex institutional geographies of financial systems both reflect and influence their functioning. This, in turn, produces geographical effects on the ability of entrepreneurs to access finance, which typically work to the disadvantage of peripheral regional economies (Wishlade and Michie 2017). These disadvantages are often accentuated by weaker institutional and administrative capacity, both in the public and private sector, and thus, impact directly on the capacity to handle financial instruments.

Financial instruments in practice

Financial instruments are used in virtually all developed countries, in some cases with a subnational geographic focus and in others more generally on a national basis (Box 2.3). They are disbursed primarily by three groups of entities:

- **Investment funds** with a remit essentially limited to SME development, such as Innovation SME+ (Netherlands), Vaekstfonden (Denmark) and Industrifonden (Sweden).
- **Public financial** institutions which operate more than one fund (or funds of funds) and often collaborate with other organisations, but whose focus remains on

business development, especially SMEs, such as Finnvera (Finland), Land business banks (Germany), Bpi (France), Strategic Banking Corporation of Ireland (Ireland), Finance Wales and British Business Bank (United Kingdom).

- **Public banks** whose operations are on a more significant scale and extend into areas beyond SME development into infrastructure, lending to local authorities and potentially international operations, such as KfW (Germany), BGK (Poland), and ICO (Spain).

Box 2.3. Financial instruments: examples from Canada and Israel

Canada Small Business Financing Program: The CSBFP supports start-ups and existing businesses by providing guarantees on loans of up to CAD 500 000 offered through commercial banks. The CSBFP covers 85% of eligible losses on defaulted loans registered under the programme. The borrower is charged an upfront fee of 2% of the loan value (which can be rolled into the loan) and a yearly fee of 1.25% of the loan value paid through the interest rate and remitted to the CSBFP. The interest rate is variable and set by the lender, but under the programme is capped at three percentage points above the financial institution's prime lending rate.

Business Development Bank of Canada: BDC is a Canadian development bank that offers direct financing to businesses and provides indirect financing to intermediaries. Through its subsidiary BDC Capital, it provides different forms of equity to businesses. It has approximately 100 business centres located throughout Canada and offers extensive advisory services in connection with its financing activities. It offers general consulting to SMEs and specialised programmes targeting high-growth firms and firms that seek to export and expand internationally.

Israel's Small and Medium Business Agency: The Agency works to create a business environment that encourages growth within the business sector in Israel so that they are able to access financing. The agency offers a wide range of tools and programmes designed to support monitoring, evaluation, legislation, generating information and developing opportunities. The agency runs the nation-wide MAOF programme, that is responsible for, among other things:

- Identifying the needs of the business sector and providing professional consultants for relevant areas as necessary (marketing, finance, operations, design, export, etc.), while significantly subsidising the cost of the consultation package.
- Funding assistance via a variety of tools at its disposal including a loan fund guaranteed by the state, and other grants.
- Subsidising training programmes in a variety of fields (e.g. entrepreneurship and business management) and making information accessible to businesses that are supplied by the regional centres.
- Improving accessibility to funding programmes for businesses and entrepreneurs by helping them locate sources of funds and preparing business programmes at the regional centres.
- Operating an entrepreneurship programme for special populations and job-seekers via the regional centres.

Source: Wishlade, F. and R. Michie (2017), "Financial instruments in practice: uptake and limitations", Background paper prepared for the seminar "When to use financial instruments" held 28 June 2017, OECD Headquarters, Paris; BDC, www.bdc.ca (accessed 29 August 2017); and Israeli Ministry of the Economy, http://economy.gov.il/English/About/Units/Pages/SmallBusinessAgency.aspx (accessed August 29, 2017).

Within the context of EU cohesion policy, financial instruments are used to support economic development for regions and cities. The growing interest at the EU level in the use of financial instruments is partly due to the perceived "sustainability" benefits of repayable instruments against the backdrop of budgetary constraints (Wishlade and Michie, 2017). The European Commission has increasingly emphasised the role that financial instruments can play in Cohesion policy delivery; yet, only a small fraction of the cohesion policy funds are used for this purpose. That figure was 4% in the last period and is an estimated 6% in the current seven-year period. There are nevertheless challenges in ensuring that funds are allocated for such purposes, and when the case, that they are indeed disbursed (Box 2.4).

While many of the general goals tend to be similar between programmes in cohesion policy and financial instruments used elsewhere, those in cohesion policy do not serve an explicit counter-cyclical measure. Cohesion policy targets long-term development irrespective of cyclical fluctuations in economic activity and credit conditions. In contrast, many of the abovementioned entities have an important mandate to act as countercyclical lenders. They are supposed to replace private lenders during downturns and thereby buffer the effect of shrinking credit supply during recessions. This is reflected by strong increases in the disbursement of financial instruments during economic downturns by these actors. Even though financial instruments in EU cohesion policy are not intended to play a role as countercyclical stabilisers, they might be affected by credit cycles. If the markets supply of finance to private and public actors declines, they will more likely seek financing provided by financial instruments. Therefore, some cyclicality in the disbursement of financial instruments should be expected.

Box 2.4. Financial instruments in the EU Cohesion Policy

Financial instruments make up a small but growing share of the EU cohesion policy budget. For the programming period 2007-13, approximately EUR 17 billion were allocated for financial instruments. However, by the beginning of 2017 only approximately EUR 15 billion were disbursed to recipients. For the programming period 2014-20, the amount of funds allocated to financial instruments has been increased to EUR 21 billion. This corresponds to approximately 6% of all funds allocated to cohesion policy.

Beyond these averages, significant differences exist across member states in the prevalence and use of financial instruments within cohesion policy. During the 2007-2013 programming period, Italy alone accounted for 29% of all funds allocated to financial instruments 83% of those funds were actually disbursed to recipients by March 2017. For the 2014-20 programming period, the United Kingdom has committed the largest share of funds of its operational programme to financial instruments, with 20%. In contrast, Ireland, Denmark and Luxembourg did not committed funds of their operating programme to financial instruments.

During the programming period 2007-13, more than 85% of financial instruments by volume were allocated to enterprises, whereas the remaining funds were used to target urban development and green energy projects. During the current programming period, EUR 8.5 billion are committed exclusively to SME support, EUR 3 billion to low carbon projects, EUR 2 billion to research and innovation and the remaining EUR 7.5 billion to multiple or other thematic objectives.[1]

[1]EUR 8.5 billion have been committed exclusively to SMEs, but SMEs may also receive funds committed to other Thematic Objectives. Thus, the total amount of financial instruments that will be used SMEs is likely to be higher than EUR 8.5 billion.

Source: Wishlade, F. and R. Michie (2017), "Financial instruments in practice: uptake and limitations", Background paper prepared for the seminar "When to use financial instruments" held 28 June 2017, OECD Headquarters, Paris; Summary of data for the whole 2007-2013, http://ec.europa.eu/regional_policy/en/funding/special-support-instruments/ (accessed 31 March 2017); and Summaries of data for 2014-2020, http://ec.europa.eu/regional_policy/en/funding/financial-instruments/.

Practical lessons for the use of financial instruments

Advantages of financial instruments as compared to grants

- Projects funded by financial instruments might have a higher probability of success

Financial instruments often attract businesses with better investment projects. Financial instruments can lead to better investment decisions than grants because they require businesses to pay back the support they receive. Therefore, businesses pay greater attention to ensuring that an investment project is viable and is likely to yield a positive economic return. In contrast, the possibility to receive a grant can incentivise businesses to make investments that have little economic benefit. For example, businesses may use grants to invest in machinery that proved to be of little value due to high maintenance costs. The decision to invest in the machinery in these cases is primarily motivated by the availability of the grant and not fully justified by the business case.

- Financial instruments do not create grant dependency

Another potential side effect of grants, one that can actually harm businesses, is the so-called grant dependency. The availability of grants can lead businesses to concentrate their activities on securing them rather than on developing business models that are viable without public support. In the long term, this can lead to business models that are better at applying for grants than at collecting revenue through market activities. Perhaps paradoxically, this can harm particularly innovative firms as they are the most likely to receive grants for their innovations, but may struggle to turn innovations into viable business models.

- Simplified administration

Some financial instruments are comparatively easy to administer from a public administration perspective. In particular, loans and credit guarantees can be easy to use, as their distribution can be outsourced to financial intermediaries or specialised funds. At the project level, within EU Cohesion Policy, financial instruments are not subject to the same monitoring requirements as grants. This removes a significant burden on managing authorities and providers for specific projects.

- Public financial instruments can improve the offer of private financing

Financial instruments can help to create institutional conditions that foster the emergence of a private market for financing. For example, they can help SMEs and public organisations to develop the skills to write a loan application or a business plan that is required to obtain a loan on the market. In the long term, this can increase demand for financing from prospective customers and can encourage more private lenders to enter the market.

Drawbacks and limits to the use of financial instruments

Several factors limit the use of financial instruments. First and most fundamentally, projects need to generate positive future revenue streams. As all financial instruments involve repayable financing, projects need to generate revenues that are greater than their operating expenses. This makes it impossible to use financial instruments exclusively to support some projects. For example, many projects that create pure public goods cannot generate revenues (Box 2.2). Likewise, some social services and projects aimed at

environmental protection do not generate any revenues and therefore, cannot be only supported by financial instruments.

While market failures justify the use of financial instruments, governments do not always operate efficiently either. "Government failures" can lead to inefficient implementation of financial instruments. These failures can be more severe than market failures and in some cases and government intervention seeking to alleviate market failures can increase distortions rather than reduce them. In some cases, government failures are directly linked with challenges that also explain market failures. For example, governments suffer from information asymmetries in similar ways as private lenders. They are also subject to moral hazard problems and face costs of information acquisition and due diligence. However, in contrast to private lenders, governments can decide to disregard these problems and to continue lending, accepting the losses that are incurred in the process as a price worth paying for the provision of finance to the targeted businesses.

Beyond government failures due to information asymmetries, governments also face challenges related with the political process when using financial instruments, in particular, the risk of political capture. Governments might decide the distribution of financial instruments based on political criteria and well-connected or politically favoured businesses or public entities could receive preferential support. Furthermore, when governments work with private intermediaries, there is a risk that the incentives of governments and intermediaries are not well-aligned. In such a case, intermediaries might distribute support according to criteria that do not match the government's objectives.

Practical considerations to implement financial instruments

- Preparing an accurate assessment of the market situation

A thorough understanding of the market situation is a precondition for a successful public intervention using financial instruments. An assessment of the market situation and specific contextual characteristics needs to identify where shortfalls in access to finance exist and what market failures are responsible for them. The market assessment should be comprehensive and detailed to provide a basis for policy and efficiently target financial instruments. As important as the context, is the assessment of administrative and technical capacities of stakeholders in the targeted city or region. Such an assessment should be conducted with the involvement of public and private stakeholders to ensure a balanced perspective of the context. It should include location specific differentiation where necessary and relate them to strategic objectives of public authorities. Lastly, the assessment should be forward looking in order to integrate, as much as possible, possible future changes in economic conditions. The analysis needs to be reviewed regularly to ensure its continued accuracy.

A market that is sufficiently "dense" favours the development of financial instruments. Density, in this context, refers to the number of suitable projects, investors and co-investors, and intermediaries (banks or fund managers) that exist. An environment with stakeholders having the appropriate expertise to deal with financial instruments also favours their development. Still, financial instruments can be used to develop a suitable ecosystem; the Scottish Co-Investment Fund has been found to have grown both capacity and capability in the market, for example.

- Incentive design matters

Financial instruments are commonly distributed through third party funds that have contractual agreements with public authorities. These agreements provide incentives to

funds that are not necessarily aligned. Whereas the theory behind the use of financial instruments is relatively well-established, contract design can be complex and depends strongly on the circumstances. Whenever the disbursement of financial instruments is outsourced to third parties, careful attention has to be given to the construction of the contract, making sure that the right incentives are provided.

As a consequence, it is important to distinguish between flaws in the financial instrument and flaws in the incentives if financial instruments are not implemented as planned. For example, private intermediaries tasked with the disbursement of financial instruments might have incentives that cause them to be more risk averse than desired by the public authority. If financial instruments do not produce the intended results in these cases, it is not necessarily a flaw in the design of the financial instrument itself, but in the incentives related to its disbursement mechanism.

To build effective links with the private incentives need to be aligned; for example, the introduction of yield restriction or loss mitigation clauses or asymmetric models for the distribution of profit can encourage private involvement. Beyond the alignment of incentives, effective control procedures need to be in place.

- Ensure stability and predictability

Recipients of financial instruments need stability and predictability in public interventions in order to be able to plan financing decisions according to business cases. Furthermore, potential recipients of financial instruments find it easier to keep informed about existing offers and the associated terms and conditions if there is sufficient continuity in public programmes.

- Ensure a suitable regulatory framework

The regulatory framework in which financial instruments are developed can determine their use and effectiveness. In general, legislation tends to be complex and subject to heavy reporting and administrative burden, which contrast with private sector practices. Administrative burden resulting from long and sometimes un-coordinated regulations may discourage the involvement of the private sector. It is thus crucial to ensure a clear and stable regulatory framework to encourage private involvement. The optimal size of funds to administer financial instruments can vary.

Opinions concerning the optimal size of funds that administer financial instruments differ. On the one hand, larger funds can be helpful due to economies of scale in the costs of administering them. Given that the fund administration involves certain fixed costs, larger funds have generally lower administration costs than smaller ones (see also European Court of Auditors, 2016). Thus, it is desirable to have a certain minimum size of funds. This view was supported by the fact that the administration costs of many funds that administer financial instruments are significantly higher than the market rates that fund managers charge (which could be viewed as a benchmark for administration costs). On the other hand, financial instruments tend to target specific segments of firms and public institutions that are not well served by the general market. Often, these segments are small and geographically fragmented. In order to reach them, funds need specific knowledge, for example related to industries or locations that can only be obtained by specialised funds. However, such specialised funds are limited in size by the size of the market segment they target. Trying to increase fund size beyond this limit may lead to a loss of specialisation and the corresponding knowledge.

It is unlikely that there is a universal rule how to best resolve the trade-off between greater economies of scale of larger funds and greater specialisation of smaller funds. Instead, funds in some areas have the potential to grow to reap greater economies of scale, whereas in other areas it is preferable if funds remain of limited size to target niche markets effectively.

- Increase risk tolerance of public authorities by focusing on average repayment rates

There is a need for greater risk tolerance of public authorities when using financial instruments. Defaults and other failures to pay back financial instruments are unavoidable. Strong risk aversion can lead to an ineffective disbursement of funds by public authorities. The more risk-averse public authorities are, the more closely they tend to mimic behaviour by private investors who care predominantly about their financial returns. As a result, they tend to provide finance to businesses and public organisations that could also obtain it from the private markets, thereby rendering public intervention ineffective or even harmful. In managing risk, public authorities also tend to over-emphasise losses with financial instruments relative to grants. If a grant project fails to achieve its goals that is also a loss, albeit this may be less visible.

In order to increase acceptance of risk by public authorities, it is beneficial to focus on average default rates across programmes instead of on individual cases. Politically, it is often feasible to make the argument that a certain fraction of funds allocated to financial instruments will not be recovered. In contrast, discussions about failed investment decisions might become politically sensitive. This is especially the case if new information emerges after the decision to disburse financial instruments that suggests that the decision was unwise but that was not known at the time of the decision.

- Address demand side issues

If the uptake of financial instruments is low, it is often caused by demand side issues. For example, lack of interest is one of the most common reasons for a limited use of financial instruments reported by cohesion policy managing authorities. Several factors might be responsible for this. First and most, fundamentally businesses might lack bankable projects that have sufficient collateral, future cash flows or adequate risk profiles to be suitable for loans, venture capital or other types of support through financial instruments. However, it should be kept in mind that financial instruments have the purpose of providing finance to projects that could not receive finance on the free market. They do not need to apply the same strict standards that are applied for market-based financing with respect to the abovementioned requirements. Thus, if uptake of financial instruments is low, it needs to be verified that the criteria for their disbursement are not too restrictive, for example because the public sector is excessively risk averse.

Other reasons for a low uptake of financial instruments, especially among SMEs, can include reluctance among owners to accept them. On the one hand, this might be due to the design of the financial instruments. For example, overly short payback times and regulatory uncertainty can limit their attractiveness. On the other hand, it might be cultural factors that make owners reluctant to accept financial instruments. These can include an aversion to the increase in the risk profile that comes with accepting loans or to the loss of control due to a dilution of the ownership share that comes with a venture capital injection.

Conclusion and ways forward

Financial instruments are used in many countries and make up a small but growing share of funds used in EU Cohesion Policy. Economic theory provides a clear and undisputed justification for their use by identifying market failures that lead to problems such as adverse selection and moral hazard that prevent an adequate supply of finance to public and private investors by markets.

Compared to grants, financial instruments have a particular advantage – they tend to attract investors with better projects. The requirement to pay back support makes them less attractive for businesses that do not expect returns on their invest investment. In contrast, if investments are paid for by grants, businesses might be willing to make them, even if they do not expect them to create significant future revenues.

Because financial instruments tend to attract more high-quality investments, and they are often administered by third parties, public authorities are better able to manage financial instruments in a comparatively hands-off approach. The behaviour of recipients is steered primarily by incentives related to the requirement to pay back the support. In contrast, grants rely on command-and-control management mechanisms. They involve performance requirements and detailed reporting from grant recipients, but are not always effective. Public authorities might have less information on the use of funds by recipients when using financial instruments. Nevertheless, their performance can be better than that of grants due to better aligned incentives.

While the theory behind the rationale for the use of financial instruments, the challenges in practice reveal that more effort is needed to make the most of their potential. In some cases, perhaps they are being used in practice in cases where the theoretical rationale is not satisfied. There is also an important issue of programme design, public risk aversion and the availability of high quality projects. Successful models across the world vary considerably and it is likely that no one-size-fits-all solution exists. Instead, approaches have to be tailored to the market segments that are targeted, to the geographical area which may have unique market characteristics, and to the institutional framework within a country.

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Chapter 3

Contracts to manage the stability vs. flexibility trade-off in regional development policies

In times of fiscal constraint and uncertainty, governments need to balance long-term regional development policies seeking to provide certainty for the public and private sector, with the need to adapt these policies to new priorities and innovation. This chapter explores how contracts can be more flexible across levels of government to respond to these challenges, while not compromising stability. It revises the rationale behind the use of contracts for regional development and looks into new insights from contract theory. After assessing how countries are using contracts, the chapter provides some key lessons from frontier thinking and practical experience for policy makers to design more effective contractual arrangements.

Introduction

Governments are seeking to improve the efficiency and effectiveness of public intervention in a context of significant changes in the economic environment, as well as issues related to climate change, migration, macro-economic shocks and demographic change. In such an uncertain context, policy makers face multiple trade-offs. Budgetary policies need to take into account the long-term nature of the processes that policy is seeking to influence, whether it be to invest in the quality of infrastructure or people's education and skills, to encourage innovation and entrepreneurship, or to improve the quality of institutions. At the same time, such budget arrangements need to be flexible and adaptable enough to address significant economic, environmental and social changes that come to pass. There is therefore a trade-off between long-term programmes for economic development which provide certainty for the public and private sector, and the need to adapt to new priorities and innovate within public policy.

Contracts are one of the tools used by governments to set a framework for long-term investments in cities and regions. The European Cohesion Policy, for example, is implemented through long-term programmes (7 years) across levels of government. Such programmes provide stability of expenditure in the context of shrinking budgets and fiscal constraints at both national and regional level. However, such arrangements may also generate various challenges, including: i) a significant inertia in the contracting system, which makes difficult to adapt to emerging needs that cannot be foreseen in advance; ii) the difficulty to align objectives between grantee, regional and national (or European) levels; iii) the risk of rent seeking behaviour from contracting parties; iv) and significant information gaps, such as asymmetries of information and incomplete information.

This chapter draws on background papers for and discussions at the seminar "Multi-level governance for regional economic development: a focus on flexibility and adaptability" held 23 January 2017 at the OECD Headquarters. This seminar was part of the seminar series conducted in the context of the partnership between the European Commission and the OECD project *Designing better economic development policies for regions and cities*. Seminar background papers include:

- Brousseau, Eric (2017), "Contract as reference points: A new approach to contracting and its implication for relationships among levels of government", Background paper prepared for the seminar "Multi-level governance for regional economic development: a focus on flexibility and adaptability" held 23 January 2017 at the OECD Headquarters in Paris, France.
- Bradford, Neil (2017), Canadian regional development policy: "Flexible governance and adaptive implementation", Background paper prepared for the seminar "Multi-level governance for regional economic development: a focus on flexibility and adaptability" held 23 January 2017 at the OECD Headquarters in Paris, France.
- Claire Charbit and Oriana Romano (2017), "Governing together: An international review of contracts across levels of government for regional development", Background paper prepared for the seminar "Multi-level governance for regional economic development: a focus on flexibility and adaptability" held 23 January 2017 at the OECD Headquarters in Paris, France[1].

Based on these background papers and seminar discussions, this chapter addresses several questions to support policy makers in managing such trade-offs:

- How can flexibility be included in the contractual system to respond to challenges, while not compromising the stability?
- What are the new insights from contract theory and how can they be used in practice? How is this trade-off between flexibility and stability reflected in different country practices?

Theoretical approach and frontier thinking

The rationale behind the use of contracts

Regional development is a shared responsibility across levels of government, even in federal countries.[2] Implementing the Constitution (the "master" contract) requires a number of mechanisms to co-ordinate across levels of government that are legally independent and autonomous actors; however, they are dependent on each other for achieving policy goals. Such interdependencies across levels of government may take several forms, including financial arrangements. While regions within countries are increasingly gaining more autonomy and decision making power, those interdependencies do not disappear with greater decentralisation. In the OECD area, for example, subnational governments accounted for about 60% of public investment in 2016, which is by nature a shared responsibility across levels of government. While in the past the focus of contracts was mainly for delegating functions through earmark funds to specific programmes and purposes, there is an increasing effort to provide incentives upfront (*ex ante*) so as to spend funds toward desired goals and to monitor achievements after the funds are spent (*ex post*).

As recognised by the OECD *Recommendation on Effective Public Investment across levels of Government,* tools to co-ordinate are needed to overcome a series of challenges when different levels of government are dependent on each other for achieving goals. Such challenges can be described as gaps. An *information gap* exists when one party has more information than the other; these asymmetries of information can be voluntary (moral hazard and adverse selection) or not (central and subnational governments simply do not have the same level of information). A *policy gap* may occur due to a lack of co-ordination across sectors or policy fields to address complex issues in a consistent way. An *administrative gap* may happen due to administrative and functional mismatches in terms of the area where the activity takes place and the perimeter of the policy maker's jurisdiction, therefore actions to build the right scale for greater effectiveness of public investment may be required. Different levels of government do not always share the same objectives or frame of reference, leading to what can be referred to as an *objective gap*. There are also differences across regions in terms of transparency and integrity of public and private action (*accountability gap*), as well as subnational capacities for policy implementation (*capacity gap*). Finally, the *funding gap* raises questions about how effectively resources are allocated and how adequate they are to achieve the targets[3].

Table 3.1. Summary table: Multi-level governance gaps

Gap	Description	Actions needed
Information gap	Asymmetries of information (quantity, quality, type) between levels of government, either voluntary or not	Instruments for revealing and sharing information
Capacity gap	Insufficient scientific, technical, infrastructure capacity of subnational actors, in particular for designing appropriate strategies	Instruments to build local and regional capacity
Funding gap	Unstable or insufficient revenues undermining effective implementation of responsibilities at subnational level	Shared financing mechanisms
Policy gap	Silo approaches by sectoral ministries and agencies	Mechanisms to create multidimensional/systemic approaches at the sub national level, and to exercise political leadership and commitment
Administrative gap	"Mismatch" between functional areas and administrative boundaries	Instruments to reach "the appropriate scale"
Objective gap	Different actors have different and often contrasting objectives creating obstacles for convergent targets	Incentives to align objectives
Accountability gap	Difficulty to ensure the transparency of practices across the different constituencies	Institutional quality measurement; instruments to strengthen the integrity framework at central and local level; instruments to enhance citizens involvement

Source: Charbit (2011), "Governance of Public Policies in Decentralised Contexts: The Multi-level Approach", OECD Regional Development Working Papers, 2011/04, OECD Publishing, http://dx.doi.org/10.1787/5kg883pkxkhc-en.

There are several instruments to address the aforementioned multi-level governance gaps that are used in OECD countries. They include co-ordinating councils, regional development agencies, or special conditions for spending, for example, and they can address one or more of these gaps. In Australia, for example, the Intergovernmental Council (COAG) gathers representatives of subnational entities and equivalent ministries at federal government. In Canada Regional Development Agencies (RDAs) collaborate together with the provincial governments on many projects, and champion the interests of their regions at the federal level.. The EU, like many other international organisations and national governments, applies conditionalities to require that certain actions be taken as a condition of receiving the funding. In the Netherlands, a Special Commission for the Delta co-ordinates public and private actors involved in the future of particular regions given particular challenges for water management. In addition, different forms of intergovernmental arrangements involving a range of different contractual relations of different types are widely used as they are comprehensive enough to address all of the aforementioned multi-level governance gaps.

Contracts across levels of government can be defined broadly as any arrangement that reorganise the rights and duties of governments, other than by way of the constitution. They define mutual obligations of parties, which have to agree on authority (the assignment of decision rights), respective duties, and enforcement mechanisms. Contracts can be complementary tools to both formal and informal arrangements. While some countries may not explicitly refer to certain arrangements as contracts, if they fulfil the basic characteristics described above, they should be considered as such.

It is possible to distinguish three types of contracts fulfilling different objectives:

- *Empowerment contracts* that can help subnational authorities, during early stages of decentralisation, to develop new capacities and gain greater autonomy in dealing with regional development policies.
- *Delegation contracts* by which the central government delegates the implementation of specific tasks to subnational government; capable of fulfilling those tasks. Delegation is based on the assumption that regional and local actors are better positioned to implement national policies at the local level. Often such contracts are used with the assumption that it will also lead to greater efficiency in public spending.
- *Policy-sharing contracts* where the central and subnational government co-operate in order to fulfil certain competences (see Table 3.2).

Contracting approaches can favour information sharing and mutual understanding in how to address a common policy priority, while at the same time reduce transaction costs for implementing a policy and generate trust between public actors for their future endeavours. Both central and subnational governments may also seek to innovate in particular areas, building new capacities and new approaches to policy making, and in these cases the contract is a tool for collective learning.

Table 3.2. Different types of contracts

Type of contract/ Objective	Description	Examples
Empowerment	Tool for transferring responsibilities to subnational governments, which gradually build capacities for implementing regional policies. Empowerment contracts may concern all regions lacking of expertise in the case of early stages of decentralisation. Example of outcome: capacity-building	In France, State-Regions Contracts (*Contracts des projets État-Regions* – CPERs) initially aimed at building regional capacities, accompanied the regionalisation process. The contract was the result of a long process of negotiation between the elected regional (and local) authorities and the regional "Prefect", representing the central government and its different ministries at regional level. In practice, parties agreed upon objectives, implementation and funding of specific tasks The Italian Pacts for the South (2016) aim to achieve economic growth, employment and environmental sustainability goals. They define priorities, actions for implementation and responsibilities of parties.
Delegation	The central government sets the objectives and delegates the implementation of specific tasks to a capable subnational government. Delegation is based on the assumption that regional and local actors are better positioned to implement national policies at the local level. Example of outcome: efficiency in public spending	The "Devolution Deals", in the United Kingdom are cross-government arrangements between central government and local areas, which involve the devolution of powers and resources, previously allocated at central level, to city regions and metropolitan areas. In Québec, responsibility for rural development is defined through contracts (place-based partnerships – "Rural Pacts" –) between the government and elected municipal representatives who manage the Regional County Municipalities (*Municipalité Regionale de Comte*, MRC).

Table 3.2. Different types of contracts *(continued)*

Policy-sharing	Central and subnational governments co-operate in order to fulfil competences that are overlapping or not fully addressed. Policy-sharing contracts allow common decision making, dialogue and collective innovation Example of outcome: Reduction of transaction costs and trust enhancement	In Spain, the "Collaboration contracts" (*Convenios de colaboración*) are co-operative agreements between the central government and the Autonomous Communities (ACs). They are negotiated on a sectoral basis, distributed between the different Spanish ministries. The Climate Adaptation City Deal in the Netherlands was signed in 2016 between the Ministry of Infrastructure and the Environment, three regional water authorities, five cities (The Hague, Dordrecht, Gouda, Rotterdam and Zwolle) and other seven partners (research centres and companies). The aim is to create a learning environment for climate adaptation at urban level for the next 4 years.

Source: Charbit, C. and O. Romano (2017), "Governing together: An international review of contracts across levels of government for regional development", *OECD Regional Development Working Papers*, No. 2017/04, OECD Publishing, Paris, http://dx.doi.org/10.1787/ff7c8ac4-en.

In the context of economic development for cities and regions, contracts can be adapted to the needs of different region and city types. The key point is to specify the regional development priorities to be addressed by contracts, which can be supported by a careful assessment of the needs and opportunities in each place. In unitary states, contracts are often used in the framework of decentralisation policies, to empower subnational governments or delegate tasks. In that context, they tend to be long-term agreements. In federal states, contracts are more complementary, specifying co-operation on tasks that are not well defined by existing constitutions or legal frameworks. Such contracts tend to be shorter term and with a narrower focus.

There are two main logics of contracting among levels of government: transactional and relational logics. In transactional contracts, the respective duties of both parties can be stated in advance, and are thus complete because the different parameters can be quantified and measured. In contrast, with relational contracts the parties mutually commit to co-operate in the future and design a governance mechanism for that purpose. In this case, contracting means implementing bilateral negotiation mechanisms and guaranteeing in the long run the dynamics of co-operation. Because of the complexity and the impossibility to establish certain conditions upfront, relational contracts are less complete. Typically, contracts aimed at dealing with regional development policies tend to be relational. However there are contracts encompassing elements of both transactional and relational contracts, especially when infrastructure projects are foreseen.

Recent advances in contract theory to inform policy design[4]

The economic literature provides several responses concerning the trade-off between flexible versus rigid commitments among parties. Issues generally considered include: the conditions attached; the objectives of the agreement; the complexity in measuring performance; the rationality of partners; the incentives that influence their behaviour; the financial arrangements; and the scope for innovation and experimentation. For these reasons, contractual arrangements have been extensively used in a variety of interactions between parties, including public authorities, and offer an interesting analytic lens to address the stability/flexibility trade-off. In practice, contracts are a tool for managing territorial adaptation. However, their flexibility in time may seem less evident. First, because they are precisely put in place to engage parties towards future identified results;

and second because the aptitude to take into account past results to shape future contracts remains limited.

Recent developments of contract theory, initiated with a 2008 paper by Hart and Moore (Hart and Moore, 2008) and subsequently the subject of the 2016 Nobel Prize in economics (Oliver Hart and Bengt Holmström), provide inputs for shaping contractual design across levels of government. In contrast with prior theories, the Contract as Reference Points Theory (CRPT) raises the issue of *ex post* adaptation, interpretation and renegotiation of contracts, which can be driven either by the need to adapt to contingencies or by exogenous shocks such as major changes in the macro-economic or political contexts (Table 3.3).

Table 3.3. Theoretical frameworks for contract theory

Theoretical frameworks	Focus	Assumptions	Limits
Incentives theory / Principal agent theory	Incentives to fix information asymmetry between parties	Perfect rationality / perfect enforcement	No *ex post* issues
Incomplete contract theory / Property rights theory	Distribution of ex post rights of decision upon surplus	Perfect rationality / imperfect Enforcement (unverifiability of inputs)	*Ex post* issues fixed *ex ante*/ specific investments requested
Transaction cost economics	Distribution of authority (mutual duties and enforcement)	Imperfect rationality / imperfect enforcement (costly decision)	Authority assumed to minimise costs of adaptation and haggling / specific investments requested
Contract as reference Points theory	Design of ex post adaptation mechanisms	Perfect rationality / imperfect enforcement (unverifiability of output)	Calibrating the dimensions of the flexibility/rigidity trade-offs

Source: Based on Brousseau, E. (2017), "Contract as reference points: A new approach to contracting and its implication for relationships among levels of government", Background paper prepared for the seminar "Multi-level governance for regional economic development: a focus on flexibility and adaptability" held 23 January, OECD Headquarters, Paris.

The **Incentive Theory**, also known as the Principal-Agent approach, focuses on information asymmetries between the parties and details how incentives schemes can help fix them. The design of these schemes calls for a perfect knowledge *ex ante* of the structure of the issues to be fixed *ex post*. The *ex post* adaptation issue is out of scope: if the contract is no longer valid under certain circumstances, the way forward consists in voiding it and negotiating a new contract to adapt to the new situation. However, this is not always possible or is too costly, as in the case of long-term investment contracts.

The **Incomplete Contract Theory**, also known as the Property Rights approach, implies that the parties will develop their own mechanisms to guarantee implementation and enforcement. Since there are non-verifiable dimensions of the exchange/co-operation between the parties, contracts are incomplete. The non-verifiable dimensions are not contractible and consequently non-enforceable, so there will be a distribution of *ex post* rights decision upon surplus. The theory does not analyse the impacts of the granted decision rights on the incentives of the party to optimally adapt in the event of significant/qualitative changes in the environment.

The **Transaction Cost** approach considers that the contracting parties do not have enough knowledge and information to design *ex ante* perfect incentive schemes. It also assumes that enforcement institutions are imperfect; making it such that parties do not always comply with their contractual obligations. The devolution of authority to one of

the contracting parties is intended as a way to minimise the costs of adaptation and haggling. However, the theory does not consider the limits of authority and implicitly assumes that the principal can fully control the behaviour of the agent *ex post*.

These first three theories assume that contracts can be adjusted in the *ex ante* negotiation. They imply that parties should have anticipated the issues and foreseen solutions *ex ante*. There are no inputs on the renegotiation of contracts *ex post*.

Ex post adaptation is, however, considered by the Contract as Reference Points Theory (CRPT). The theory relies on two main assumptions: perfect rationality but imperfect enforcement. The latter is due to the fact that there are always some dimensions of a contribution to a transaction that are difficult to assess (e.g. of quality of work). According to this theory, parties negotiate upfront and will decide how to behave *ex post* in the next period. Parties can deliver either a basic (*perfunctory*) verifiable performance (basic level of provision of service) or an exemplary (*consummate*) unverifiable performance (e.g. working "hard" x hours: difficult to verify "hard"). Contracting parties expect from one another the provision of an exemplary/consummate performance. This implies commitment and credibility. If these expectations are not met, there will be disappointment (*aggrievement*) that can result in additional costs to prevent retaliation (*shading*) , leading to *ex post* conflict or to under-performance, which results in deadweight losses or only basic performance that generate inefficiencies.

However, aggrievement may not occur if one of the parties does not mind the other party's under-performance, or in the case where there is little difference between the basic and exemplary performance. Shading is not possible or difficult in case of verifiability in consummate performance. In the case of shading, contracts that are too flexible can be manipulated *ex post* by one of the parties. The theory therefore calls for contracts that are less subject to interpretation and manipulability than the usual recommendations from other contract theories. Everything being equal, more rigid or shorter term contracts should be preferred. This means that new arrangements should be renegotiated when adaptation is needed.

Concerning the typologies of contracts, the theory would suggest that for transactional contracts (delivery of a good/service in exchange of payment/grant) rigid contracts would be preferred to avoid aggrievement and shading (see Box 3.1). Flexibility could be obtained through indexation, but it should be totally external to the parties to avoid possible manipulation of budget and costs. Relational contracting (*ex post* mutual adjustments of contributions) foresees rigidity on purpose, but flexibility in the implementation. However, the reshaping of the relationship *ex post* could generate aggrievement and shading. Between these two categories, there is an intermediary one (delivery of a good/service of uncertain quality), by which the authority is given to the party more attentive to quality (if there are asymmetries in potential aggrievement and shading).

Box 3.1. Why the CRPT is relevant for both transactional and relational contracts

Transactional contracts tends to be "complete" agreements in which the reciprocal duties of the parties are established in advance, while relational contracts establish a governance framework to make decisions in the future about the actual rights and duties of parties.

Box 3.1. Why the CRPT is relevant for both transactional and relational contracts *(continued)*

A transactional perspective is relevant in case of shorter/simpler relationship, especially when one of the parties expects from the other the delivery of a good or service in exchange of a payment; e.g. a grant. A relational perspective is more adapted when i) there are complex mutual provisions in kinds by the two parties; ii) the parties face uncertainties that prevent setting mutual requirements *ex ante*; iii) parties are interdependent in the sense that the quality of either provisions should be mutually adjusted.

At first sight, the CRPT addresses the transactional perspective in contracting since one of the conclusion of the theory is that, in many settings, it is better to write simple rigid contract and to renegotiate in case of significant change in the environment. Moreover, the theory relies on theoretical models that describe a very simple "transaction" between a buyer and a seller who make decisions about price and quantity (or quality considered in a single dimension; e.g. low vs. high).

While relevant for the analysis of transactional contracts, the theory is also useful to understand relational contracting. The core issue addressed by the theory concerns indeed the fundamental trade-offs it highlights between rigidity, aimed at protecting the parties — against each other "opportunistic" behaviors and against external risks —, and flexibility that allows to adapt to new conditions. The theory highlights that flexibility has a cost, and that therefore there are tradeoffs in terms, both, of cost and risks when adopting a more flexible contract, whether it is transactional or relational.

A typical flexible transactional contract is based on contingent clauses, renegotiation mechanisms, etc. A typical relational contract, while, by definition, more flexible than a transactional contract, can either implement several mutual commitments (as default quantity and quality to be exchanged, restricted spans of renegotiation, etc.) or be loose and implement only a mechanism to negotiate *ex post*. A (more) rigid relational contract is precise about the purpose of the co-operation, and is flexible about implementation.

An extremely flexible contract would typically allow renegotiations even on the purpose and the objective of the relationship *ex post*. As pointed out by the CRPT, this could be suboptimal. A contract being rigid on purpose, but flexible on implementation would be most preferable, when transactional contracting is non-implementable, and more relational contracting is requested. In other cases, a rigid contract, which revision should be based either on some form of indexing, or on assessment of contractual performance by a third party should be settled.

Source: Brousseau, E. (2017), "Contract as reference points: A new approach to contracting and its implication for relationships among levels of government", Background paper prepared for the seminar "Multi-level governance for regional economic development: a focus on flexibility and adaptability" held 23 January 2017, OECD Headquarters, Paris.

Legitimacy is a key dimension for contractual agreements. The CRPT theory insists on the necessary legitimacy of the fair conditions of the initial contracting phase, consisting in having objective information and balance between the parties. Moreover, the theory highlights the role of the necessary legitimacy of any process of adaptation of the agreement to unforeseen contingencies. The mechanisms triggering adaptation as well as any process of revision should involve equally the two parties, to avoid manipulations and ensure that the revision is fair to avoid any dominant positions.

Some lessons from this latest theory can be drawn concerning the adaptation of contractual commitments to shocks/radical changes and with respect to the stability vs. flexibility trade-off. They include:

- **An independent agency can facilitate and oversee negotiation and revision:** such an entity would help in the revision, by collecting the information, providing background, and helping the party with less capability to negotiate a contract, for example.
- **Short-term commitments, although renewable, are preferred:** if uncertainty and *ex post* adjustments are expected, there should be a preference for short-term renewable commitments. Renewable commitments could help limit renegotiations to only cases of significant adjustments, thus avoiding costs of renegotiations when possible.
- **Renegotiation should not be subject to manipulation:** this means implementing automated renegotiations (when certain thresholds or ceilings are reached), or clauses establishing that renegotiations should be decided by a trusted third party. Such mechanisms should be preferred to any provision allowing one of the parties to call for renegotiation.
- **Decision rights should be granted to one of the parties only in very specific situations:** an example is when either the central or subnational government cares more than the other about the way a public good is provided. In other circumstances, discretion in the adaptation of the contractual commitment should be avoided.
- **Contracting among levels of government should be envisaged in the long-term perspective of building trust:** while in the long run trust allows mutually beneficial adjustments, in the short run, unilateral decisions to adapt to circumstances might generate distrust and under-performance. It may be preferable to perform an inefficient contract and wait for the next contract, rather than adapting the existing one at the cost of diminishing mutual trust.

Contracts in practice

How are countries making use of contract approaches?

Many countries are actively using contracting approaches. This section assess opportunities to consider on how such existing approaches could be reviewed in light of the advances in contract theory that, as highlighted above, place a greater emphasis on the relationship of the contracting parties and thus have implications for how to structure contracts.

The EU context

EU Cohesion Policy is delivered through programmes which are in fact several different contractual relationships of different nature. These long-term programmes in EU Cohesion Policy provide stability, which is seen as a major advantage. This also requires having a ten-year vision, which is not easy to achieve. There are several forms of contractual arrangements in EU Cohesion Policy, including Partnership Agreements and Operational Programmes as well as tools and instruments for implementation such as Integrated Territorial Investments, among others. Very often there are trilateral

relationships, among local/regional, national and European levels, adding complexity to contract implementation.

In a context of financial crisis, providing stability is certainly an advantage. However, responding to emerging challenges requires some flexibility. The issue of flexibility does not only concern Cohesion Policy, but the EU budget as a whole. Flexibility represents the capacity of the budget to react rapidly without major legislative changes to emerging challenges (e.g. migration, security and external borders) and unexpected priorities, which could not be identified *ex ante* in the negotiation phase of the contract. However, there are drawbacks to flexibility: flexibility can create instability, administrative costs and undermine shared commitments to long-term goals. Despite the prevalence of stability, there are already some options for flexibility, such as that of shifting money across priorities within the same programme, the possibility to address major economic and policy priorities by re-programming (i.e. country specific recommendations: if there is an emerging challenge the EU can ask the Member State to re-programme), the Partnership Principle, etc.

When looking at the nature of the contractual agreement in Cohesion Policy there are a number of areas where theory could provide new insights. In the EU context there are asymmetries of information and gaps between the EU level which negotiates and monitors programmes and the level of government in which operations take place and where the beneficiaries (e.g. firms, municipalities) are located. The key mechanism through which these information gaps are addressed is through monitoring and evaluation mechanisms of the programmes. At the same time, strong accountability requirements at the EU level, which is responsible for the budget, are established through a detailed set of assurance requirements based on reliance on national and regional management and control systems. The way in which these relationships were managed reflects variations across and within countries, reflecting different capacities, powers (fiscal, legislative, etc.) and interests. At Member State level, there is a documented capacity gap at local and regional level in many locations, including in terms of strategic planning, co-ordination across sectors and co-ordination across governments at the same level or higher levels. These arrangements have evolved over time in the context of negotiations of the regulatory framework at European level and individual negotiations at Member State and regional level. A stronger focus on the contractual nature of these relationships could help understand how the trade-offs between flexibility and certainty could be better managed.

The Portuguese experience of territorial contracts in Cohesion Policy

The Portugal 2020 Territorial Approach is based on 3 levels: CIM contracts/ Integrated Territorial Investments (ITI), Community-led local development (CLLD) and Sustainable Urban Development (SUD). There are more than 200 strategies promoted by municipal associations with the support of other actors. Results after 3 cycles of contracting highlight several changes. A first change has been in the scale of intervention, as there has been progress in strengthening a sub-regional level of inter-municipal co-operation in a short-term period. Improved capacity of sub-regional actors has also been observed. There has been a change in the type of interventions, such as the increasing relevance of interventions beyond physical infrastructure by municipal actors. There are also signs of the transition from inter-municipal (e.g. municipal networks of collective services) to supra-municipal projects (e.g. anchor projects or e-governance at NUTS 3 level).

Portugal confronts several challenges in the implementation of contracts. In a unitary country such as Portugal, there is not just "one" contract, but rather a nested set of contracts, adding complexity to the system. In fact, it is difficult to achieve both detailed information (objectives, outputs, results) and the need of territorial / thematic flexibility. There are also overlaps with several instruments with different geographies, which imply some selection on which projects should be implemented where. It has proven challenging to implement variable contract geometry with democratically elected actors.

The French experience with the State-Region Planning Contracts

The State-Region Planning Contracts in France have played a critical role in shaping regions as increasingly autonomous and legitimate entities for policy making. The first generation of contracts was launched in 1984. Today, the 6th generation of contracts (2015-2020) encompasses five priorities (transport; higher education, research and innovation; environmental and energy transition; digital technologies; and factory of the future and promising technological niches). The EUR 30 billion budget represents on average 0.5% of the national yearly budget and 8.5% of the regional yearly budget. Co-funding varies across regions and according to the priorities.

Since the 1980s, the general frame has been substantially modified. Contracts shifted from those focused on "empowerment" of regions to those with a policy-sharing approach according to the typology outlined above. However, a national vision could be developed, given that negotiation is on a case-by-case basis. Similarly, project-based planning could be complemented by a comprehensive vision of local development. There is also the temptation to label projects that would have been carried out in any case, even without plan contract. The interministerial co-ordination (ex-DATAR / now-CGET) can act as a third party able to make decisions and better co-ordinate interministerial policies. The often transport-oriented investments result in long-term projects within the context of these contracts. Flexibility takes place at mid-term revision or more commonly during the preparation of the following contract. Currently, monitoring is carried out through mainly financial indicators, thus under-utilising the full potential to learn from the contracting process over time.

Regional Development Policy in Canada[5]

The Canadian Constitution commits federal and provincial governments to reduce disparities in opportunities and ensure quality public services across the country. There are two broad tracks of Canadian regional policy from 1960-2017: the first is around inter-provincial fiscal equalisation and the second is on geographically targeted economic development support, seen as an extended social learning process through new ideas, frameworks and mechanisms. In the 2000-2017 the "New Regionalism" empowered regions to develop diversity of regional economic and innovation systems, to avoid one-size-fits-all approaches, and to achieve policy learning about what works where.

In the Canadian context, flexibility can be intended as movements over time: the capacity of the public governance system to adjust to shifts and shocks, renewing goals and budgetary priorities. Adaptability in the Canadian context is the capacity of the public governance system to customise interventions to regional/local contexts. All this is a context of multiple interdependencies and co-ordination challenges (institutional, fiscal, policy) in a highly decentralised federation with strong autonomous sub-national governments (10 provinces, 3 territories).

Hybrid contracting increasingly expresses Canadian flexibility and adaptability in managing multiple interdependencies. According to the hybrid logic, transactional and relational contracts can run simultaneously through sequencing within a programme, reflecting transactional federal parameters and local discretional priorities (e.g. urban development agreements). There is also flexibility in the scope of contracts associated with the federal Regional Development Agencies (RDAs). The six RDAs work in a framework of five-year renewable contracts. Contracts concern mainly business innovation (60% of budget); community development (35% of budget) and knowledge mobilisation (5% of budget). Contracts are hybrid with sunset clauses for federal discretion on the future.

There is also spatially-sensitive programming, whereby programmes are implemented at local level (e.g. housing, urban programme) and capacity building actions from the federal government are foreseen. A "flexible conditionality" is applied as middle ground between highly specified conditional granting vs unconditional granting, by which the federal government sets broad parameters around sustainable infrastructure investment, lists a series of eligible projects, and mandates municipalities to come up with a ten-year plan to local actors to match resources and priorities. There are two important dimensions underpinning "flexible conditionality": local knowledge and the capacity of the community network. These are relational and transactional with the mix determined by regional contexts (e.g. urban vs. rural, growth vs. weak market, immigrant diversity or homogenous population).

"Community-based regionalisms" are learning pilots and demonstration projects to tackle so-called wicked problems by generating new knowledge and problem-solving strategies. They represent laboratories for policy, launched by the federal government to emphasise project experimentation and learning evaluation. Contracts can evolve from transactional to relational (Winnipeg) or from relational to transactional (Vancouver). The governance innovation aspect is based on the "Collaborative Consent Principle" in Federal-First Nations Policy Process (progressive consent from design through delivery). According to the Principle, every stage of the policy process, from the initial consultation to design to financing, to project management, is based on mutual consent.

The example of Canada shows that contracts can be devices for learning, even in the case of rigid contracts. This goes beyond the intuitive idea that rigid contracts bring less capacity building. The need for institutional intermediaries between the parties pushed the RDAs, which are not intermediary agents per se, to play this role. The Collaborating Consent Principle highlights the importance of legitimacy and trust amongst the parties.

Co-operative agreements in the United States

Relationships between the federal government and contractors (state and local governments) can be managed through what is termed contracts, grants and co-operative agreements. For the purposes of this discussion, all may be deemed "contracts". What is referred to in the US context as a contract is the legal instrument to use when the purchase of goods, services, and/or property is for the benefit of the federal government or executive agency, akin to the transactional contract model described above. There are two types of such contracts. Fixed price implies a maximum risk to contractor with responsibility for all costs. Such modes give an incentive to perform more effectively and minimise the administrative burden associated with contract oversight. The cost-reimbursement contract is a more risky type of contract, used primarily when there is uncertainty in performance of the contract. Reimbursement is for agreed upon

services/activities and only up to maximum ceiling award amount. Grants are transfers of money, property, or services to state and local government to accomplish a public purpose of support and where no substantial governmental involvement is expected from the Federal government. Finally, co-operative agreements are grants but with substantial federal government involvement. The federal government has already transferred resources, which should be spent accordingly to national priorities more broadly defined, and it will be involved in the way the other parties manage the process. The latter is more similar to the relational contract described above.

The Community Development Block Grant, under Title 1 of the Housing and Community Development Act of 1974, provides annual grants on a formula basis to entitled cities and counties. The purpose is to develop viable urban communities by: providing decent housing and a suitable living environment as well as by expanding economic opportunities, principally for low- and moderate-income persons. It promotes a wide range of community development activities directed toward revitalising neighbourhoods, economic development, and providing improved community facilities and services. There are monitoring and evaluation mechanisms in place, such as a Consolidated Annual Performance and Evaluation Plan. When activities in the Annual Plan are not carried-out as planned, it triggers monitoring visits or remote monitoring to assess how to address the barriers in implementation.

Lessons from theory to implement contractual arrangements in practice

Based on the uncertainty of *ex post* behaviours of the parties involved, the Contract as Reference Points Theory proposes a new approach to contracting. This approach assumes that, independent of the circumstances, different dimensions of contracts are difficult to assess in terms of quality, matching, principal-agent needs, timeliness, due diligence, etc. Contracts have a limited power to anticipate or control *ex post* behaviours. In this sense, contacts should not aim at responding to any contingency or foreseeing flexibility that that would grant authority to one of the party when future adjustments will be needed.

Indeed, if contracts integrate high degrees of flexibility, then the door is open for different and divergent interpretations, yielding aggrievement and shading. This new approach then calls for contracts that are less subject to interpretation and manipulation than other theories. Everything being equal, more rigid or shorter term contracts should be preferred. This means that new arrangement should be renegotiated when adaptation will be needed.

Each party involved in a contractual arrangement expects, on the one hand, credibility of the agreement, and on the other, a mutual underlying commitment to the agreed *ex post* behaviours. In other words, each party expects their counterpart to do their best to guarantee that the freedom sacrificed *ex ante* will be compensated by *ex post* choices. In this sense, legitimacy of contractual arrangements is crucial. Legitimacy is indeed needed when setting initial conditions; both parties should have access to the same information and the negotiation process should guarantee balance between the parties. Legitimacy must be present as well in any *ex post* arrangements done to respond to unforeseen contingencies. The revision process should be neutral, avoiding any manipulation from the parties.

Following theoretical and practical experiences, *ex post* evaluations and enforcement of contracts are also essential for improving their effectiveness and credibility. *Ex post* evaluations of contracts help in detecting which are the main facilitators and impediments for contract implementation (see Box 3.2). They can also help in addressing certain

challenges when the renegotiation or renewal of contracts takes place. Notably, evaluations can help in assessing strategic and opportunistic behaviours that one or both parties could have taken. The repetition of interactions, and its proper evaluations, can also help in reducing transaction costs over time as the *ex ante* needed time for the negotiation would be shorter and trust higher.

Enforcement is also a key aspect of contract effectiveness. Enforcement aims to ensure that each party fulfils the mutual commitments and deals with conflict resolution. Enforcement can be internal (performed by the parties) or external, based either on stakeholders engagement (e.g. citizens, businesses, universities, NGOs, etc.) or on third parties (e. g. a judge, a group of peers, international agencies, media). Yet, internal enforcement has a limited use in contact arrangements and the external approach depends strongly on the availability of information the clarity of the allocation of roles amongst the contracting parties. It is also important to note that mobilising external institutions to enforce contracts relies strongly on their neutrality, independence and competences.

- **Limiting conflict of interest**: the evaluator should be "neutral" and cannot be judge and party to the contract at the same time. For this, resorting to international peer experiences sharing challenges and opportunities can limit conflicts of interest.
- **Adopting contractual period across different electoral mandates:** one way to avoid the risks of opportunistic behaviour, self-interested actions, or political conflicts is to adopt a contractual period operating across more than one electoral mandate. Such a strategy helps stabilise relations across levels of government and bridge political changes. Long-term commitments might help stabilising relations across levels of government and bridge political discontinuity.
- **Benchlearning:** sharing information among peers can create more effective contracts and draw lessons from success stories and common challenges. It favours comparison among actors and regions especially for selecting good practices in the experimentation of complex policies.
- **Favouring "repetition" in contractual agreements:** it is important to identify pitfalls and backlogs in public action, especially when they can create vicious cycles of inefficiency in public spending. Repeated games, inspired by lessons from past experiences, are not typically used in contracting amongst levels of government. Usually new contractual phases between higher and lower level of government start from scratch, being negotiated without clear reference to past experiences and results.
- **Using rewards and not just sanctions:** rewards can help reinforce the capacity of subnational government to propose valuable projects and create some competitive pressure for adopting good practices across subnational governments (and not just measuring if money has been spent in due time).
- **Involving different stakeholders:** including other regional/ local stakeholders in the project selection, design and implementation (above and beyond central and subnational government partners) could help achieve better outcomes. It helps enhancing collective behaviour towards the achievement of agreed targets, favouring information exchanges and transparency.

Box 3.2. Creating trust: lessons from the evaluation of the Vancouver Agreement

The Urban Development Agreement in Vancouver was a partnership between the federal, provincial, and municipal governments to support local community solutions to economic, social, health and safety issues. The initial agreement was signed in 2000 and renewed in 2005 for another five-year term. The evaluation of the Vancouver agreement, which covered the 2000-2010 period, aimed at assessing the relevance and performance of investments conducted under the agreement framework.

Some of the main challenges to achieve the desired outcomes that were identified by informants of the focus groups were the inconsistency of political support throughout the period as well as the bureaucratic procedures, among others. They also identified as main facilitators of the implementation for the Agreement the high level of commitment of people involved, and the relationships that were developed during the process.

The evaluation highlighted, indeed, that the agreement strengthened relationships, found collective solutions and built foundations for future collaborations. It was successful in engaging the community and developing key relationships with community partners and with the private sector. The evaluation emphasised that, on of the most important outputs of the two five-year agreements was the creation of social capital and trust. These elements allowed for more spontaneously co-operative practices among stakeholders.

Source: Western Economic Diversification Canada (2010), "Evaluation of the Vancouver Agreement", Audit and Evaluation Branch, May; Charbit, C. and O. Romano (2017), "Governing together: An international review of contracts across levels of government for regional development", *OECD Regional Development Working Papers*, No. 2017/04, OECD Publishing, Paris, http://dx.doi.org/10.1787/ff7c8ac4-en.

Conclusions and ways forward

As intergovernmental arrangements involve a range of different contractual relations of different types, insights in this chapter can be applied in a range of different contexts from highly transactional contracts to more relational contracts and from political objectives to fiduciary assurance.

Several challenges for transposing recent developments of theory regarding contracts among private parties to the special case of contracts across levels of government for several reasons exist One challenge is that often these contracts are in the end more trilateral than bilateral arrangements. This generates a "cascade problem", as it is difficult to combine the detailed information from higher levels and the need for territorial / thematic flexibility. Some forms of asymmetric decentralisation or variable geometry are called for given circumstances in some countries, but there are political considerations when treating different places differently (countries in the case of the EU or regions in the case of a country). The contracting process also takes place with a background of territorial reforms that are changing the counterparts within countries and the geography of regions. Indeed adaptability and flexibility are not only important for addressing the allocation of resources over time, but also across geographies.

Legitimacy is a key issue in the Contract as Reference Point theory, as well as one raised in practice, given the importance of building trust in the relationships across levels of government. In the context of regional development, citizens and the private sector may also be relevant to actively engage in the process and to be informed of the content of the contract to facilitate their buy-in and interest. Legitimacy is also one of the ways by which to manage uncertainty, and this needs to be viewed within a given political context. Designing policies based on the Principal-Agent Theory implies that it is a matter of

putting in place the right incentives and enforcing them. Because of the uncertainty in regional development, there is the need to reflect further on this standard approach.

The Contract as Reference Point theory also highlights the importance of designing simple robust contracts *ex ante*, with a clearly agreed arrangement for *ex post* modification of conditions, based on monitoring and robust evaluation. This evaluation could be performed by an independent body. This contrasts with some attempts to create very detailed and technocratic systems *ex ante* with built in technical adjustments.

Contracts should be seen as progressive tools to learn from one period to another. There is room for improving evaluation more than monitoring, if learning is the ultimate goal. The distinction offered by the latest theory on what is verifiable and non-verifiable is very important and deserves closer attention when designing and implementing contracts. The neutrality of the evaluator is also important to enhance fairness and credibility. Capacity building has been raised for subnational governments but also for collective learning: the higher level government may also need to develop certain capacities.

Enforcement is an essential element of a contract; however progress is needed in this area. Different country examples show that third party for enforcement can vary (Auditor General in Canada, third parties in England). There may be a role for an institutional intermediary in this contracting approach (Regional Development Agencies may de facto play the role of intermediary in Canada; or the ex-DATAR/CGET in France). Fully capable partners and external evaluators would however be preferable to warrant commitment of parties and preserve the spirit if not the letter of contracts among levels of government. There is a need for trust to build effective contracts among levels of government and to allow for a flexible implementation through repeated short-term contracts instead of the more common long-term rigid engagements. What remains to be developed is the adaptation of contractual devices for long-term investment in infrastructure. Further research in this area could also focus on the sectoral relevance of different types of contracts for managing relations across contributing levels of government.

Notes

1. This paper was subsequently published as: Charbit, C. and O. Romano (2017), "Governing together: An international review of contracts across levels of government for regional development", OECD Regional Development Working Papers, No. 2017/04, OECD Publishing, Paris, http://dx.doi.org/10.1787/ff7c8ac4-en.
2. Within the OECD, this is true with the exception of Belgium.
3. For further explanations on these gaps, see Charbit and Michalun (2009).
4 This section is based on Brousseau (2017).
5. Based on Bradford (2017).

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Chapter 4

Conditionalities for effective public investment in regional development policies

This chapter provides theoretical insights for the use of conditionalities in regional development policies. It examines different perspectives from academic literature, including from Game Theory, Public Choice, and Neo-institutional Economics Perspectives, among others. The chapter explores when it is most useful to use conditionalities to support public investment and how different theoretical approaches can help policy-makers better use them. It provides lessons from theory and practice for designing conditionalities for regional policy. It highlights a series of critical factors that are crucial for their effectiveness in triggering regional policy reforms and changes, regardless of conditionalities applied. These range from a need to be context specific, to the fundamental importance of ownership.

Introduction

Subnational governments play a key role in economic development policies for regions and cities. In 2015, for example, they represented, on average, more than 59% of total public investment and 40% public expenditure.

To achieve a greater impact from those investments or to align them with spending priorities, some "conditions" may be required when a higher level government offers resources to a lower level government. The term conditionalities has been defined as a type of governance arrangement whereby a government takes, or promises to take, certain policy or institutional actions, in return for which a higher-level government authority or an international institution will provide specified amounts of financial and/or technical assistance.

Conditionalities may be embedded in the arrangements for various types of grants and loans provided by international institutions, supranational governments or national governments to subnational governments for public investment. Conditionality is also present in any borrower-lender relationship, by definition, because the lender cannot be indifferent to the borrower's ability to repay. Many international donors, in particular the World Bank and the IMF, make their development aid conditional upon implementation of certain policies or measures and have played an important role in the last decades. Conditionalities have also played an important role in the EU enlargement process; the EU has also considerably extended the use of conditionalities in its Cohesion Policy during the 2014-2020 period. These include, in particular, *ex ante* conditionalities (general and thematic), macroeconomic conditionality and the link to country-specific recommendations.

The objectives of conditionality-type mechanisms are likewise extremely diverse. When it comes to regional development policy, the conditions attached to grants, loans or other financial support may be aimed at reducing the knowledge gap between levels of government, changing the subordinate actors' incentives to make specific policy choices or supporting other objectives, such as ensuring that minimum financial and administrative capacities exist to manage the funds effectively. They can range from *ex ante* conditionality with respect to macroeconomic performance to very specific programme requirements. Still, conditionalities alone are generally not sufficient to achieve or ensure lasting change in information flows, policy choices, or capacity.

Some particular issues have been identified as being crucial for their effectiveness. Issues of ownership and accountability seem, for example, to be critical. Questions of procedural legitimacy can also arise if the application of conditionalities to different recipients does not appear to be fair and consistent or even relevant. Other factors, such as mutual trust may also be an important precondition for effective implementation of conditionalities.

This chapter draws on background papers for and discussions at the seminar Conditionalities for More Effective Public Investment held 28 April 2017 at the OECD Headquarters. This seminar was part of the seminar series conducted in the context of the partnership between the European Commission and the OECD project *Designing better economic development policies for regions and cities*. Seminar background papers include:

- Berkowitz, Peter, Ángel Catalina Rubianes, and Jerzy Pieńkowski (2017), "The European Union's experiences with policy conditionalities", Background paper

prepared for the seminar "Conditionalities for More Effective Public Investment" held 28 April 2017, OECD Headquarters, Paris.

- Mizell, Lee (2017), "Conditionality in practice: Emerging lessons for public investment", Background paper prepared for the seminar "Conditionalities for More Effective Public Investment" held 28 April 2017, OECD Headquarters, Paris.
- Shah, Anwar (2017), "Development assistance and conditionality: Challenges in design and options for more effective assistance", Background paper prepared for the seminar "Conditionalities for More Effective Public Investment" held 28 April 2017, OECD Headquarters, Paris.

The seminar focused on theoretical perspectives and the lessons from the academic literature in the field of conditionality for public investment, including from Game Theory, Public Choice, Fiscal Federalism, Political economy and Neo-institutional Economics Perspectives; and practical experiences and lessons from countries, around the world.

Based on this, this chapter addresses several questions to help policy makers in designing and implementing conditionalities:

- When is it most useful to promote conditionalities, particularly in supporting public investment?
- How do different academic theories help us understand how to better use conditionalities?
- What factors in practice contribute to their successful implementation?

Theoretical approach and frontier thinking

The rationale behind the use of conditionalities

At their essence, conditionalities are "terms of exchange" involving two or more parties. In general, the concept of conditionalities is linked to the "strings" attached to assistance provided by international financial institutions, such as the World Bank or the International Monetary Fund. However, their use is not restricted to international financial institutions; the European Union has strongly sustained its enlargement process and its regional policy on the use of conditionalities. National governments can also make use of this mechanism in the context of transfers of resources to subnational governments.

Most often, the parties in a conditional relationship are someone who provides assistance (donor or lender) and one who receives it (recipient or borrower). The conditionality is the basis for receiving the object of the agreement, or the "payment" (e.g. a grant, a loan, etc.). Conditionalities are frequently used in the context of development assistance loans made to national governments by international financial institutions (IFI), such as the World Bank, the International Monetary Fund (IMF), or regional development banks (e.g. Inter-American Development Bank), and they are generally intended to achieve reforms that a government might not otherwise undertake. Conditionalities can also be placed on grants provided by supra-national institutions and governments, and used by diverse levels of government (e.g. national, regional/provincial, municipal). In these cases, conditionalities are used primarily to align national and subnational spending priorities, to promote subnational spending in

particular areas, to address fiduciary and accountability concerns, and to promote minimum public service standards.

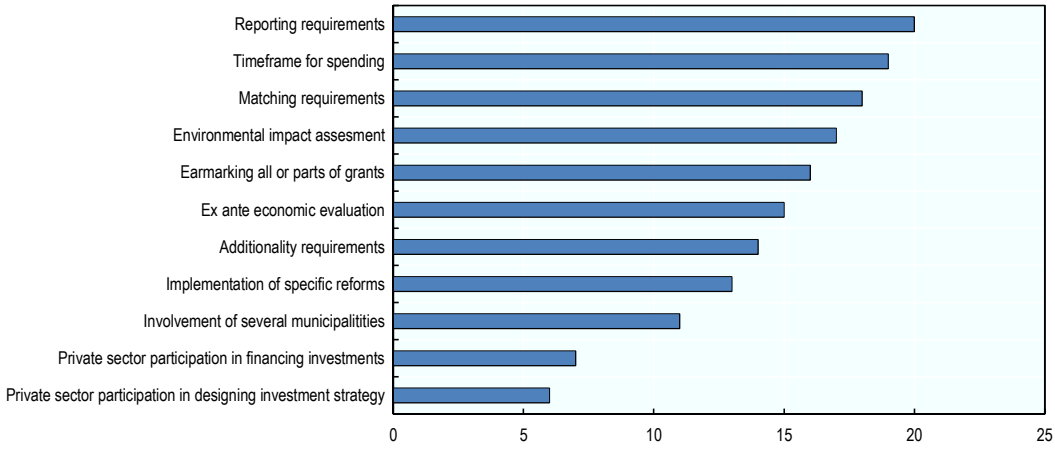
As a governance mechanism, conditionalities are applied toward a specific arrangement where financial, technical or other assistance is provided in exchange for certain policy or institutional actions being undertaken. Conditionalities are a "soft power" instrument in multi-level governance that shapes contractual relations between parties and sets the terms under which this financial, technical or other assistance will be delivered. Conditions might be *ex ante* – prior to the assistance delivery – or *ex post* – during the implementation of the contract or based on policy delivery results. They are often set where there are no legal instruments to enforce reform or specific decisions, and can imply a contractual relationship rather than a legal obligation.

Why using conditionalities?

Conditionalities can be used to ensure that the borrower or beneficiary lives up to their "end of the bargain". They can also be used to encourage a change in behaviour or to align interests (e.g. EU membership, strengthening inter-municipal co-operation), to promote the priorities of the lender or "grantor" (e.g. more liberal monetary policy), or to support specific policy agendas and choices (e.g. renewable energy). They are also called upon to reduce information asymmetries or knowledge gaps between levels of government; to encourage recipient actors' incentives to make specific policy choices; or to support other objectives such as ensuring minimum financial and administrative capacities exist to manage funds effectively. Of course these reasons can overlap. In the case of public investment, conditionalities will mostly be used to ensure that interests are aligned and priorities are met.

Specifically with respect to public investment funds, most OECD countries attach some form of conditionality to the grants or transfers provided to subnational governments. In OECD countries, most of the conditionalities attached to public investment funds are linked to a budgetary process in which fund recipients need to report on requirements or spend resources assigned in a predefined timeframe (Figure 4.1).

Figure 4.1. Types of conditionalities attached to public funds



Note: The number of countries reporting is 20 and countries may report more than one answer.

Source: Adapted from: OECD (2013), *Investing Together: Working Effectively across Levels of Government*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264197022-en; OECD (2012), "Multi-Level Governance of Public Investment", national and regional case study questionnaires, OECD, Paris, www.oecd.org/regional/effectivenessofpublicinvestmentatsub-nationallevelintimesoffiscalconstraints.htm.

While conditionalities can be useful to encourage changes in behaviour or promote specific policy choices and agendas, their use faces a number of challenges. Widely known, problems linked to principal-agent relationships – particularly moral hazard, rent-seeking and adverse selection- and information asymmetries determine any type of agreement or term of exchange. "Gaming" is another challenge, though this may be more endemic in the aid-driven exchanges that characterise the relationship between international financial institutions (IFIs) and recipient countries. When identifying outputs and outcomes, policy makers may also face some unforeseen consequences in relation to a particular conditionality that may undermine its effectiveness. In all these situations, setting conditionalities might result in sub-optimal outcomes where there is a tendency to gain from non-compliance and little incentive to enforce loan conditions.

The use of conditionalities has not been without controversy. Some evidence suggests that the use of this mechanism has not been effective in improving economic policies in recipient countries; some studies conclude indeed that, in the past, conditions have often not been effective as an incentive tool for recipient governments (Berkowitz, 2017). Inefficiencies associated to the uptake of conditionalities might be related to some unwillingness from recipient countries to accurately implement policy reforms. The lack of adequate capacities and skills may also partially explain why conditionalities have not necessarily reached the expected outcomes.

In light of this criticism, the World Bank, the IMF and other institutions have undertaken important reforms to increase the uptake of conditionalities that coincides with increasing research from scholars on the topic. Indeed, despite some flaws in its implementation, policy makers and academics emphasise the relevance of this mechanism to bring about real and concrete policy changes. Barca (2009) for example, in the context of the Cohesion Policy argues in favour of conditional grants to address market or government failures where economic institutions are weak. In this sense, theoretical and conceptual developments from the academic world can continuously highlight where the use of conditionalities can be improved to address challenges in a proactive manner and achieve a more optimal use of resources.

Conceptual perspectives in designing conditionalities

How conditionalities are used and perceived has been evolving over time, at least at the conceptual level. The traditional view sustained that the "donor knows best." Following this approach, conditionalities were designed from the donor perspective and revolved around donor objectives. The focus was input-based and process driven; and they were used as tools for leverage and control. However, as aforementioned, this approach to conditionalities has shown important constraints, notably on the uptake of conditionalities by recipient countries.

This is why during the last years the focus – from a theoretical and practical view- has been evolving toward a perspective that emphasises ownership by the beneficiary. This means, for example, that efforts are now concentrated in designing conditionalities where the recipient together with the donor define programme objectives through a greater bottom-up approach. Conditionalities then are in place to monitor progress as well as ensure accountability and results. This newer approach seeks to work within existing local systems of the recipient so that it meets grantor requirements, rather than imposing new systems. With this, the new co-operative approach seeks more flexibility and ownership from the recipients to overcome distrust resulting from one-sided and

externally imposed conditions. There is broad consensus in the academic and policy worlds around the value of this new approach, but fully embracing it appears to be a work in progress.

Different theoretical approaches to understand conditionalities

Scholars have developed a number of theoretical approaches – game theory, public choice, fiscal federalism, political economy, new public management (NPM), new institutional economics (NIE) – that can guide the use of conditionalities, all of which have something to say about how to improve their effectiveness. Table 4.1 summarises these approaches by highlighting how, from the different theoretical perspectives the effectiveness of conditionalities can be improved and what are the main implications for the design of conditions.

Table 4.1. Conditionalities' theoretical frameworks

Theoretical Approach	Description	How to improve aid effectiveness?	Implications for conditions	Limitation
Game Theory	Focuses on strategic choices made by donors and recipients in the presence of conditionalities. Sets that recipients and donors face perverse incentives that might affect the effectiveness of conditions Country's compliance or non-compliance is influenced by the donor's willingness to maintain loans in response to non-compliance.	Ways to increase compliance with conditions: – Increase cost of non-compliance in the future – Reduce payoffs of donors of maintaining the loan in case of non-compliance Most effective approach to address incentives problem: shift goals of donors from technical conditions compliance towards a focus on results.	Conditions should assure that both the donor and the recipient share both the rewards of success and the consequences of failure.	Difficult to increasing cost of non-compliance because of: limited credibility and short time horizon. Static approach but reality is dynamic (repeated interactions of multiple stakeholders).
Public Choice	Focuses on self-interested behaviour of principals and agents (donors and recipients) that defeats the public interest objectives of development assistance. Distinguishes a broad spectrum of aid agencies: from wholly motivated by altruism to those guided by economic and political imperialism.	Encourage greater transparency, task specialisation for aid agencies, risk and reward sharing with recipient governments to restrain donor self-interest Promote government's competition within and beyond government, greater transparency and accountability to citizens to limit government failures. Grant design should be consistent with its objective, respect autonomy, but also enforce accountability for results.	Focus on the governing environment as a pre-requisite of assistance.	This approach takes an extreme (negative) view of self-interest doctrine whereas in practice there is a wide range spectrum in donor and recipient agencies from self-interest to altruism and public interest
Fiscal Federalism	Focuses on safeguarding donor objectives while creating incentives that respect the autonomy of recipients and strengthen their accountability to overcome perverse fiscal behaviour of recipients.	Choice of grant instrument and conditions must be based on the objective pursued They must have a singular focus. Allocation criteria must be simple, objective, transparent and fair.	Conditions should be output-based to enforce results-based accountability.	In an international context with multiple donors with conflicting interests, donor harmonisation is costly and difficult to achieve

Table 4.1. Conditionalities' theoretical frameworks *(continued)*

New Public Management	Focuses on civil services regimes in aid agencies and recipient countries as they might explain aid effectiveness. Civil servants are encouraged to spend public and aid resources following financial and procedural controls, and are not held accountable for failures in service delivery performance. It proposes a results-based managements approach.	Develop HR management environment that promotes public managers autonomy and flexibility, and result-based accountability. Reform bureaucratic culture of aid agencies and recipient government to embrace results-based management and evaluations. Some common elements of NPM approaches: – Contracts based on pre-specified outputs, performance targets and budget allocations. – Managerial flexibility and results-based accountability – Subsidiarity in assigning responsibilities. – Competitive public service provision.	Conditions should be output-based to monitor the results-based chain and hold the recipient to account for service delivery performance	The effectiveness of NPM results-based management approach critically depends upon the public management paradigm in place in donor and government agencies.
Political Economy	Focuses on designing conditions to forge recipient ownership and commitment to reform. Reflects upon timing, sequencing, and consensus building for feasible and effective reform. In the absence of recipient country ownership, non-credible sanctions undermine conditionality effectiveness.	The design of assistance need to assess countries institutions and must develop mechanisms to deal with issues related to recipient ownership and interests of special groups. It is important to build coalitions for reform.	Detailed analysis of country political, economic and social institutions should be a pre-requisite for assistance. Conditions should facilitate coalition building.	To implement reforms, the approach requires a deep understanding of political and institutional environment in the country and the relevance of various stakeholders.
Neo-institutional Economics	Focuses on minimising transactions costs associated with donor-recipient interactions and holding both accountable. Two main problems in principal-agent relationship that lead to incomplete contracts: moral hazard and adverse selection. The challenge is to mitigate these problems by designing incentive regimes that encourage agents to be truthful to their principals. Additional challenges: countervailing institutions, path dependency, interdependency of various actions, vertical and horizontal co-ordination.	The design of grants should ensure that agents serve public interest while minimising transactions costs for principals. Establish institutional arrangements to clarify roles and responsibilities and mechanisms for consultation, co-operation, and co-ordination. Promote networks that rely on trust, loyalty, and reciprocity between partners, with no formal institutional safeguards: – Interest-based networks (shared interests). Repeated interaction among members builds trust. – Hope-based networks (shared beliefs) depend on the commitment and style of their leadership. Local government can facilitate the roles of these networks in improving outcomes. In donor-recipient relations, the NIE framework argues for complete contracts with fully enforceable conditions.	Conditions should be contractually enforceable for donors and recipients for specific results to be achieved. Local government to be given an enhanced role in service delivery and oversight of higher government activities in local area.	Complete contracts remain infeasible and agency problems could be, at best, mitigated to some extent (with transparency, home rule, strengthening countervailing institutions, and accountability and redress mechanisms) but could never be completely overcome.

Source: Shah, A (2017), "Development assistance and conditionality: Challenges in design and options for more effective assistance", Background paper prepared for the seminar "Conditionalities for More Effective Public Investment" held 28 April, OECD Headquarters, Paris.

Conditionalities in practice

Different types of conditionalities

Ex ante conditionalities

Conditionalities can be *ex ante*, a format used frequently by the European Union (EU). *Ex ante* conditionalities (also known as programming conditionalities) are those that need to be met, at least in part, before the "payment" is received. They create boundaries for national ownership and the political setting for effective investment in the long term (e.g. Europe 2020, the Sustainable Development Goals, etc.). *Ex ante* conditionalities can bring together long-term objectives and make room for ownership. They are also found to increase co-ordination among different levels of government and diverse stakeholders, thus having a potentially positive impact on multi-level governance practices. There are, however, challenges associated with this approach, including additional costs, too many conditionalities (quantity), and the fundamental need for monitoring in order to learn what works and what does not.

Currently the EU has 36 *ex ante* conditionalities for EU Structural Funds, taking a tailored approach as conditionalities are applied as appropriate to the investment or project at hand. Thus, if there is no investment in transport, then certain transport conditionalities are not applied. *Ex ante* conditionalities are also considered able to stimulate public investment. By encouraging horizontal investment, the conditionality can trigger and speed up structural reforms and better target public funding. From an investment standpoint, *ex ante* conditionalities can help promote regional development if they are chosen in the right way.

Policy-based conditionalities

Conditionalities that are policy based can lead to significant change and are a part of much of the support provided through development aid. In the European context, many of the *ex ante* conditionalities contain elements of policy conditions. For example, innovation strategies implemented by almost all regions in the EU have led, in some countries, to legislative change in order to introduce reforms to reorganise national and regional innovation systems. However, they can entail high political costs, which will put a strain on capacity and is a risk factor for success (see below). Indeed, unless the domestic constituency is in favour of the reform, policy conditionalities are rarely effective in bringing about change.

Macro-economic conditionalities

Due to the practical difficulties experienced in certain countries, there is some debate around macro-economic conditionalities, which have been used by international financing institutions and to some extent by the EU. For example, European Structural and Investment Funds (ESI) can be partially or totally suspended if a Member State fails to take effective action in complying with either the Excessive Deficit Procedure or the Macroeconomic Imbalance Procedure (surveillance procedures for fiscal and macro-economic policies, and part of the EU economic governance procedures). Before 2012, there was only one case of a macro-economic conditionality being called into play, when the European Commission called upon suspending the Cohesion fund to Hungary. This resulted in Hungary taking the effective action and so the suspension was lifted. More recently, as in the case of Portugal and Spain, the Commission did not propose any

suspension of funding but the conditionality provisions arguably provided the incentives for compliance. While macro-economic conditionalities can be successful to build coherence among macro-economic frameworks, it is also important to avoid confusing macro-economic conditionalities with micro-economic issues, such as investment.

In some instances conditionalities with a macro-economic orientation can be "self-imposed". This has been seen in Latin America with the introduction of fiscal rules, which appear to have served as a condition for stabilisation and a movement away from pro-cyclical behaviour. This is illustrated, for example, by Peru, which with a strong finance minister, established fiscal rules, limiting budget deficits and growth on current expenditure. When the country went through a boom, since current expenditures could not increase, there was a shift toward investment, leading to increased infrastructure provision.

Key lessons for designing conditionalities for regional policy

From theory and practice in the implementation of conditionalities it is possible to extract a series of critical factors that are crucial for its effectiveness in triggering regional policy reforms and changes, regardless of the type of conditionality applied. These range from a need to be context specific, to the fundamental importance of ownership.

Be context specific

When designing conditionalities, care needs to be taken to ensure that the form matches function – i.e. that the conditionality used corresponds to the issue and circumstances at hand. This includes the level of government, the capacity of the government to implement, and contextual specificities. For instance, providing assistance to encourage socio-economic change in a lower-income country by supporting changes in governance practices, influencing sector policies, or addressing the political atmosphere is not the same – and thus will require different conditionality design – as that related to a grant for public investment. Public investment is very specific, project-based and often time-bound. The results are concrete and needs are quite straightforward.

Strike a balance between the need for parsimony and managing complexity

The fiscal federalism theoretical approach emphasises the need to have one programme or focus per instrument. Too many conditionalities can affect uptake, making a strong case for parsimony in the number of the conditionalities to be applied in any one instance. Doing so could keep complexity in implementation and administration of the benefit in check. However, governments have many objectives, and so they may call upon a multiplicity of instruments linked to diverse conditionalities. This makes it important to pay attention to whole-of-government complementarities. In addition, consideration in conditionality design must also be given to the interests and the behaviour of third parties, be they other government sectors or the private sector. This may be particularly important with investment projects and funds designed to support these, as they may involve the private sector. The private sector is particularly adept at identifying complementarities, which may support the public intent, or may take advantage of the frameworks in a way that does not correspond with the intended purpose.

How are these various actors and interests managed? One way is to limit the number of conditionalities, which while potentially optimal may not always be realistic. Ultimately, a significant amount of co-ordination by national and subnational actors is

required to manage this trade off. This is critical in order to prevent a combination of donor priorities and the priorities of individual ministries fragment the approach. It is also fundamental to ensure that the mix of instruments makes sense and does not lead to perverse or cross cutting incentives. This is particularly important as the legitimacy of conditionalities ultimately rests on its ability to improve policies and outcomes. Thus attention should be paid to interactive effects and those conditions which represent binding constraints on the outcome of interests.

Be aware of time, especially for determining impact

There are two dimensions to the issue of time with respect to conditionalities. The first has to do with time constraints in the design phase. Effective design, including sufficient time for consultation of diverse interests, is not quick. Time can be a constraining factor especially if there are economic, political, social, or other pressures to put the agreement into place. This is why it is common to see agreements reached with conditionalities designed rapidly and in a less-than-optimal manner. These pressures prevent policy makers from assessing effectively information asymmetries and context characteristics; it may also prevent the establishment of the appropriate consultation mechanisms.

The second relates to the need for a short and long-term perspective when determining the effectiveness of conditionalities. In the short term, conditionality can induce governments to take actions they would not otherwise take, but compliance is often far from ideal. For example, at one end of the spectrum one can observe 100% compliance with well-defined, single conditions in the context of intergovernmental transfers in the United States (e.g. the minimum drinking age law in the US case); yet, the US case demonstrates resistance to full implementation where a state perceived the threatened loss of funds as a coercive overstep by the federal government.

At the other end of the spectrum the case of Greece demonstrates uneven or limited compliance with a suite of conditionalities of varying complexity (see Box 4.1). A 2007 IMF examination of 1 306 conditionalities associated with 43 programmes between 1999 and 2003, found a 54% rate of on-time compliance. But what encourages compliance, particularly in the short term? Uptake is assumed to occur where the prospective benefits exceed the costs of adoption (for a discussion of adoption costs, see Schimmelfennig and Sedelmeier, 2004). Dimensions that affect this calculation include i) the clarity and formality of the conditions; ii) the size and speed of the rewards, iii) the credibility of the imposing body, and iv) that the costs to adopt are low.

Box 4.1. Lessons on grants and conditionalities: The cases of the United States and Greece

United States

The United States has a long tradition in using conditional federal grants in aid to states. States (and local governments) play a central role in the delivery of public services in the United States, accounting for a large portion of public sector expenditures and revenues. Federal grants to states and local governments play an important role in financing subnational service delivery and investments.

Box 4.1. Lessons on grants and conditionalities: The cases of the United States and Greece *(continued)*

According to the US Office of Management and Budget (OMB, 2016), in fiscal year 2015 the federal government distributed USD 624.4 billion in grants to state and local governments (3.5% of GDP). Federal grants accounted for 25.1% of subnational spending and 22.3% of state and local governments' gross investments. Most federal non-defence investment in physical capital is funded via grants to subnational governments, generally with a co-funding requirement.

The federal government attaches a variety of conditions to intergovernmental grants that restrict how states and local governments may spend the funds: administrative conditions that shape how a programme is run (e.g. matching requirements, fiscal controls), programmatic conditions regarding service delivery (e.g. eligible beneficiaries/projects, types of roads that can be built), cross-cutting conditions that apply to all grants with certain characteristics (e.g. non-discrimination requirements, wage rates and benefits), and cross-over conditions that apply restrictions based on performance in another area. In general, they aim to promote accountable use of funds, align national and subnational priorities, and spur subnational action in areas that they would otherwise not take.

For a federal country the conditionalities can be a heavy-handed instrument that weakens downward accountability and puts states in conflict with the federal government. The proliferation of waivers and numerous court challenges highlight the tension between the federal spending authority and state autonomy. While they may align national and subnational priorities, address interjurisdictional spillovers, or ensure responsible grant implementation – there is a risk that conditionalities undermine the benefits of decentralised service provision, overcompensate for spillovers, and place substantial financial or administrative burdens on subnational authorities.

Greece

After the crisis, Greece has benefited from three rescue packages: the first 3 year rescue package (2010) brought together EUR 30 billion in funds from the IMF and EUR 80 billion in pooled contributions of 15 bilateral loans from European countries managed by the European Commission; the 2012 package worth an additional EUR 172.7 billion, again bringing together IMF funds with European funds; the third package involved only the EU who provided an additional EUR 86 billion through its European Stability Mechanism.

While first and second round reforms focused on fiscal and labour market reforms, product market reforms have lagged behind (OECD, 2016). In many instances, a lack of co-ordination in related areas has undermined the effectiveness of reforms.

Some factors that have contributed to an uneven compliance with conditionalities include: i) lack of prioritisation; ii) low ownership of the reform agenda iii) high costs of compliance; iv) capacity constraints.

The Greek case reflects the tensions and limits of conditionalities that have been identified by practitioners and scholars. This case reminds the downside of a proliferation of conditionalities, a lack of clear prioritisation, and the risks of weak domestic "ownership". A clear lesson is the importance of institutional capacity; benefits will be slower to materialise when large numbers of conditions confront weak institutional capacity to fully implement them.

Source: Mizell, L. (2017), "Conditionality in practice: Emerging lessons for public investment", Background paper prepared for the seminar "Conditionalities for More Effective Public Investment" held 28 April, OECD Headquarters, Paris.

Uptake can be a good short-term indication of whether or not a conditionality was effectively designed. In the longer term, it is impact that provides evidence of success. In

other words, did compliance, or uptake lead to benefits? Evidence suggests that where (willingness to) reform is already underway, narrowly defined and targeted conditionalities can have a meaningful impact on outcomes. Well-designed, they have a place in ensuring basic levels of public service, encouraging subnational contributions to national goals, and counteracting local preferences that act against general welfare. The experience of the EU ESI Funds suggests *ex ante* conditions can secure changes, particularly for "pro forma" type conditions. Anecdotally, some OECD countries report that the conditions attached to grants for public investment have enabled the central level to better understand the local conditions (e.g. Estonia, Italy, Slovak Republic). In Canada and Estonia, such conditionalities have helped to enhance systematic assessments of likely and actual impacts of investments, thereby reducing the incidence of "bad" investments. In Italy and Norway, conditionality has successfully encouraged the concentration of resources, thereby making it easier to promote and anticipate measures deemed crucial for regional development (OECD, 2013, p. 62).

Selecting between input, output and outcome-based conditionalities

Significantly, each of the theoretical approaches outlined in Table 1 argues against input-based conditionalities as they can accentuate moral hazard. Yet, they do not coalesce in an agreement for output-based conditionalities or who should be responsible for these. For example, while game theory suggests that rewards for success should be shared together with the consequences of failure, there is no attention to results. Fiscal federalism advocates for output-based conditionalities to enforce results-based accountability. New Public Management theory makes a case for conditions that help monitor the results-based chain but holds only recipients to account for outputs. New Institutional Economics supports contractually enforceable conditions for all parties for specific results to be achieved.

From a policy maker perspective, linking conditionalities to outcomes is part of a "gold standard." However, it is very difficult. In the United States, for example, this was tried in environmental grant programmes and performance partnerships where outcome measures were negotiated for pollution levels with individual states. The government faced significant difficulties in negotiating the exact outcome(s) on which to link the conditionality because the states did not feel they had enough control over all of the contributing factors. With public investment policies, outcomes are often uncontrollable.

Monitoring, evaluating and ensuring accountability

Monitoring and evaluation mechanisms are considered fundamental both in theory and in practice to improve the effectiveness of conditionalities. Their importance is equally applicable to the actions of the donor as well as to the recipient. Monitoring and evaluation processes contribute to evidence bases, and provide the foundation for accountability to relevant parties and to citizens. The challenge is designing indicators that are objective, measureable, timely, meaningful, comprehensible, well documented and widely disseminated. For performance-based management to support greater accountability in the application and uptake of conditionalities, all parties must subscribe to human resource management frameworks that espouse results-based management and evaluation. In the aid community, for example, the culture and incentives of staff in aid agencies and in executive agencies of the recipient governments typically promotes aid maximisation, not necessarily effectiveness. In addition, having independent evaluation is important, i.e. undertaken by outside actors, as the incentive structures in donor institutions do not often support truly objective and independent evaluation.

Building ownership

Ensuring appropriate ownership of the change that conditionalities are intended to generate – be it in behaviour, in priorities, or in programming – is fundamental to building legitimacy and improving the likelihood of compliance, or uptake. "Government ownership" is a basic criterion as governments must agree on the conditions and the changes they target. Without this there is no exchange. However, "government ownership" is not sufficient; it is "country ownership", which goes beyond "government ownership" that is critical. Governments can agree with the reform, but if it doesn't have the support of citizens (country ownership), implementation and long-term sustainability will be compromised. Thus citizen-centric governance or strong citizen empowerment can help support the broader effectiveness of government and donor objectives. Citizens can also influence the ability and willingness of donors to apply conditions, as a lack of citizen support can erode donor legitimacy vis-à-vis citizens – the government could have an incentive not to apply the conditionality because the political cost is too high, and it could also impact the donor's capacity to apply sanctions if conditions are not met.

In an investment context, building ownership among subnational stakeholders – ranging from local authorities, private sector, civil society and citizens – is also important. It can help grantors and beneficiaries identify what is most suitable and which conditionalities can be most effective.

If there is a requirement in the agreement that consultation needs to be undertaken, it is important to ensure that the beneficiary has capacity to perform the consultation. Consultation processes can be improperly done; this is not necessarily done out of bad faith, but rather arises from of a lack of institutional architecture or capacity/experience in effective and efficient consultation processes.

Conditionalities are not risk free

Despite the benefits that conditionalities can produce, they do not come without a series of risks:

- **Hamper local accountability**: Conditionalities are upwardly accountable. They condition the release of funds on the implementation of actions identified by the lender/donor. Even if these reforms are intended to enhance general welfare, it is the higher level of government that determines the acceptability of their implementation. The greater the discrepancy between grantor and recipient priorities, the more downward accountability is hampered.
- **Lack of prioritisation of binding constraint**s: Negative interactions among conditionalities are often inadequately targeted by structural reform programmes. Thus the proper identification of binding constraints is critical to unlock growth and avoid unintended consequences. This point to the importance of a context specific approach that considers place-based characteristics and avoids conditionalities that are not necessarily a good fit for a particular place.
- **Higher levels of government may not always know best**: In some cases, an international body or higher level of government assumes responsibility for the design of conditions and their monitoring. This places a premium on the technical capacity and the knowledge of the higher level of government regarding what actions to take, when, and how – as well as the best way to monitor them. A proliferation of conditionalities is likely to exacerbate this situation as the number

of domains of action in which the lender/donor must have better information increases. This suggests focusing on areas of core competence (a position taken by the IMF).

- **Implementation capacity may be weak:** The ability of target governments to implement conditions is a fundamental consideration in the use of conditionalities. A lack of subnational capacity can hamper the effectiveness of conditional grants to achieve outcomes – despite the conditions attached to them. Conditionality may also have the unintended effect of rewarding the most capable (those with the capacity to achieve conditions) and sanctioning the least (withholding funds from those least able to achieve the conditions). Waivers might mitigate this problem but too many will weaken the technical legitimacy of the conditions (reform).
- **Cosmetic compliance:** Several factors may contribute to cosmetic compliance, such as: a lack of capacity for adequate implementation, a lack of willingness to implement deep reforms for political reasons, or poor monitoring technology on the part of the imposing entity that does nothing to discourage shirking or may even signal a lack of priority for deep reform on the part of the lender/donor. As in other cases, a proliferation of conditions is likely to exacerbate the problem insofar as it strains available implementation resources and makes cosmetic compliance appealing in the short-term even if there are noble aspirations to revisit and deepen reforms over time.

These various risks can interact with one another, thereby affecting the effectiveness of conditionality. For example, a proliferation of conditions can multiply capacity problems and introduce co-ordination problems when distributed across sectors. Weak capacity hampering full implementation of conditions may delay the needed "rapid and sizeable" payoffs to sustain reform commitment. It makes administrative burden of reform more difficult to bear, and overall lead to "cosmetic compliance".

Conditionalities may also erode trust: the more they are used, the more they undermine trust that a system works properly. This is linked to a perception that donors have found no other way to achieve goals, and thus have opted for one that is associated certainly with benefits but also with sanctions and which is often considered coercive.

Taking a co-operative approach to conditionalities

While the various points explored above may call into question the value of conditionalities, when well-designed conditionalities have a place in improving service delivery and encouraging reform. Where circumstances do not lend themselves to "hard core" conditionality approaches, more co-operative mechanisms can be considered that seek to create that ownership. Three mechanisms are discussed below. The first seeks to "soften up" the environment for reform and cultivate local demand for change through persuasion and learning. The second forgoes efforts to force or convince the target government of the need for reform, and instead rewards those already committed to it. The third option prioritises consensus on outputs and outcomes, and provides the target government with greater autonomy to choose the best fit strategies to get there. The mechanisms are not mutually exclusive. "Softer" mechanisms to promote compliance include:

- **Persuasion and learning:** Governments may be persuaded to adopt reforms by the legitimacy of the reforms themselves and their fit to address domestic

problems. Ownership is a result of persuasion and learning. It suggests mechanisms for improving alignment between national and subnational priorities, and as an alternative or even complement to conditionality. However, both parties need to share the same understanding of how a reform leads to a mutually desired result.

- **Selectivity:** Research suggests that conditionalities works best as a facilitator rather than an instigator of reform. Some would say that donors should engage with beneficiaries that already demonstrate an environment in which lending is likely to be most effective – i.e. those with demonstrated commitment to good policies but which face significant needs. Doing so can mitigate many of the problems that emerge from a lack of ownership. But it can result in favouring higher income countries, support unintended expenditures, or result in assisting cosmetic rather than deeper reforms.
- **Output and outcome-based conditionalities:** Approaches that reward governments for achieving outputs and/or outcomes are considered less coercive than input/process-based conditionality and sanction mechanisms. They also have the benefit of providing the target government with greater flexibility in policy design while still maintaining accountability. While such approaches should be considered among the tools for promoting performance, conditioning the release of funds on achievement of outcomes (but not necessarily outputs) poses important technical challenges, not least of which is attributing the outcomes observed to the policies and efforts of the target government.

Conclusion and ways forward

Overall, theory points to the fact that designers of conditionality-driven agreements need to have a clear understanding of the trade-offs and consequences of their design. This needs to take into account objectives, choice of instruments, degree of administrative burden, and capacity of all parties to implement the agreement and realise the desired objectives. There is also a need to ensure ownership and legitimacy by establishing mutual accountability, and there is increasing pressure for transparency and accountability, programme evaluation and monitoring. When it comes to putting conditionalities to use, there are some practical matters to keep in mind.

Conditionality has a place in the toolkit of lenders/donors, and as such for enhancing contractual relations between parties. Properly designed, conditionalities can produce benefits – albeit in some cases limited. These are cases in which a "softer'" route to reform is not feasible either practically (to ensure repayment capacity, to limit moral hazard) or ethically (to protect civil rights – such as for desegregation in the United States), or because stronger incentives are needed.

Ownership also matters. The literature on conditions by international financial institutions is clear in this regard. Factors that mediate ownership include: the pre-existing alignment between priorities at different levels of government; the complexity of the reform and the capacity of the target government to address it; and the extent to which the proposed reform(s) impinge on the target government's autonomy (or conversely, the extent to which uptake of conditions is voluntary). With respect to public investment, this highlights the importance of narrowing the gap in priorities and knowledge prior to the implementation of any conditions to improve the likelihood of their uptake. It also

suggests limited use of conditionalities for encouraging complex reforms, particularly in low capacity environments.

Conditionalities should be used strategically. This is particularly so given the intrusions that conditions imply for both national and subnational governments, and the related erosion of downward accountability that may be amplified by the number of conditions. As its legitimacy ultimately rests on its ability to improve policies and outcomes, attention should be paid to interactive effects and those conditions which represent binding constraints on the outcome of interest.

Capacity constraints at all levels of government affect the uptake of conditionalities. The weaker the capacity of the target government to implement conditions, the less likely it is that benefits will materialise in a timely way. Sufficient capacity is also needed at the higher level of government to prioritise, design, and monitor conditionality. Demands on all levels of government will increase with the number of conditions imposed and the number of sectors involved.

"Softer" mechanisms to promote performance can be considered in conjunction with, and as alternatives to, conditionalities. Mechanisms that promote persuasion and learning have a place both before and alongside the use of conditionality. Selectivity can reward (and thereby encourage) good practice, although it runs the risk of leaving behind those that are most need reform. Output (and less so outcome) conditionality can provide greater autonomy in policy choices while at the same time encourage and reward performance.

A proliferation of conditionalities is to be discouraged. Too many conditionalities may jeopardise agreement and uptake by the beneficiary, leading to sub-optimal implementation. In addition, having many conditionalities can strain the administrative capacity of both the donor, and the recipient. They can also lead to gaming by third parties. Appropriate co-ordination mechanisms are therefore important to manage multiple and potentially competing conditionalities.

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Chapter 5

Performance frameworks for regional development policies

While there is broad consensus that public investment policies should focus on performance, policy makers face a number of practical challenges when designing performance systems. This chapter addresses some of the key questions that policy makers are seeking to address, including, how can they measure and monitor performance, how to design incentives to ameliorate performance and how performance information can inform budgetary discussions. For this, the chapter explores recent advances in theoretical analysis as well as practical approaches to performance and incentives. This includes a focus on the behavioural aspects of incentives and how to balance the desire for innovation, performance, and compliance, while keeping administrative costs and regulatory burdens manageable.

Introduction

At a time of increasing pressure on public finances, all budgets – regional, national and European level – are under pressure to improve the efficiency and effectiveness of public spending. Many governments have introduced performance frameworks to improve effectiveness, such as the European Commission's "EU Budget focused on results". However, applying a performance framework for investment policies is particularly challenging as investments are by nature long term, often complex and require strong co-ordination between levels of government and sectors to achieve their potential impacts. Large-scale investments are further subject to political interests which do not necessarily follow the same criteria as a value-for-money logic.

The European Union's cohesion policy funded from the EU budget was reformed for the period 2014-2020 in order to reinforce the focus on objectives setting, monitoring and performance (including the introduction of a performance reserve and review). A review of the specific challenges faced by applying performance frameworks to investment policies is therefore highly relevant in reflecting on how these mechanisms can be improved.

While there is broad consensus that public investment policies should focus on performance, policy makers face a number of practical challenges when designing performance systems for public investment policies. Many variables are considered when allocating resources, however performance is rarely the most pressing. Some of the key questions policy makers are seeking to address include:

- How can policy makers measure and monitor performance?
- How can incentives for improved performance be created?
- How can information about actual performance feed budgetary discussions?

To answer these questions, this chapter explores recent advances in theoretical analysis that can inform policy maker's implementation of performance frameworks in public investment policies. It considers therefore both theoretical and practical approaches to the issue of performance and incentives, including a focus on the behavioural aspects of incentives and how to balance the desire for innovation, performance, and compliance while keeping the administrative costs and regulatory burdens manageable.

This chapter draws on background papers for and discussions at the seminar "Incentivising performance in public investment delivered at national and subnational levels" held 31 March 2017 at the OECD Headquarters in Paris, France. Seminar papers include:

- Moynihan, Donald P. (2017), "Challenges for goal-based learning in public investments: A behavioral perspective on performance information use", paper prepared for the OECD seminar "Incentivising performance in public investment delivered at national and subnational levels" held 31 March 2017, OECD Headquarters, Paris.
- Beazley, Ivor (2017), "Managing across temporal and institutional horizons", paper prepared for the OECD seminar "Incentivising performance in public investment delivered at national and subnational levels" held 31 March 2017, OECD Headquarters, Paris.

Theoretical approach and frontier thinking

The rationale behind performance frameworks

Why developing a performance-based framework for public investment?

To optimise the impact and efficiency of public investment and regional development policies delivered at national and subnational levels, there is broad consensus that they should focus on performance and results. Facilitating a goal-based learning that allow assessing if public investments are being well-run and delivering expected results can enhance the efficiency of public investments. Focusing on results and investment goals should also help governments in improving accountability.

Governments can use different tools to focus on investment outcome goals and pursue them throughout the investment cycle. Focusing on results includes, but is not limited to: performance budgeting; investment strategies with clearly defined policy goals; well-designed tendering procedures and performance monitoring of procurement; technically sound project appraisals; effective investment monitoring systems; and high-quality *ex post* evaluation (OECD, 2014, 2015).

In the OECD, governments use performance budgeting to instil greater transparency and accountability through the budget process, two of the most effective outcomes of performance budgeting. In addition to accountability and transparency, OECD countries indicate that performance budgeting has also been important in promoting a culture of performance, parliamentary budget scrutiny, and legal compliance. While legal compliance is not highly regarded as a motivating reason for developing performance budgeting systems, it is among the leading outcomes of performance systems.

Performance frameworks in practice: main challenges

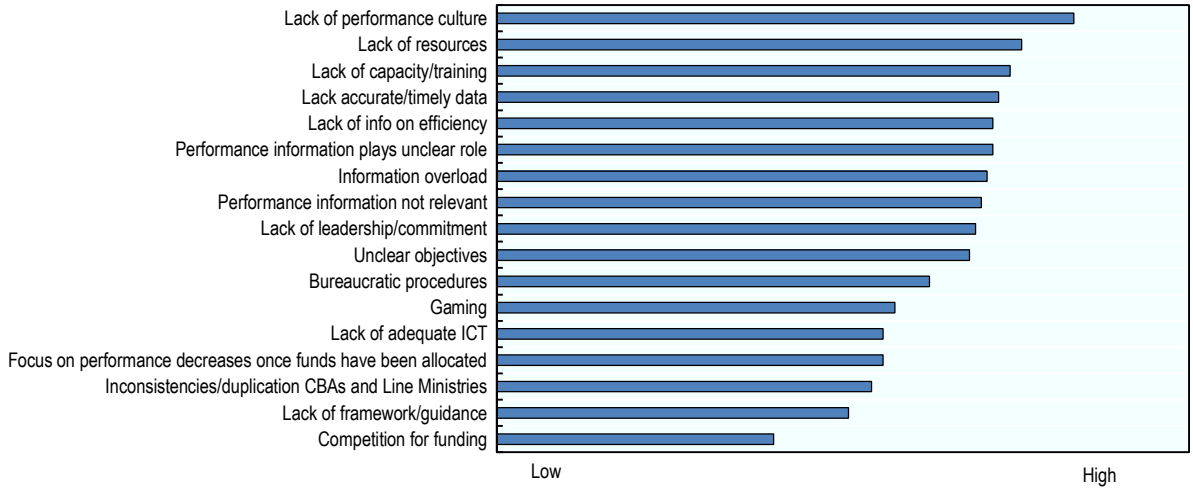
Several challenges for performance management of public investment policies span multiple levels of government. Governments should ensure that the various elements of the programme-logic chain are properly specified and connected and that incentives are in place to guarantee performance at each stage of the project cycle. Furthermore, incentive mechanisms should also be tied to accountability mechanisms in abroad sense (individual and managerial accountability as well as political/parliamentary). Performance frameworks also depend on the use of performance data which is not always readily available. Some features of investment policies make these delivery and accountability chains more fragile and complex, including:

- **Temporal dimension:** Outputs, especially those of public investment policies, are expected to be met in the medium to long term. The outcomes are typically measured and accounted for over a number of years. In contrast, financial allocations and output targets are handled over a shorter time period (usually one year). Yet, it is often difficult to make informed judgements as to the future effectiveness of the investment at such an early stage.
- **Transaction costs:** Collecting, verifying and disseminating performance data implies by nature transaction costs in maintaining the performance system. These costs become burdensome when there is little evidence of the actual use of the performance data by policy makers, who are often confronted with information overload.

- **Attribution:** It is often difficult to distinguish the role of a given output or set of outputs in contributing to the achievement of desired outcomes. In many areas of public investment for the economic development of cities and regions, the outcome is likely influenced by a broader range of factors than any particular intervention (literacy rates, recidivism and urban regeneration are examples of such multi-factorial issues).
- **Multiplicity of actors:** Across the OECD, an increasing proportion of public services is delivered at subnational levels, for which resources are contributed by national and, in some cases, supra-national levels. Co-ordinating multiple actors around a single performance goal is a common problem for performance systems generally. This is particularly true for public investment decisions where the resource-allocating authority may be several steps away from the delivery agent. This multi-level framework also causes challenges for operational oversight and accountability. More generally, the question of ensuring accountability of lower levels of governments for delivering results mandated by higher level institutions has long been central to performance budgeting, often framed as classic principal/agent challenges.

While performance budgeting has great potential to improve the quality of investment, it is clear that challenges persist and prevent its effective implementation in a number of ways. A lack of performance culture is seen as the greatest challenge across OECD countries (Figure 5.1). Organisational challenges such as a lack of resources and capacity/training are also rated among the top. A number of challenges also relate to the availability and use of performance information. In addition to the fact that there is a lack of accurate/timely data, senior OECD budget officials identify that there is a lack of information on efficiency. However, at the same time, too much information that is not relevant is also seen as a challenge. There is a general feeling that at times performance information plays an unclear role.

Figure 5.1. Challenges to effectively implementing performance budgeting



Source: 2016 OECD Performance Budgeting Survey (database), Q32, https://qdd.oecd.org/subject.aspx?Subject=90B147D4-005C-462A-9678-4CF7A931A4CA.

Many performance frameworks are not meeting expectations and providing the information that is needed by managers. Performance budgeting tools should enable governments to achieve objectives, but to do this, they need to:

- **Allow tracking of progress towards strategic goals** through high-level outcome data that enables the executive leadership of government to pursue its strategic goals.
- **Improve accountability** with data on activity/process, outputs and – most importantly – outcomes to the parliament, the supreme audit institution and civil society that enables these actors to hold the government accountable.
- **Promote transparency** using output and outcome data that can be linked with input data in a way that provides transparency as to the efficiency and effectiveness of spending so that budget officials and parliament can monitor and steer the limited budgetary resources to where they matter most in a given political context.
- **Facilitate improved programme management** by providing input, process and output data that enables the programme managers to adjust their operations so that services and programmes are delivered more efficiently and effectively.

Frontier thinking: behavioural insights in performance management to inform policy design

To date, the most common approaches to address the aforementioned challenges have drawn heavily upon the traditional repertoire of budgeting and public financial management. This literature typically takes a supply-side approach, whereby improving the quality and accessibility of performance data or attaching financial incentives to performance results is deemed the solution. The soundness of programme-logic chains is supported through the use of robust evaluation frameworks, intended to test the achievement of programme objectives, the efficacy of programme design and the rationale of underlying assumptions. The principal/agent issues in programme oversight have been addressed through clearer specification of outputs and reporting frameworks, "contractual" models for the delivery of well-defined outputs, and more public-facing channels of reporting and accountability. One challenge with the principal-agent approaches is an over-emphasis on compliance which can lead to heavy bureaucracy and perverse incentive structures or unintended consequences.

One promising avenue for further progress is to reflect carefully upon the incentive structures that are inherent in the traditional approaches to performance budgeting, and notably the role of behavioural insights. Advances in that field have led to deeper understanding of what motivates individuals and organisations to use information and to respond under various conditions. This line of research has proved productive in framing policy-related discussions. The behavioural public administration area of research has been addressing questions linked to performance or goal-based learning by examining how people use performance information and process different types of data. Researchers have identified a set of factors that make it more or less likely for people to use data, providing insights on how people cognitively process information on public sector outcomes. Understanding these factors may facilitate goal-based learning as a strategy to improve the efficiency of public investments.

Behavioural science shows that the use of performance information is affected by cognitive and related features of human perception and reasoning (Table 5.1). The institutional structures, political systems, arrangements for accountability, and the political context are all important determinants of the degree of consensus about public investment choices and results. Partisan political conflict makes evidence about public investments controversial when citizens think of themselves as supporters of a particular party and an investment is politicised. The use of performance information may not in and of itself be able to overcome pre-conceived notions of performance.

Table 5.1. Behavioural insights regarding how users process performance data

Factors	Description	Practical implications
Numeric literacy	Users are more likely to be influenced by anecdotes or stories when judging public sector performance	Use illustrative stories, connect numbers to narratives, reduce number of metrics presented, simplify metrics
The power of comparison	Comparative data is more persuasive and compelling; comparisons with peers and across countries have stronger impact	Present comparative data with realistic targets and suitable peers
Sense of autonomy	More autonomous policy makers tend to use more performance data	Provide autonomy for managers while holding them accountable; combine performance systems with autonomy instead of compliance requirements
Anti-public sector bias	Citizens assume government services are less efficient than those provided by the private sector	Awareness of this bias can guide government decision, for example, on communication issues
Distrust of government data	Citizens trust more on data provided by a third party than self-reported public performance data.	Use third independent parties to collect and report on outcomes.
Motivated reasoning	People tend to select, weight, interpret, and use information in ways that fit with their ideological beliefs.	Frame and disseminate data in ways that are non-ideological.
Negativity bias	Users are more responsive to numbers showing bad performance than they are to evidence of positive performance.	Present information in terms of level of achievement rather than failure; direct resources to trouble-shooting areas that performance data suggests poses the greatest risks.

Source: Derived from Moynihan, Donald P. (2017), "Challenges for goal-based learning in public investments: A behavioural perspective on performance information use", paper prepared for the OECD seminar "Incentivising performance in public investment delivered at national and subnational levels" held 31 March 2017, Paris.

Numeric literacy

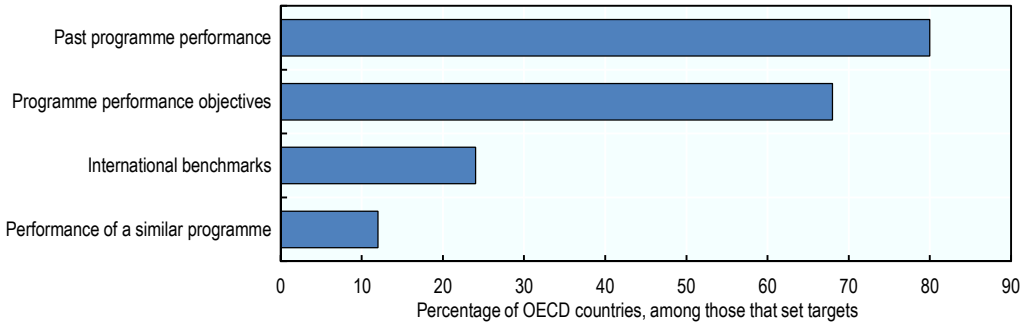
Researchers have identified that users (citizens or experts) are more likely to be influenced by anecdotes or stories over numbers when judging public sector performance (Moynihan, 2017). In practice, the presentation of data becomes more persuasive when it is part of a broader narrative or when data are accompanied by illustrative stories. This is found to be true even if users formally declare that they prefer quantitative over qualitative performance data. This is even true for policy makers who may lack the time to process data even if they have higher numeric literacy. Furthermore, evidence shows that the way numbers are presented and framed matters. For example, people underestimate the significance of a number that occurs to the right of a decimal point. An increase from 5.1 to 5.9 receives less attention than a number that crosses a threshold, such as from 5.9 to 6.0. As numbers are not persuasive on their own, governments may need to present information by connecting numbers to broader narratives or qualitative analysis using illustrative stories and presenting them in certain formats. Some

governments have indeed responded by reducing the number of metrics they offer to policy makers and citizens (Moynihan and Beazley, 2016).

Power of comparison

Comparative data has proven to be more persuasive and compelling than performance alone, as it provides some reference for users to assess how good (or bad) performance may be. Interestingly, some research has pointed out that comparisons with peers appear to have a markedly stronger impact on citizen evaluations of program performance than do comparisons with an organization's own past. However, OECD countries typically use past performance in setting targets, and much less frequently international benchmarks (Figure 5.2). One international example of performance comparison is that of the OECD's Programme for International Student Assessment (PISA) that seeks to assess education systems through international tests of the skills and knowledge of 15-year-old students. This performance metric has guided and influenced education policy management in several countries. Public managers also seem to be motivated by comparative data, even if its use is not necessarily attached to specific rewards.

Figure 5.2. OECD country approaches to target setting for performance measurement



Source: OECD (2016), Performance Budgeting Survey (database), Questions 24-25, https://qdd.oecd.org/subject.aspx?Subject=90B147D4-005C-462A-9678-4CF7A931A4CA.

Presenting comparative data can help governments to draw more attention to performance, especially when using peer comparisons. About one-third of OECD countries use some form of national indicators, and the majority of these are internationally comparable, including many that are aligned with the Europe 2020 objectives (OECD, 2016b). However, using unrealistic targets or unsuitable peers can raise expectations of what is deemed good performance to an unattainable level. Governments should thus find suitable peers, engage in benchmarking, and avoid unrealistic targets.

Sense of autonomy

The use of performance data tends to go hand-in-hand with greater autonomy of policy makers. Indeed, policy makers with more discretion over the final policy outputs and outcomes tend to make greater use of performance data. On the contrary, policy makers with lesser power to influence policy outcomes have little motivation to learn about performance. The existence of a sense of autonomy implies that managers should be given more autonomy for the management while holding them more accountable for

performance. Ideally, performance systems should be matched with autonomy instead of mere compliance requirements.

Anti-public sector bias

Different studies have shown that citizens assume government services are less efficient than those provided by the private sector. This is true in very different settings – for example, the United States and Denmark – where citizens rated public service providers lower than private ones, even when given exactly the same performance data. The implicit anti-public sector bias offers no direct guidance for policy makers on ways to ameliorate it. However, being aware of this bias can help governments and guide some decisions. For example, governments can emphasise the existence of public-private partnerships to elicit more positive associations when they are used.

Distrust of government data

In line with the anti-public sector bias, research has shown that citizen trust of self-reported public performance data is lesser than when it is data provided by a third party that is perceived as neutral. Distrust of government data seems to be greater when the task reported is more complex. For example, citizens appear to believe more in measures provided by governments on information that is more easily observable (such as the share of streets cleaned) than something less straightforward (such as citizen satisfaction). This is accentuated when governments show good performance results. Governments can use independent third parties to collect and report on certain outcomes. Evaluations by third parties provide another means of building trust in public investments.

Motivated reasoning

People tend to select, weigh, interpret, and use information in ways that fit with their ideological beliefs. For example, when confronted with the same performance data, people react differently depending on their position on the political spectrum. Political beliefs and partisan identifications shape how users assess the performance of specific public investments. Users of performance data tend to give some credit to those they believe they share ideological beliefs and on the contrary they discredit those coming from different parties. The anti-public sector bias and distrust of government data could be exacerbated or attenuated by motivated reasoning. In this sense, and especially in complex scenarios, performance information may serve to only reinforce pre-existing beliefs.

Addressing motivated reasoning is not easy. While a neutral approach to data is unlikely, governments should look to frame and disseminate data in ways that are non-ideological, such as building consensus across the political spectrum upfront with respect to data and goals in the future. Having a trusted third party provider of data may also help to mitigate this bias.

Negativity Bias

Both survey experiments and actual elections have shown that citizens, managers and policy makers are more responsive to numbers showing bad performance than they are to evidence of positive performance. For example, Olsen (2016) shows that presenting information about hospital performance in negative terms (patient dissatisfaction) has in impact on citizen evaluation; however, no impact is perceived while presenting the same information in positive terms (patient satisfaction).

The negativity bias often results in politicians taking actions to minimize political blame from poor performance or shifting blame for poor performance on to others. The latter is found in an experiment in which local elected officials were asked to attribute responsibility for outcomes of schools to leaders. The treatment group was given performance data while the control group did not receive any performance information. The results showed that performance data increases responsibility attribution in cases of low performance.

Aware of the negativity bias, governments can present information in terms of level of achievement (e.g. satisfaction rates) rather than failure (dissatisfaction rates). Most importantly, the negativity bias can generate a perverse incentive for policy makers to focus their efforts on minimising the failure rather than maximising performance. Governments should direct resources to trouble-shooting areas that performance data suggests poses the greatest risks and assess if those efforts are making a difference.

Performance frameworks in practice

How are countries applying performance frameworks for public investment?

Most countries have some form of performance framework to focus on investment outcome goals throughout the investment cycle. This may take the form of key national indicators, effective investment monitoring systems and high-quality *ex post* evaluation, or performance budgeting initiatives, for example. Recent OECD research has confirmed that most countries have developed national performance frameworks. They seek to clarify the intended results and impacts of public spending, broadening the focus of budgeting beyond financial accountability to results-based accountability. Still, levels of confidence among OECD governments in these systems is mixed, and no standard "best practice" model has yet emerged for effective public and parliamentary accountability for results. Indeed countries often struggle to provide the "right" information without contributing to information overload.

Performance budgeting

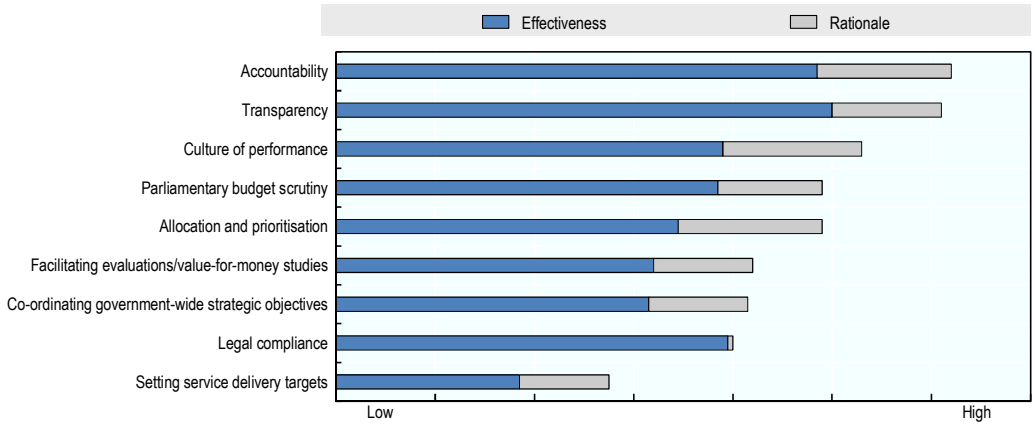
Some OECD countries have a long tradition of performance budgeting, such as the United Sates (since the 1960s) or New Zealand (since the 1980s), followed by Canada, Denmark, Finland, the Netherlands, Sweden and the United Kingdom. Today, 26 OECD countries have in place some form of performance budgeting. Still, the performance models vary highly across countries: some countries only collect information on performance but it is not necessarily used for spending decisions; in other countries funding is strictly linked to outputs and outcomes.

There exists a variety of approaches due to the absence of a consensus on the optimal approach to performance budgeting. The OECD has identified three broad categories of performance budgeting systems:

1. **Presentational performance budgeting** whereby performance information is produced and shown alongside funding allocations, but not necessarily used to make spending decisions;
2. **Performance-informed budgeting** where such information explicitly influences the allocation of resources; and
3. **Direct performance budgeting** in which funding is strictly linked to outputs and outcomes.

The 2016 OECD Performance Budgeting Survey shows that performance budgeting systems have been successful in providing legal and accountability controls. Transparency is also cited as one of the most effective outcomes of performance budgeting. However, even if a strong motivation to set up performance budgeting is orienting policy decision towards specific goals by influencing management practices, senior OECD budget officials suggest that performance budgeting is instead promoting legal/financial compliance (Figure 5.3).

Figure 5.3. The rationale and effectiveness of performance budgeting



Source: 2016 OECD Performance Budgeting Survey (database), Q22 and Q23, https://qdd.oecd.org/subject.aspx?Subject=90B147D4-005C-462A-9678-4CF7A931A4CA.

A major challenge to assess performance of public investments is linked to the long-term nature of investment policies. Major capital investment projects generally fall outside the normal cycles of both the annual and medium-term budgets. Often the lifetime of projects extends beyond the term of office of the government that initiated it. These timing differences set up tensions between the budgeting processes for capital and recurrent spending.

While performance budgeting has the potential to be a useful tool, especially in areas like infrastructure, until now it has not produced strong results. This is due mainly to the challenges in designing a comprehensive performance budgeting system, managing the large volumes of performance data and the difficulties in attributing results to spending. This has led most OECD countries to downplay strong performance incentives, such as rewards and sanctions, and to accept rather loose links between budget allocations and performance. Nevertheless, certain OECD members have experimented with incentives. The EU's cohesion policy has introduced mechanisms to strengthen the link between performance and budgetary allocations through a reserve.

Box 5.1. Summary of key elements of the strengthened performance framework of the European Regional Development Fund (ERDF) 2014-20

The ERDF is the largest of the EU cohesion policy funds delivered through "shared management", with important tasks delegated to national or subnational (regional) programme managers. Given the wide diversity in socio economic needs and potentials, the range of investment themes supported, the range of public administration capacities in the beneficiary programmes and the differences in investment intensity from the EU budget, developing a common performance framework is challenging.

For 2014-2020 the EU has reformed the approach to performance ("result orientation") under the ERDF through the following key elements. 1) ERDF support is structured under eleven high level "thematic objectives" which are further specified through a list of "investment priorities" defining in more detail the still generic goals to be pursued. Minimum financial concentration requirements for EU funding sought to maintain a focus and critical mass of EU financing in selected thematic objectives. 2) Translating the EU level investment priorities into national or sub national specific objectives for each investment priority was reinforced in negotiation. The Commission promoted an approach based on identifying a specific objective linked to identified needs and required the identification of specific (policy) result indicators representing the key policy change targeted (theory of change). By design the result indicators are influenced by programmes investment but not solely. Evaluation has the key role of trying to assess performance (effectiveness and efficiency) and the contribution of the programme to the specific objective. There will be important time lags between implementation and evaluation. 3) A revised and more complete list of EU common indicators are used under each investment priority, with programme-specific output indicators, to set output targets to be used in tracking implementation. 4) Monitoring and reporting arrangements were established leading to, as a minimum, annual reporting to the Commission (also covering the tracking of financial inputs). The structured nature of the reporting using specific IT tools allowed for a major step forward in transparency of financial flows and progress under common indicators as presented on the ESI Funds Open data site: https://cohesiondata.ec.europa.eu/.

In additional to those key elements, the EU legislation also introduced a new form of mid-term "performance reserve" (around 6% of EU resources) which will be allocated in 2019 based on each programme meeting self-defined financial and output milestones by the end of 2018. The reserve is designed primarily to incentivise early implementation. That mechanism is part of a legally defined "Performance Framework", not to be confused with the broader term "performance framework" as used in this paper (relating to the overall process of objective setting, monitoring and assessing the performance of public budgets). For the ERDF the "Performance Framework" narrowly defined is as set of legal provisions defining the mechanism for awarding the performance reserve and for imposing potential penalties at the end of the period for investment programmes that have failed to address under performance.

Source: European Commission (2015), "European Structural and Investment Funds 2014-2020: Official texts and commentaries", http://ec.europa.eu/regional_policy/sources/docgener/guides/blue_book/blueguide_en.pdf

National performance frameworks: using high level targets

A number of OECD countries have explicitly designed their performance budgeting system within an over-arching framework of higher-level strategic goals and more intermediate, operational targets. The rationale for this approach is that Key National Indicators (KNIs) – and indeed subnational indicators – should frame and motivate all government policy action and provide a road map for joined-up delivery. Such an

approach is sought to promote organisational clarity and coherence with political and developmental objectives.

OECD analysis indicates that national performance frameworks can be more cohesive and impactful when they are i) geared more towards outcomes than on outputs and ii) anchored within an overall framework of Key National Indicators or Strategic Goals. Thirteen OECD countries report using high level targets such as Key National Indicators (KNIs). Two thirds of these KNIs are internationally comparable and almost half are aligned with Europe 2020 objectives (45%).

High level goals by their nature attract public buy-in and thereby contribute to political/parliamentary relevance. They also tend to allow for international comparability, providing an opportunity for a healthy dialogue among citizens and decision-makers on the position and progress of the nation and its regions. Accordingly, a clear framework of national / subnational indicators has the potential to generate political momentum which is propagated throughout the delivery pathways, and motivates the engagement of stakeholders in the chain of accountability. However, the buy-in of subnational levels to these indicators can be challenging when there is a perceived mismatch between higher level objectives and subnational or regional goals. Furthermore, different time horizons in terms of the deliverables and associated accountability at different levels can lead to divergence of incentives between actors at national and subnational level.

Box 5.2. High levels targets and planning: improving performance of infrastructure investment in Italy and Ireland

Italy

In Italy the Law 196/2009 set the route to define a management process aimed at designing national physical infrastructure investment strategies. In Italy, investments in public infrastructure are run by a multitude of actors (fifteen thousand entities invest in public infrastructures) from different levels of government and the private sector. Italy created a database with a common set of information on a national basis in order to set the appropriate conditions to promote more transparency and the definition of fair criteria to evaluate public investments. Italy's approach is built on systematic networked data collection that provides integrated information. The system collects data of all public infrastructure projects, whatever the financial source and the responsible actor. The database now collects information on more than 160,000 projects. One of the most important lessons of the Italian experience is that Improving the effectiveness of performance management for public investments in physical infrastructures requires fine tuning between the legislative framework, the administrative process and the ITC systems available.

Ireland

In Ireland, up-front investment prioritisation, planning and appraisal enable better value for money and subsequent performance monitoring. Robust appraisal brings analytical discipline and baseline data provides the platform for subsequent performance monitoring and evaluation. Ireland publishes all investment plans starting with the National Development Planning Process. Government Departments and State Agencies publish sectoral plans, which are consistent with the overall financial allocation. These set strategic policy and frame the context for major projects.

Individual projects must also stand up on their own merits. Central government issues rules on the type of appraisal that must be delivered for investments according to the financial scale of the investment. Compliance with this framework is a condition of delegated control over capital budgets. Government Departments are free to adopt their own sector-specific frameworks, consistent with the overall rules.

Source: Rizzo, G. (2017), "Physical infrastructure investments in Italy", PowerPoint presentation and Hearne, E., "Incentivising Performance in Public Investment: Investment planning and *ex ante* appraisal" presented at the seminar "Incentivising performance in public investment delivered at national and subnational levels" held 31 March 2017, Paris.

For a decade, OECD member countries have been making efforts to simplify and refine performance systems. In light of criticisms of information overload, many have attempted to scale back the number of performance indicators and targets in place. However, in the 2016 OECD survey, there is no clear trend toward reducing the number of targets. While seven OECD countries report a multi-year trend toward fewer targets (Canada, Denmark, France, Mexico, Netherlands, New Zealand, Norway and Turkey), roughly an equal number indicate a trend toward more targets (Australia, Austria, Estonia, Greece, Israel, Italy and Switzerland). The Europe 2020 framework seeks to ensure a results oriented budget (Box 5.3).

Box 5.3. The Europe 2020 framework

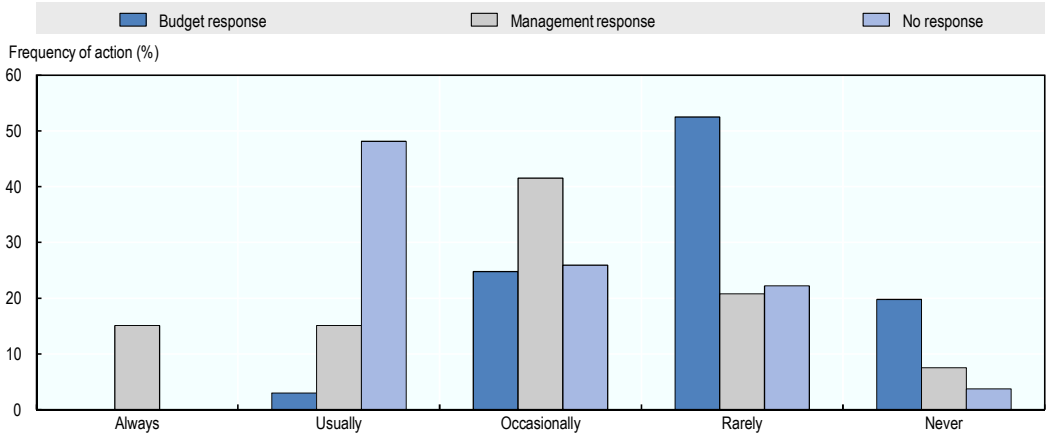
The EU, similar to several OECD countries, has developed a broad performance framework. Combining the Europe 2020 framework with the Juncker 2014 priorities, the Commission has set a broad spectrum of goals as part of the 2014 "EU Budget focused on results". With a strong focus on public investment, over half of this budget is assigned to the European Structural and Investment (ESI) Funds. The "EU Budget focussed on results" seeks to clarify where and how money is spent, how budget performance is assessed and how it is communicated. Nevertheless, the translation of high level objectives and associated indicators into national and subnational targets for investment programmes has remained challenging in the EU, as in many countries.

Source: Downs, R.., Moretti, D., Nicol, S., (2017) "Budgeting and performance in the European Union: a review by the OECD in the context of EU budget focused on results", OECD Journal on Budgeting, Volume 2017/1, OECD, Paris, http://www.oecd.org/gov/budgeting/budgeting-and-performance-in-the-eu-oecd-review.pdf.

Performance indicators and incentives

The effective use of performance frameworks need to go along with the appropriate performance incentives and management responses to performance information. Aligning incentives across the different levels of government that intervene in the investment cycle is also crucial While a diverse range of incentives have been applied by OECD countries, budget or management responses to a positive or a negative performance are less common across the OECD. Overall, no response is the most usual response when performance targets are met (Figure 5.4).

Figure 5.4. Consequences triggered when performance targets are met



Source: OECD (2016), Performance Budgeting Survey (database), Question 29, https://qdd.oecd.org/subject.aspx?Subject=90B147D4-005C-462A-9678-4CF7A931A4CA.

When designing and using indicator systems, it is important to recognise that they create implicit incentives in addition to any explicit incentive that may be identified. Implicit incentives arise because reporting performance data is not a neutral activity. Both, implicit and explicit incentives of any performance framework need to be carefully assessed as they both affect the information revealed by policy makers and the manager's behaviour.

Governments can design performance frameworks around soft or hard incentives or mixing both of them. Soft incentives can include for example encouraging competition by producing reports comparing different regions. In this line, reputational effects can be used to generate external pressure for accountability, as well as peer pressure for reform.

In contrast, hard incentives, including explicit rewards and sanctions, can be used to stimulate efforts by different levels of government where specific performance objectives are to be met. These hard incentives can be financial rewards, commonly assigning some funding based on performance results. On the administrative side, incentives can be linked to some changes of the rules and regulations that directly affect policy makers such as a relaxation (or tightening) of budgetary rules, decreased (or increased) oversight, etc. To apply hard incentives successfully, the relationship between inputs, outputs, and outcomes must be known and measurable, and the indicators associated with incentives must capture performance under the control of the managers being evaluated. Hard incentives have proven hard to apply in practice because of unclear relationships between investment decisions and outcomes, which is particularly complex in some fields such as innovation (Box 5.4). For public investment policies outcomes are generally difficult to measure and the time frame between implementation and results is large.

Box 5.4. Performance indicators for research investments: Lessons from Austria

Austria has implemented performance indicators in the area of research and development. From the Austrian experience, the first lesson to consider is the importance of using simple indicators and a clear terminology and definitions, notably in the distinction between "outputs" and "outcomes". While assessing the performance of investment in research, indicators include output but also input indicators, e.g. researcher days. However, outcome indicators are not suitable due to time lags, external influences, and the chance that research can fail. The Austrian experience, with respect to verifying the reported outputs and their quality, suggests the need for a shift from a financial and compliance audit orientation to checks limited to reviewing the procedures.

Source: Rossbacher, J. (2017), "Direct Performance Budgeting in Multilevel Management Systems: Reflections from an Austrian Perspective", PowerPoint presentation for the seminar "Incentivising performance in public investment delivered at national and subnational levels" held 31 March, Paris.

To support economic development for cities and regions, national objectives cascade down through multiple layers of government, and are broken down further into individual projects and contracts. The result is a multiplication in the number of variables that adds to the challenges of designing a fair and effective system of performance indicators and incentives linked to outcomes. To enhance the effectiveness of performance indicators in aligning incentives and increasing accountability for results, they have to be operationally useful and used selectively to avoid overwhelming users. It is also important linking indicators to standards and benchmarks and ensuring its comparability. To the extent that they enable performance to be compared across different geographies, over time and against generally accepted standards, they are likely to have greater influence. For this, a crucial aspect is selecting indicators with legitimacy

Encouraging the use of performance data: behavioural insights in practice

In the United States, through the Government Performance and Results Act of 1993[1] each agency must complete a strategic plan and measure performance on an annual basis and the data needs to be publicly available. Since 2010, US agencies must work together on cross-agency priority goals (Government Performance and Results Modernisation Act of 2010[2]); these cross priority goals are high-level goals that require the co-ordination of multiple actors. To facilitate co-ordination and monitor the use of performance data, the Modernisation Act requires a quarterly report and revision of the cross-agency priority goals need by relevant officials.

With this approach, the US government seeks to embed agencies with a new social routine. Indeed, the creation of the quarterly reports requirement follows the principle that mere existence of data will not lead to its use by managers and policy makers; instead, some requirements need to be in place in order to integrate the use of performance data into the routine. Regular reviews of a small number of key goals forces policy makers to pay attention to performance data and generate feedback about progress. To support this idea, one study showed that when managers actively take part in the development of cross-agency priority goals and quarterly reviews, they are more likely to report making use of performance data when allocating resources and managing programmes. Moreover there appears to be a positive and enhancing relationship between the quality of the quarterly reviews and the use of them by managers. The establishment of these routines helps to deal with several behavioural biases associated with performance data. The

routine reporting can moderate the negativity bias by employing positive reinforcements, and these reviews can weaken motivated reasoning by compelling people to engage in evidence-based discussions.

Conclusions and ways forward

Four pillars of performance assessment can be highlighted: the supply side, the demand side, the institutional design and the behavioural insights for performance data. For well-designed performance frameworks it is crucial to balance the supply and demand side of performance information. On the supply side there is more data than ever and the quality of the data available is also increasing by combining different sources of information. The key issue for dealing with the increasing supply – that needs to be used more intelligently in the future – is how to manage this supply (using an incentive-based approach) and how to make use of data management, including prioritization and direction of information, to meet the needs of different users.

On the demand side, strengthening accountability mechanisms is important but so is promoting a culture of learning from results as a tool for improving performance. Policy makers and managers need to be aware that data is generated and used in different contexts and that it will be used ultimately for different purposes. It is important to clarify the final purposes and final users of performance data generated: is it for accountability or learning? Is it going to be used by policy makers or policy managers? Such work is more challenging than a supply-side or incentive-based approach to performance systems, since it also requires investing effort in understanding where learning routines exist, and where these routines can be built so that the results feed back into improved performance.

The institutional design is also a critical element for creating the right framework of incentives. Setting standards and monitoring performance as well as performance reviews and peer comparisons are all a performance incentive. Appeal to external actors (external regulators for example) can be an interesting tool to better produce and use performance information. The United States offers an interesting example of promoting performance and accountability through a high level requirement to monitor performance, while leaving it up to individual agencies to develop performance frameworks that are tailored to their needs. The federal government then intervenes when needed to solve both generic and specific performance issues.

Designing a better approach to performance of public investment policies requires considering insights from the principal agent theory, but also taking into account the behavioural responses to performance information. Both approaches are complementary and should be assessed together. An important challenge when designing performance frameworks is indeed to minimise or avoid cognitive biases that are harmful, while exploiting cognitive tendencies in positive ways. A first step to integrate behavioural insights into performance policies can be the creation of learning forums that may ultimately become embedded in organisational routines. Such routines offer a setting for structured dialogue about performance that can incorporate insights about how to minimise biases such as motivated reasoning, or amplify the positive tendencies building on the responsiveness to comparative data or feeling a sense of control over outcomes and rigour; i.e., indicators that are meaningful, movable and measurable.

Notes

1. For more information, see https://www.congress.gov/bill/103rd-congress/senate-bill/20
2. More information also available at https://www.eda.gov/performance/

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Chapter 6

Behavioural insights and organisational behaviour in regional development policies

This chapter explores how behavioural insights can be used to improve the effectiveness and efficiency of regional development policies, programmes, and practices. Behavioural insights are applied by governments to gain better evidence on how human beings actually behave, with the aim to make public policies work better. A number of underlying factors have behavioural drivers challenge the effectiveness of regional policies, including the time horizon, political dynamics, and rent seeking, among others. After exploring new frontier thinking on how to apply behavioural science to organisational behaviour, this chapter offers lessons to consider when applying behavioural insights in regional development policy. These may help to improve strategy and decision making, management, and implementation of policies and programmes.

Introduction

"Behavioural insights" are lessons derived from the behavioural and social sciences, including decision making, psychology, cognitive science, neuroscience, organisational and group behaviour (OECD, 2017). The 2017 Nobel Prize in Economics was awarded for research in the area of behavioural economics, which integrates economics with psychology.[1] Behavioural insights are being applied by governments to gain better evidence on how human beings actually behave (versus how they are assumed to behave) with the aim of making public policies work better. The use of behavioural insights has moved beyond a trend and is now firmly established in the processes of many governments around the world. However, the application is limited in most cases to affecting the choice architecture of the individual – either within government or citizens themselves – to help them make better decisions. The next frontier is to expand the use of behavioural insights to shape the behaviour of organisations and enhance the impact that behavioural insights can have on making public policies work better (OECD, 2017), including those aimed at fostering the development of regions and cities.

How can behavioural insights be used to influence organisational behaviour to improve the effectiveness and efficiency of regional development policies, programmes and practices? There are a number of underlying factors that challenge the effectiveness of such policies, including the time horizon (typically longer term for economic development), political dynamics (including often multiple levels of government), rent seeking, as well as unintended consequences from policies. However, the remedies to address these challenges may lead to complicated procedures, misaligned incentives as well as burdensome and not necessarily effective control procedures. Many of the underlying factors have at least some behavioural drivers. Key questions that behavioural insights can help to address include:

- **Are the "right" people engaged?** Behavioural insights can offer techniques that improve the effectiveness of communication, access and ease of engagement and saliency of programme purposes and objectives so that those who are most targeted, relevant and interested and can benefit the most from the programmes can participate in their design and engage actively in their implementation.
- **Are the "right" people/activities funded?** Funding decisions can be significantly improved through improved group decision-making and better forecasting by, for instance, factoring in biases related to underestimating resource needs.
- **Are the funds used appropriately?** Violations of programme rules are often the result of a "feeling of unfairness" that provides individuals with a justification for committing the violation. Using fair procedures and due processes helps create desired values and norms, which can effectively shape behaviour and result in reduced violations and improved use of funds.

To answer these questions this chapter draws on background papers for and discussions at the seminar "Behavioural Insights and Organisational Behaviour" held 10 May 2017 at the OECD Headquarters. This seminar was part of the seminar series conducted in the context of the partnership between the European Commission and the OECD project *Designing better economic development policies for regions and cities*. Seminar background papers include:

- Foster, Lori (2017), "Applying behavioural insights to organisations: Theoretical underpinnings", Background paper prepared for the seminar "Behavioural Insights and Organisational Behaviour" held 10 May 2017, OECD Headquarters, Paris.
- Shephard, Daniel (2017), "Applying behavioural insights to organisations: Global case studies", Background paper prepared for the seminar "Behavioural Insights and Organisational Behaviour" held 10 May 2017, OECD Headquarters, Paris.

Theoretical approaches and frontier thinking

The new frontier: Applying behavioural science to organisational behaviour

The natural starting point for discussing how behavioural science can be applied to organisational behaviour is to question how traditional behavioural interventions created for individuals can lead to whole organisations being "nudged".[2] This is arguably less a matter of nudging whole organisations versus the people inside of them, and more a matter of nudging whole organisations via the people inside of them – and via organisational policies, systems and procedures. Organisations are made up of people, and by nudging the right number or types of people and/or by tweaking the right policy levers in organisations, whole organisations have the potential to change.

There are several levers by which organisations can be nudged via the people within them. For instance, when enough people are nudged towards a particular behavioural change, those new behaviours have the potential to become habit. In other words, they switch from deliberate choices and actions (known as controlled processing) to less deliberate, less effortful and more habitual actions (known as automatic processing). Whether due to choice or habit, when enough people in a work group or entire organisation behave in a certain way, that behaviour has the potential to become a norm, i.e. rules for expected and accepted behaviour. Shaping norms through changes in individuals' behaviour can be a powerful tool to affect organisational behaviour. Similarly, violating norms tends to make individuals uncomfortable and individuals tend to conform to the norms of the work group and organisation.

Nudging both formal and informal leaders is another way to nudge organisations. Nudging supervisors or other powerful or influential people within an organisation can have a multiplying effect such that the behaviours exhibited and endorsed by influential individuals have a better chance of being adopted more widely, nudging a whole organisation in the process. Moreover, those in formal leadership roles toward the top of the organisational hierarchy are also in a good position to effect widespread behavioural change by altering organisational policies and procedures. Nudges that help high-level decision makers (leaders, boards, etc.) optimise organisational policy decisions, in the face of their own biases and irrationalities, can have an effect. Thus, helping both informal opinion leaders and formal decision makers see the connection between the behaviour of staff and the organisation internally and at the point of delivery of their programme, or service is another way to nudge whole organisations.

Last, and of particular importance, organisational policies and procedures affect behaviour at work by shaping who is doing the work and how they are doing it. Behavioural science theories and methods can be used to help organisations develop behaviourally-informed policies and procedures that strategically and intentionally nudge the organisation as a whole. Rather than hoping for human behaviour that supports the policies and procedures in place, it is a matter of creating policies and procedures that

will encourage the work behaviours that support the broader mission and vision of the organisation at hand.

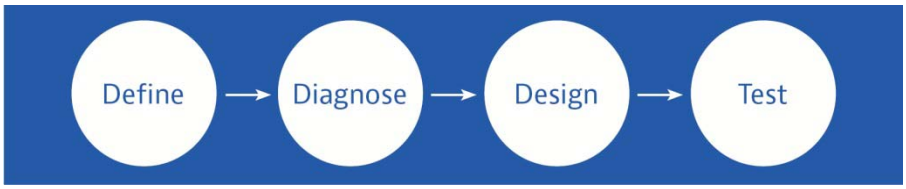
However, to effect widespread organisational change would require going beyond traditional nudge techniques used in behavioural economics. It requires both a narrower and broader focus than we typically see in behavioural economics. The focus can be narrower in that it is constrained to the field of work and organisation in particular, addressing the phenomena of greatest relevance and concern within the specific working context – worker and organisational wellbeing, work motivation, efficiency, effectiveness, productivity, and so forth. At the same time, the pursuit of organisational nudges requires broadening the theoretical and methodological focus to integrate traditional behavioural economics approaches with years of science that has accumulated in other relevant fields, most notably industrial and organisational psychology.

Industrial-organisational psychology

Traditionally, there has been a strong reliance on psychology in the field of behavioural insights, which has historically borrowed from social psychology and cognitive neuroscience to shape theory and applications. As we move from affecting the behaviour of individuals to that of organisations, the neighbouring sub-discipline of industrial-organisational (I-O) psychology becomes especially relevant. I-O psychology is "the scientific study of working and the application of that science to workplace issues facing individuals, teams, and organisations. The scientific method is applied to investigate issues of critical relevance to individuals, businesses, and society".[3]

One important commonality between I-O psychology and behavioural economics is the define-diagnose-design-test approach to implementing and testing behavioural interventions (Figure 6.1). Clearly defining the problem, soliciting inputs from experts and stakeholders, identifying barriers or bottlenecks, and then addressing these objectives and evaluating the interventions can be very valuable in ensuring that these interventions remain effective and sustainable in the long-run. One tool used by I-O psychologists at the diagnosis phase is the Critical Incidents Technique, which entails using a specific interview protocol to collect and document stories of effective and ineffective behaviours at work, related to superior or inferior performance (Flanagan, 1954). Through the collection and content analysis of hundreds of "critical incidents," the organisation can get a good picture of behavioural bottlenecks ripe for intervention.

Figure 6.1. Stages of the behavioural design process



Source: Adapted from Datta, S. and S. Mullainathan (2014), "Behavioral Design: A New Approach to Development Policy", *Review of Income and Wealth*, Vol. 60, pp. 7–35.

Moreover, the model lends to a variety of nudge-style tools that can be implemented, including simplification, active choice, the use of social norms, and implementation intentions. As well, overlapping techniques commonly employed by industrial-organisational psychologists also exist, which include goal setting, redesigning work, and

adjusting staffing, training, performance management, and reward systems. Testing can also be accomplished by using a variety of methodological tools, including, Randomised Controlled Trials (RCTs), systematic reviews, quasi-experimental studies, non-experimental evaluations, cohort studies, case-control studies, surveys, qualitative research, experience-sampling studies, and other types of intervention studies (such as quasi-experimental evaluation designs).

Building the foundation: What does I-O psychology tell us about organisational behaviour?

Given the relevance of psychology to behavioural insights and organisational behaviour, there are several key insights that can be drawn from the I-O discipline and applied to nudging organisations. Some issues to be considered include: how to structure rewards and measure performance that is in line with intended outcomes; aligning individual and organisational goals through a positive work cycle; the use of big data; effective partnerships and communication; the recognition of small wins; and the need to understand that not all organisational problems are behavioural, as sometimes the problem is simply about poorly aligned incentives structures.

Rewards can motivate and backfire

A common tool for any organisation to improve the efficiency of its staff is to provide incentives to achieve certain goals. While incentives are a useful tool in motivating behaviour, they need to be aligned with organisational objectives to ensure that organisations are falling victim to "rewarding A, while hoping for B" (Kerr, S. 1995). For instance, governments often allocate next year's funding for agencies based on this year's expenditures. While governments do so hoping for economy and prudence in spending, it is rewarding the opposite by encouraging agencies to spend the maximum amount of money they can. Similarly, success in organisations often requires collaboration and communication both across institutions as well as within, but rewarding individual efforts can have adverse effects. At the micro level, when rewards structures are misaligned this can lead to punishing people for failed attempts, which can result in learned helplessness, creating an environment of passivity that persists even after changes to the environment that would make success possible. This may affect individuals' desire to innovate, managers' willingness to support innovative ideas, and create a general mind set of "it cannot be done" throughout the organisation.

Solving this requires that organisations solve any inconsistency between what is hoped for and what is rewarded. They need to ensure that unintended incentives are removed from informal or formal reward structures. This requires that organisations focus on making sure rewards are aligned with desired outcomes and balancing risk with innovation, understanding the behavioural consequences of going too far in either direction.

Behavioural insights have proven to be successful at diagnosing problems with incentive models, and providing alternatives that align incentives and encourage risk-taking in organisations to promote innovation. This includes providing scope for unintended consequences and learning from gaps and failures, which can be supported by developing good feedback mechanisms and building partnership and trust across stakeholders. Rewards, which may not necessarily be financial, must also make sure that incentives are properly targeted and do not further incentivise bad behaviour. Proper testing before implementation is therefore required.

Motivating through non-monetary rewards and incentives (intrinsic motivation)

Even when properly aligned with outcomes, monetary incentives can create extrinsic incentives and rewards as workers view their motivation to perform a task in external terms (e.g. for a bonus), rather than as intrinsically worthwhile. Self-Determination Theory (Deci, Olafsen and Ryan, 2017), a macro theory of human motivation, teaches us that humans will be autonomously motivated and perform at a high level when they have three basic psychological needs met: autonomy, competence, and relatedness (i.e. relationships with other people). Therefore, when determining how to nudge a whole organisation, considering how these needs are met can help promote intrinsic motivation to succeed for the entire workforce.

Research shows that several factors help significantly improve motivation. This occurs when people see the fruits of their labour, feel appreciated, engage in projects that are more challenging, know that their work helps others, and are influenced to follow rules when they know it helps others. Indeed, the standard Job Characteristics Model asserts that performance is motivated by three psychological states: i) the meaningfulness of the work, ii) responsibility for outcomes at work, and iii) knowledge of the actual results of work activities.[4] Even in organisational settings with limited control over job design and incentives, reflecting on these three states can help improve intrinsic motivation.

One possible tool for improving motivation is found with goal setting theory, which has been perhaps the most useful theory of motivation for I-O psychologists. According to this theory, to improve job performance, goals must be i) challenging; ii) specific; iii) accepted by the worker; and iv) accompanied by timely feedback on progress toward the goals (Locke and Henne, 1986; Locke and Latham, 1990; Spector, 2012). Goal acceptance and buy-in by workers can be achieved by allowing workers some voice in the goal-setting process, by tailoring goals to workers' needs and interests, and/or by an effective leader who inspires goal acceptance. This overlaps with familiar techniques from behavioural economics and other sub-disciplines of psychology, such as commitment devices and implementation intentions. Fundamentally, organisations need to decide at what level the goals should be set (individual, subgroup, unit or organisational level), consider what behaviours to target, and consider how to ensure the four elements are present.

Performance management: more than just motivation

Timely feedback is critical for performance management. To be maximally useful, feedback should be frequent, constructive, specific, and behavioural in nature, helping the workforce see precisely what types of actions should be discontinued, continued, or increased. However, behavioural barriers to high-quality feedback exist, which are both cognitive (e.g. limited ability to recall information, halo effects that influence our perception of performance, confirmation biases and recency effects, among others) as well as social (i.e. uncomfortable for all involved) in nature. Advances in computing have opened up new opportunities to track performance metrics digitally, which similarly require attention to ensure workers do not see a threat to their autonomy or control. Behavioural solutions to cognitive biases also exist, especially to solve the well-known present bias which motivates managers to favour gains now over larger future payoffs.

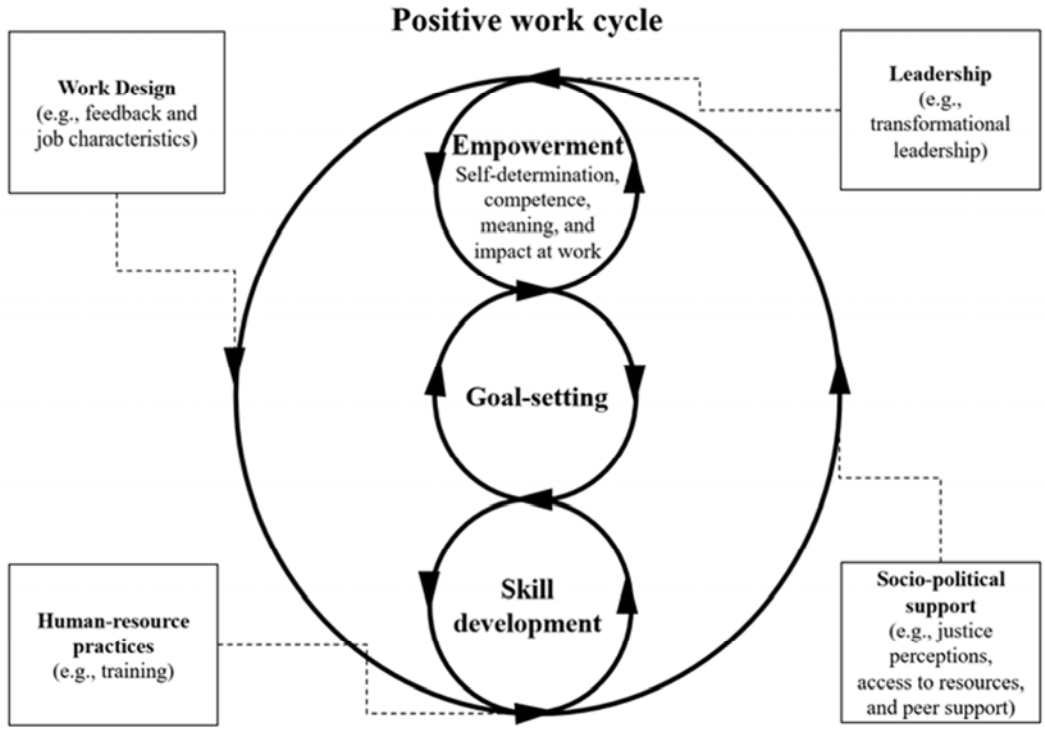
However, it is important to note that not every performance problem is a motivational problem. Even the most motivated group of people will fail to produce results if they do not have the resources or skills needed for the job. I-O psychology has a long history of

developing and testing interventions to ensure fit between the Knowledge, Skills, Abilities, and Other Characteristics (KSAOs) required for the work assignment, compared to those possessed by the staff. This means tweaking the organisational hiring process, training process, or both, to ensure the necessary KSAOs are present for the job. As networks of relationships become more complicated – as with regional development programmes – the ability to pinpoint and meet KSAO needs for administrative staff becomes harder. However, it is still valuable to consider which KSAOs are needed to achieve goals, and whether additional policies or programmes can be implemented to support the development of these KSAOs.

Aligning individual and organisation goals through a positive work cycle

The overarching message of many traditional behavioural interventions is that desired decisions and behaviours are much more likely when programmes and policies are set up consistently with people's self-interests. Therefore, aligning individual and organisational goals has the potential to create a "win-win" situation. The Positive Work Cycle requires attention not only to an individual worker's goals, but also to job design, leadership, human resource practices, and the socio-political context in which the work occurs (Figure 2). At the heart of this cycle is the setting of challenging and specific goals and the realisation that people are powerfully motivated by the need to fulfil certain fundamental psychological needs.

Figure 6.2. The positive work cycle



Source: Bhawuk, D.P. et al. (2014), "Poverty reduction through positive work cycles: Exploring the role of information about work, culture and diversity, and organizational justice", in S. Al-Atiqi (ed.), *Barriers to and opportunities for poverty reduction: Prospects for private-sector led interventions*, United Nations Development Programme, Istanbul, www.undp.org/content/dam/istanbul/docs/2014_Barriers_to_and_Prospects_for_Poverty_Reduction.pdf.

Use of big data

Data science and behavioural science can and need to work more closely together to maximise the potential to nudge organisations through behavioural insights. This has started to happen, but the full potential of this integration has yet to be realised. At its core, big data is behavioural data as it often captures the actual actions of individuals and organisations, such as identifying how hierarchical an organisation is through email traffic patterns. Big data has the potential to facilitate multiple points in the define-diagnose-design-test framework (previous Figure 6.1) by providing a clearer picture of the "state of play" as problems are being set, while also facilitating the design of "smart" behavioural interventions that are both tailored to the individual or population in question and serving as an important source of feedback for workers and decision makers. Big data can also serve as important criteria when evaluating behavioural interventions: behavioural scientists may obtain a detailed picture of moment-to-moment work outcomes of interest. As before, electronic monitoring is partly implied with the use of big data and needs to be balanced with concerns over privacy and potential lost autonomy or control perceived by workers.

Collective impact requires effective partnership and communication across organisations

There is no doubt that partnerships are critical to organisational effectiveness in today's increasingly interconnected world of work. When implementing regional development programmes, this is even more important as there exists a variety of government and non-governmental actors – each of them in their own organisation – with often misaligned or conflicting incentives. As a result, effective partnerships need to be established that involve organisational and individual issues alike.

Research has identified conditions for collective success. They include: i) a common agenda; ii) shared measurement systems; iii) mutually reinforcing activities; iv) continuous communication; and, v) backbone support organisations (Kania and Kramer, 2011). This is particularly relevant in regional development policies were co-ordination and communication among stakeholders is key for success. There are very human and behavioural elements to many of these conditions, such as the dynamics at play when establishing and negotiating a shared agenda or measurement system. Communications is particularly noteworthy as communications and networks can be mapped, with problem areas diagnosed and successes better understood through advanced analytics and social network analysis. To influence organisational behaviour, it is worth considering these five conditions, with special focus on communications mapping to diagnose areas that require bolstering. Including some of these conditions when designing co-ordination tools for regional development policies can help enhancing their effectiveness. Mapping areas where proper communication is more needed, in turn, help avoiding administrative burden with the creation of different co-ordination institutions and, rather, targeting efforts in areas where there is real need.

Recognition of small wins

There is no single, simple prescription for how to nudge organisational behaviour. This is especially true for institutions characterised by a complex set of actors working independently and collectively to accomplish innovative development goals. Under such circumstances, it is easy, and very human, to get overwhelmed into inaction or path dependency given the scale and scope of the challenge at hand. One approach to address

this problem is to focus on small wins that build a pattern that "attracts allies and deters opponents" (Weick, 1984: 40). This approach can be applied internally to those charged with effecting change through the application of behavioural insights. Similarly, four principles contributing to the success of the White House Social and Behavioural Sciences Team's approach to changing behaviour in a U.S. policy context included: i) convert interest into impact; ii) quantify your wins; iii) celebrate small wins; and iv) the importance of generating buy-in (Shankar, 2016).

Understanding that not all organisational problems are behavioural

When effectiveness and efficiency are lower than desired, it is tempting to immediately point to "people problems" – cognitive biases, poor fit, inadequate skills, and insufficient motivation. This temptation is fuelled in part by a phenomenon known as the fundamental attribution error. When explaining others' behaviour (e.g., poor performance), we tend to discount or ignore situational factors that shape behaviour (e.g., resource constraints) and gravitate toward dispositional explanations instead (e.g., lack of skills, motivational deficit). Furthermore, confirmation bias may exacerbate this tendency. The reality is that judgment, decision making, attitudes, and behaviour are not always the source of the problem. Without proper resources – tools, technology, staffing, and so forth – even highly skilled, motivated workers will fail to perform adequately.

Organisation Behaviour in practice

Key lessons on behavioural insights – from theory to practice

While it is the case that behavioural insights are mostly being applied at the individual level, there exists a body of case studies that demonstrate ways in which behavioural insights can either be applied directly to affecting organisational behaviour or can inform interventions at the organisational level. An important caveat to remember is that where groups function similarly to individuals, many of the same behavioural insights could apply. However, where groups and organisations function differently than individuals, it will be important to tailor any intervention to the behavioural insights that are unique to them. Merging the above theoretical context with the body of transferrable knowledge contained in case studies, it is possible to apply behavioural insights to affecting organisational behaviour in the regional development field to improve strategy and decision making, management, and implementation of policies and programmes. Lessons learned from case studies show us that these areas can be addressed in several areas.

Strategy and decision making

- **Establishing a good reference class when forecasting is essential.** Often, forecasts are impacted by escalation of commitments, planning fallacies, and over-confidence that result in overly optimistic cost estimates and eventual cost overruns. By establishing a reference class, decision makers can compare estimates against the reference distribution to help de-bias estimates or identify misleading proposals (Box 6.1). In regional development policies, when establishing contracts or designing conditionalities for example, behavioural insights can provide some guide to better present data to different stakeholders, to define which data is important to use/provide/demand to or from subnational governments in order to align objectives; to select data that can be more effective

to reward, monitor or evaluate performance, etc. Having access to relevant and good data is also necessary. Open data from the European Commission or the OECD can help, for example, to create reference classes for milestones achieved, absorption rates, error rates, costs per unit of output in particular policy or programme categories. All these, in turn, could contribute to improving the uptake and the efficiency in the use of funds.

Box 6.1. Using reference class forecasting

The Scotland Rail example

Flyvbjerg and colleagues have compiled a comprehensive database of infrastructure projects to use as a reference class and have found that average inaccuracy in cost forecasting was 44.7% for rail, 33.8% for bridges and tunnels, and 20.4% for roads while inaccuracy in estimated usage was -51.4% for rail and 9.5% for roads (Flyvbjerg 2006: 6). In one case, this database was used in an effort to debias cost estimates for the Edinburgh Tram System project. The initial budget was set at GBP 375 million out of which GDP 165 million was allocated toward constructing Line 2 and a subsequent business case estimated the cost at GDP 255 million and added 25% for optimism bias, totalling GDP 320 million, for only Line 2. However, while the business case did use a reference database with the costs of other U.K. light rail schemes and debiased the initial estimate, this second estimate did not adequately account for the potential for cost overruns in Flyvbjerg's reference class distribution. Using step three of reference class forecasting and the database mentioned, it was determined that the estimate would need to be increased by 57% (not 25%) in order to have an 80% likelihood of staying within budget. This adjustment brought the estimated cost of Line 2 to GDP 400 million. The total project budget for both lines was later set at GDP 545 million in 2007 when construction first began.[1] The final cost of the project, after running three years late and reducing the total project to only 15 out of 23 stops of Line 2, was GDP 776 million without interest (Green 2015). Although cost overruns were significantly higher than expected after using reference class forecasting for Line 2, they were much less biased than the original estimate of GBP 165 million.

In another example, reference class forecasting was used as a due diligence process to determine the accuracy of a forecaster's prediction before beginning a multi-billion dollar rail project (Flyvbjerg, 2013).[2] The process suggested by Flyvbjerg uncovered that the forecast was unrealistic. The forecaster had presented a 95% confidence level that the demand shortfall would be 15% or less, while the reference class database showed a shortfall of 85% or less for the same confidence interval. The process also revealed two previous multibillion-dollar projects in the reference class that were forecasted by the same organization. These previous forecasts were among the most inaccurate of the reference class – indicating that the forecasts were likely to be worse (not better) than the benchmark. This process resulted in the investors in the public-private partnership deciding not to invest in the project. This case study highlights how poor forecasting can be a result of mistakes and biases, but can also be the result of strategic misrepresentation. However, even in the latter case, a behaviourally informed approach can assist in flagging such misrepresentations.

[1] It should be noted that if a similar cost uplift was applied to Line 1 this final budget should have been much higher. By simply applying the same ratio of increase in cost from Line 2 (400m / 165m = 2.42) to the total original budget allocation of GBP 375 m would result in an estimate of over GBP 900 m.

[2] The project name, location, and forecasting company were masked in the original research to protect anonymity.

Source: Shephard, D. (2017), "Applying behavioural insights to organisations: Global case studies", Background paper prepared for the seminar "Behavioural Insights and Organisational Behaviour" held 10 May 2017, OECD Headquarters, Paris.

- **Flatten decision-making structures to encourage innovation** and reach higher levels of performance. Organisations, which are inherently composed of imperfect decision makers, make a trade-off between avoiding mistakes and taking advantage of opportunities. Models show that less hierarchical forms of decision making are likely to out-perform more hierarchical structures in contexts were multiple options exist.
- **Balance top-down and bottom-up accountability systems**. Public institutions are increasingly using bottom-up accountability, such as providing citizens with local government performance data or establishing local institutions, such as councils (Box 6.2) A greater participatory approach to regional development policies can enhance uptake, as well as a sense of fairness which is crucial for collaboration and stakeholder engagement. Results show that while effects on accountability are mixed, these citizens had a more positive and satisfied perception of government performance, compared to those without this information. Combining both top-down and bottom-up systems has shown the most promising effects on both satisfaction and accountability.

Box 1. Bottom-up accountability in England and Brazil

In England among citizens in Exeter (N = 439), an evaluation through a randomised controlled trial (RCT) found that showing data on a local government's performance compared to other localities had a positive effect on citizens' perceptions of and satisfaction with the government's performance compared with citizens who are shown no such information. For elected officials, downward accountability may be particularly potent around election season.

In Brazil, municipalities that more effectively implemented a conditional cash transfer programme for child education were also more likely to be re-elected. For example, mayors who created a council to oversee the programme were 26 percentage points more likely to be re-elected. Mayors in municipalities where the programme more accurately targeted low-income individuals, and those with larger programs, were also more likely to be re-elected.

Source: Shephard, D. (2017), "Applying behavioural insights to organisations: Global case studies", Background paper prepared for the seminar "Behavioural Insights and Organisational Behaviour" held 10 May 2017, OECD Headquarters, Paris.

- **Setting the right incentive structure**. It is known that monetary incentives can crowd out intrinsic motivation, which calls for a balance between monetary and non-monetary incentives. Cases also show us that people value immediate incentives more than future incentives, and are influenced more by losses than equivalent gains. Balancing both the type and timing of incentives can have strong impacts on performance. Yet, developing the appropriate conditions to stimulate intrinsic motivation applied to regional development policies can be a difficult task.
- **Correctly diagnosing the issue and the target group.** This involves deciding what are the primary outcomes the intervention is trying to influence, and to whom the intervention should be targeted. From there, organisations need to determine who the right actors are to engage and if staff implementing the decisions is equipped with the right tools to accomplish the intended goals effectively.

Management

- **Train managers to be aware of and counteract behavioural biases** through promoting a growth mind-set, stronger one-to-one relationships through leader-member exchange, and avoiding halo effects to improve the performance of the organisation.
- **Keeping it simple when managing projects**. Use plain language and, where appropriate, images that are easy to quickly understand. Visually showing users how to complete a desired action is more effective and less prone to mistakes than writing lengthy instructions in text and less prone to mishearing by audio. Simplify and shorten the rules and regulations wherever possible and use goal-directed behavioural insights to increase follow through, improve implementation and decrease errors. In the context of regional development policies, where administrative burden represent a particular challenge for regions and cities, resorting to behavioural insights to simplify procedures can be crucial. Building routines and habits by simplifying procedures can also generate a virtuous circle: habits can in turn make the procedure simpler.
- **Encourage more engagement by stakeholders by framing opportunities positively,** which can prime organisations to take advantage of opportunities and encourage submissions for projects. This can be paired with shortening the length of time between notification and deadline to promote action.
- **Attributing the right balance of responsibility or independence.** Depending on the context, it may be more effective to influence people to take ownership of the project or issue, or alternatively encourage greater independence so as to dissuade biased decision-making. Independence may be especially necessary when making hard decisions, such as removing funding from a programme to avoid sunk cost biases. This is why new leadership is often more effective at shifting organisational priorities – because they are independent of and are not emotionally committed to previous decisions.

Implementation

- **Pay attention to the context**. Context can be complex, as an intervention may take place in an ecosystem of different actors, elements, and layers. What may work with a target group in one environment or culture may not work in another. Using behaviour insights to "nudge" an individual versus an organisation may require setting very different baselines and incentive structures to achieve the stated goal.
- **Prompt organisations through personalised contact and behavioural framing** using personalisation, simplification, social norms, and implementation intentions to help ensure programmes and policies are implemented smoothly and enforced effectively. Such prompts might leverage organisational identity as well as individual factors.
- **Encourage the use of implementation intentions and public commitments to increase follow-through on goals.** Studies suggest that people are more likely to follow through on intended actions if they form a specific implementation intention at the beginning of a process than if they merely set goals. Public

commitments can also encourage follow-through, with Integrity Pacts providing an example in the context of regional development programmes.

- **Do not underestimate the importance of transparency and fairness.** When people violate or fail to comply with policies, it may very well be because they do not understand the rules or its implications, do not feel it affects them, or perhaps feel they are justified due to systemic unfairness. The opposite is also true – when people perceive the system as fair, they voluntarily reciprocate by following the rules.

Conclusions and ways forward

Behavioural insights in public policy have typically been applied to the behaviour of individuals, but less so to organisations. However, there are many lessons from this work that may be useful for assessing how to "nudge" organisations towards particular goals, including organisations seeking to support the development of regions and cities. This policy area has the additional complexity of trying to influence long-term factors and doing so across multiple levels of government and intermediaries. Therefore the application of behavioural insights is relevant to organisations at all levels: the higher level governments providing funding, the lower lever governments managing the funds, and the intermediaries that are often used to work directly with programme participants.

One clear lesson from practical examples is that not all organisational or programme problems are indeed behavioural; there may simply be the wrong incentives. One of the common challenges is ensuring that the "right" people and activities are funded. However, the programme design and the nature of outreach may ultimately attract recipients that are most in need of funding, not necessarily those with the highest impact or even the "right" people. Within and across organisations, especially given the multiple organisations involved in the process from initial grant to final recipient, there are many possible misaligned incentives to address. These incentives are not only monetary. Behavioural insights highlight the many non-monetary disincentives for individuals in organisations to act in the desired ways, such as personnel reward systems or other aspects of organisational culture. The design of policies should also not diminish the "intrinsic motivation" of the individuals in donor, intermediary and receiving organisations. In some cases, monetary rewards to support the desired outcomes may backfire in the long run.

Integrating behavioural insights can shape the way in which regional development policies and investments are conceived. Either when deciding the conditions to be included in a contract, or which indicators should be considered to evaluate performance understanding the behaviour of policy-makers or policy-implementers can make a significant difference to the quality of outcomes. Behavioural insights can help frame the thinking about public investment and regional development policies, where different instruments are interdependent and cannot be thought in isolation. Behavioural insights can provide some guidance in ways to make instruments more effective and overcome trade-offs that often arise between short term costs and long term benefits.

The typical behavioural insights methods may require adaptation in the context of programmes to support regional and urban development. For example, randomised control trials are typically not possible. However, adaptations to the "define-diagnose-design-test" model may be possible. But this requires fostering a culture of trial-and-testing which is not often rewarded in public sector organisations or embedded in

programme designs Many lessons from applications in practice highlight different strategies that management can use, as well as organisational practices that may be more encouraging of innovation, such as flatter decision-making structures. Furthermore, given common biases such as underestimating the cost of certain infrastructure projects, solutions such as defining reference classes and comparing such estimates with the actual costs of similar projects can help. There is also a lot of underutilised potential in using the data from prior projects for addressing other cognitive biases.

Another clear lesson from the work on behavioural insights is that clear, succinct and convenient instructions and rules can improve participation and reduce errors. There is also an element of capacity and relationship building that underpins the degree to which certain regulations are necessary. Common buy-in and a sense of fairness about the rules also lead to greater compliance. In some practical examples, there are questions about why greater flexibility in rules may actually give incentives to individuals in organisations to ask for more detailed guidance. Applying behavioural insights in such cases helps to clarify why these unintended consequences are occurring and how to address them.

Notes

1. The 2017 Nobel Memorial Prize in Economic Sciences was awarded to Richard Thaler for his contributions to behavioural economics, including with respect to its applications in public policy.
2. In this case, the term "nudge" refers to efforts to modify behaviour by seeking to influence the motives, incentives and decision making of people (individuals or groups), as opposed to doing so through compliance-oriented measures
3. Per the Society for Industrial-Organizational Psychology, www.siop.org.
4. For recent experiments see Gross (2015); for the Job Characteristics Model see Hackman and Oldham (1976).

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