Fiscal Transfers in Asia
Challenges and opportunities for financing sustainable development at the local level
Overview and summary
Overview

Much of the public expenditure critical for achieving the Sustainable Development Goals (SDGs) – such as expenditures on rural roads, irrigation, health and education – is managed locally by subnational governments (SNGs). Due to the low own-source revenue capacity of most subnational governments, fiscal transfers from central governments are essential for making these expenditures possible and thus for making progress to achieve the SDGs. The resourcing, design and administration of the various fiscal transfer instruments, the way they are allocated across SNGs, and the way they incentivize subnational governments all matter greatly for achieving the SDGs. This report summarizes experiences in fiscal transfers in Asia and makes key recommendations.

Key recommendations:

For better resourcing of fiscal transfers:

- Support research to estimate the costs of local service delivery mandates in accordance with service standards, and use the estimation to advocate for increasing subnational budget resources
- Consider incorporating incentives in fiscal transfers for greater local revenue-generation effort

For better design of fiscal transfers:

- Make the rationale and objectives of each fiscal transfer instrument explicit, especially for revenue-sharing arrangements and Conditional Grants
- Establish clear rules for determining the overall national fiscal transfer pools
- Allocate fiscal transfers to SNGs in a predictable manner with clear criteria
- Avoid “gap-filling” or “deficit” grant transfers
- Move towards a higher share of Unconditional Grants in the mix of fiscal transfers, over time
- Avoid allocation of transfers to SNGs on the basis of existing number of staff and stock of facilities
- Use Conditional Grants sparingly, to finance service responsibilities requiring tight compliance with national standards such as health, education and social protection
For better administration of fiscal transfers:

- Signal transfer amounts to SNGs early enough to allow sufficient time for subnational budget preparation
- Give clear guidance to subnational governments on eligible and non-eligible uses of grants
- Strengthen subnational planning and budgeting capacities
- Streamline funds release procedures, reporting requirements and other treasury procedures
- Allow carry-over of funds accompanied with accountability measures

For making expenditures more equitable across SNGs:

- Ensure national fund pools for equalizing transfers (Unconditional Grants) are adequate for the task
- Beware of establishing revenue assignments or revenue-sharing arrangements which create inequities for which other transfers cannot compensate
- Take into account own-source revenues and revenue-sharing transfers when allocating fiscal transfers to SNGs
- Design allocation formulas for Unconditional Grants to ensure they are genuinely equalizing
- Link Conditional Grants to service needs and standards
- Allocate Conditional Grants based on service outputs reflecting service needs and standards

For positive performance incentives for SDG-related service delivery:

- Generally, use indicators of “process” performance for Performance-Based Grants (PBGs); use “output” indicators only for sectoral or thematic PBGs; and beware of using “outcome” indicators since the latter are very challenging or not feasible in practice
- Put in place basic preconditions for the good performance of SNGs, e.g. laws, regulations and capacity
- Conduct preliminary ground work, e.g. baseline studies, determination of reasonable standards and assessment of capacities
- Choose appropriate performance criteria, e.g. relevant, objective, verifiable, few in number and based on reasonable standards of performance
- Design PBGs with appropriate size, selectivity and simplicity
- Ensure independent and robust quality annual performance assessments, which are not too costly or complicated to be sustained
- Communicate both the process and results of PBGs to garner political support.
Executive summary

Introduction

Much public expenditure critical for achieving SDGs is managed locally by SNGs. For example, Gram Panchayats and Union Parishads, the lowest SNG tiers in India and Bangladesh respectively, are usually responsible for building and maintaining village roads and bridges, water supplies, irrigation, early education, primary education and primary health facilities, and for managing various social welfare programmes. Vietnamese communes, Indonesian kabupaten and Mongolian soums have similar responsibilities. The range of SDG-critical public expenditure widens further when higher-tier SNGs are also considered.

Achievement of the SDGs and advancing sustainable development requires more and better public spending by these SNGs. However well-prepared are policies and plans, the SDGs cannot be met unless these policies and plans are operationalized into locally appropriate SNG budget spending priorities, and executed so as to make the best use of scarce resources; unless investments are made into assets and these assets are sustainably operated and maintained; and unless resources are allocated and spent transparently and accountably. In addition, SDG 10 envisages that resources are allocated equitably across SNGs.

Fiscal transfers to SNGs are the major source of financing for SDG-related expenditures for SNGs everywhere, and certainly in Asia.

Fiscal transfers matter for achieving the SDGs in several ways. First, and most obviously, the volume of resources transferred will determine the levels of local spending on sustainable development priorities. Second, the manner of their allocation across SNGs will affect territorial equity in spending, and hence may promote – or undermine – progress on SDG 10. Third, and less obviously, fiscal transfers often also carry various incentives (sometimes designed, but also often unintended) which can shape both the SNGs’ efforts to raise local revenue and also – perhaps more importantly – SNG budget priority-setting. These incentives can directly affect the levels and quality of local spending on SDG priorities.

The flipside to this is that, in many countries, fiscal transfers can and should be significantly improved so that they better help subnational governments to work effectively to make progress on the SDGs.

Objectives and types of fiscal transfers

The primary objective of all fiscal transfers is to address fiscal gaps and supplement local spending capacity. With the exception of large, wealthy metropolitan areas, the amount of revenues assigned to and collected by subnational governments is almost always much less than the amount of public expenditures needed at the subnational level. This asymmetry is due to a combination of economic and political reasons. The basic economic reason is that, in general, the major revenue sources are collected more efficiently under central control. The political reason is that there is often central resistance to decentralize even those revenues which are better placed under local control. As a consequence, there is a vertical fiscal gap between actual and desired fiscal resources at the subnational level, which governments seek to fill through intergovernmental fiscal transfers.

The basic types of fiscal transfers are Unconditional Grants and Conditional Grants (UCGs and CGs), Revenue-Sharing (RS) Transfers, and Performance-Based Grants. In addition to the objective common to all fiscal transfers – filling the financing gap at the subnational level – different types of transfers serve different policy objectives, such as addressing horizontal inequities between provinces or

1 Fiscal transfers are made by central governments to legally constituted subnational governments to whom responsibilities are devolved or delegated. Fiscal transfers are different from the flows of resources from central government ministries to deconcentrated local branches of these ministries, though fiscal transfers usually coexist with deconcentrated flows. This paper focuses on fiscal transfers; however, some of its recommendations are also relevant for deconcentrated flows of finance to subnational administrations.
districts, encouraging local spending on national priorities, compensating some provinces and districts for spillover effects from economic activities in adjacent or upstream provinces and districts, giving incentives to subnational governments to perform better, and satisfying local political claims on land and natural resources.

**Patterns and trends in fiscal transfers in Asia**

There is a large diversity in Asia in the magnitudes of fiscal transfers to subnational governments. Indonesia carried out “big bang” decentralization reform in the 1990s; Cambodia, the Philippines and Viet Nam have been implementing more incremental intergovernmental policy reforms for well over a decade; while the Lao People’s Democratic Republic, Malaysia, Myanmar and Thailand have opted to retain a much higher degree of centralized control over public spending. In consequence, the relative importance of subnational spending in total government expenditure varies greatly – from a mere 4 percent of government expenditure in Cambodia to 85 percent in China (OECD and United Cities and Local Governments, 2016). Figure 1 shows the share of subnational government spending – a measure of fiscal decentralization – for selected Asian countries.

Two major trends in Asia can be discerned over the past three decades.

**Figure 1. Subnational government spending share in total national expenditures, selected countries in Asia, 2013**

![Figure 1](image)

Source: Based on OECD/United Cities and Local Governments (2016).

Over time, in some countries fiscal transfer systems have become more complicated, with a proliferation of different Conditional Grant transfers, each with their own allocation criteria and procedures, reducing – in some cases for better, but often for worse – the degree of local discretion in spending, and complicating local planning, financial management and reporting.

On the positive side, there are important trends in Asia to reform fiscal transfer systems. Some countries have moved towards establishing more stable, transparent and predictable rules-based arrangements for the financing of the allocable pools and for the allocation of transfers to individual subnational governments. For example, China has been implementing major reforms since 1994, placing transfers to provinces within a more stable and transparent rules-based framework, although there is still a way to go. In Indonesia, the Law on Fiscal Decentralization of 1999 requires allocation of a minimum of 25 percent of the Indonesian Government's national budget to subnational governments through Dana Alokasi Umum (DAU), an Unconditional Grant. India, where the fiscal transfer system is already well embedded in law, has recently embarked on a major reform of its fiscal transfer system following the 14th Finance Commission (CFC) recommendations, to both increase States’ share in national revenues from 32 percent to 42 percent, and to shift the balance in local government transfers much more towards UCGs, in order to promote local discretion and leverage the benefits of decentralized decision-making.2

**Challenges and opportunities with fiscal transfers**

Better resourced, and better designed and implemented fiscal transfers are necessary for the realization of the 2030 Agenda for Sustainable Development and the achievement of the SDGs. One key problem with fiscal transfers in developing countries is that overall national budget constraints mean that they are never enough to meet local development needs – and yet, achieving the SDGs would require significant increases in investment and recurrent spending. That aside, problems related to their design and administration can also have serious knock-on effects which undermine the effectiveness, efficiency, sustainability, transparency and equitable allocation of local public spending on SDG priorities.

**Better resourcing for fiscal transfers**

Fiscal transfers are generally insufficient to meet the real fiscal gap, and in some cases they are woefully inadequate. This is a serious constraint on achieving local SDGs. To some extent, this inadequacy of central budgetary allocations for fiscal transfers is simply a reflection of the overall budgetary constraints faced by most Asian developing countries. But it is also often because of poor advocacy for SNG transfers in the national budgeting process – and this, in turn, is often due to lack of information about what is actually needed.

---

1 The recommendations are for a five-year period from 2015/2016 FY to 2020/2021 FY.
It is therefore recommended to support basic research on the service standards and delivery costs for decentralized SDG-critical responsibilities, to allow more informed advocacy for ensuring that SNG transfers receive due weight in the national budgetary process, and that the various fiscal transfer pools are resourced at levels closer to actual needs.

It is worth noting a common view that fiscal transfers promote “dependence” by SNGs and discourage local revenue effort. However, there is evidence that UCGs – when announced in good time and predictable – can encourage local revenue mobilization, so that the existence of unconditional transfers to subnational governments might in itself help increase their own sources of revenues. For instance, recent data show that in Morocco, a 10 percent increase in UCGs was associated with a 6.9 percent increase in subnational governments’ own revenue collection (Brun and Khdari, 2016). In the Philippines, a 10 percent increase in IRA grants is associated with a 3.4 to 3.9 percent increase in fiscal efforts. In Indonesia, an increase of 10 percent in DAU grants was associated with a 1.2 percent increase of SNGs’ own-source revenues (Troland, 2014; Lewis and Smoke, 2017).

**Incentive issues in fiscal transfer systems**

Implementing the local sustainable development agenda requires translation of policies and plans into actual budget spending priorities. Fiscal transfers can convey incentives which influence subnational governments’ spending decisions, sometimes for better, but often for worse. In many countries, problems exist in all critical design elements of fiscal transfers. Two sets of incentive issues can be distinguished: issues arising from the design and issues relating to the administration of fiscal transfers.

**Design issues**

There are three main design elements of fiscal transfers, concerning:

1. How is the total allocable pool for this transfer instrument determined?
2. How is allocation of fiscal transfers made to individual subnational governments?
3. What is the degree of discretion allowed to subnational governments in using the transfers?

First, where the national pool is determined on an ad hoc basis, or from a percentage of only one or two potentially volatile revenues, then the size of the transfer pool may vary considerably year by year, causing unpredictability and undermining sound local budgeting. For example, in Mongolia, the Local Development Fund is very dependent on a few (mainly mining and oil-related) revenues. The decline in mineral and oil prices since 2013, coupled with the yearly changes made to the percentages of these revenues financing this Fund, has resulted in substantial yearly changes, with the backdrop of the overall decline of the national pool for these transfers. Such uncertainties make year-to-year planning and budgeting very hard for SNGs, and undermine the incentive for SNGs to take budget prioritization seriously. They can propagate “boom and bust” cycles at the subnational level – with unplanned, wasteful spending in some years, and last-minute damaging cutbacks in lean years.

Second, if fiscal transfers are allocated to subnational governments in an ad hoc manner, with no obvious criteria, the uncertainty also makes it very hard for subnational governments to establish budget priorities and target spending where most needed. A special case of this problem is seen in regard to the negotiated “gap-filling” transfers typical of many current or former socialist countries, such as the Lao People’s Democratic Republic, Mongolia, Viet Nam and Commonwealth of Independent States (CIS) countries. These transfer arrangements require that SNGs first send up their spending and revenue proposals to central government, on the basis of which their “legitimate financing needs” are determined, often based on bilateral consultations by central government with individual SNGs, and the “gap-filling transfer” is approved. This encourages an inflated “wishlist approach” from SNGs and discourages any effort for local budget prioritization and hence for targeted SDG spending; it also promotes non-transparent deals and encourages patron–client relations between central and local politicians and officials. Many of these countries are implementing reforms of such “gap filling” transfers, but there are often major political obstacles to such reforms, including from subnational governments which would lose from these changes.

Where UCGs or CGs are allocated by a formula based on service delivery inputs – such as local staff or facilities (e.g. numbers of teachers or classrooms) – then this may encourage overspending by SNGs on these inputs in order to raise future transfer allocations, even where other spending priorities may be more important. To avoid such negative incentives, it is better that allocations not be made according to the stock or level of inputs, but instead

---

3 There is also a widely shared theoretical concern that fiscal transfers will “crowd out” local fiscal efforts, especially if the allocation formula aims to equalize allocations across SNGs by including actual SNG own revenues. However, this concern is not generally backed by evidence, especially with regard to UCGs.

4 The evidence from Morocco suggests that CGs do not stimulate own-revenue effort to the same degree as UCGs.
be made on some output-related basis (e.g. based not on classrooms or teachers, but on numbers of pupils and on the average annual cost of educating one pupil).

Third, proliferation or excess rigidity of earmarked or conditional grants can undermine the ability of subnational governments to flexibly tailor spending to local needs, although conditional grants are needed to protect critical public services which may otherwise be undervalued locally. Proliferation of Conditional Grants – or excessive earmarking – burdens subnational governments with excessive planning and reporting requirements and – crucially – limits the ability of local governments and stakeholders to tailor spending to the local context in the flexible manner that the sustainable development agenda requires.

Administration issues

All too often, there are also incentive problems stemming from the manner in which transfers are administered.

A first issue concerns the timing of information to SNGs about their transfers in the upcoming fiscal year. In some countries, very little time is given to subnational governments to formulate their budgets after the next year’s transfer amounts are announced. This leads to serious problems in deciding on spending priorities. For example, in Mongolia and Myanmar, after being informed of the size of their transfer allocations, subnational governments have only a few working days to select priority investments from the very long list of budget proposals and to finalize their budgets. The time is inadequate to do the necessary analysis or consultations to assess the merits of different spending options, as SNGs need to have a sufficient period to, for example, consult with different stakeholders and compare the costs and benefits of options. Consequently, the actual spending priorities selected in this rushed process are unlikely to be the most effective and efficient in attaining the SDGs.

A second issue concerns the actual release of funds to subnational governments. In some cases, the funds flow so slowly that subnational governments only receive transfer funds very late in the fiscal year. An extreme case is the Backward Regions Grant Fund in India, from which grants arrive sometimes at the end of the fiscal year or even one to two years late. In such cases, when funds actually arrive in the subnational government accounts, local officials will be compelled to spend funds hurriedly, often disregarding originally decided budget priorities – so that the resultant expenditures may be far from optimal in their benefits.

A third problem is related to carry-over rules. If subnational governments are not allowed to carry over unspent transfer funds into the next fiscal year, this can affect local spending. Although these rules have their rationale – to promote more efficient execution of budgetary resources – the reality is that subnational governments are often faced with serious implementation constraints due to no fault of their own. The delays in implementation are often due to funds arriving late in the fiscal year; seasonal

Recommendations

- Make the rationale and objectives of fiscal transfers explicit, in order to be able to design the right transfer mechanism for the right purpose. It is especially important to be clear about the objectives of transfer mechanisms that also have downsides, such as Revenue-Sharing Transfers which typically exhibit regional inequity and volatility; and Conditional Grants which tend to proliferate, sometimes encouraged by donors.
- Establish clear rules for determining the overall fiscal transfer pools, to ensure that these pools are predictable and stable; these pools may be based on a fixed percentage of all or most national revenues, or a per capita-based norm.
- Allocate fiscal transfers to SNGs in a predictable manner, with clear criteria; phase out “gap-filling” transfers.
- Plan to move over time towards greater local discretion for subnational governments and hence a higher share of Unconditional Grants in the mix of fiscal transfers. Accompany this move with increasing capacity and accountability of subnational governments, restricting overspending on non-developmental expenditures, and providing clear guidance to subnational governments regarding the uses of transfers.
- Avoid using inputs, such as number of staff and stock of facilities, in allocating both UCGs and CGs, as this may encourage overinvestment in such staff and facilities to “game” future allocations at the expense of more important service delivery expenditures.

- While Conditional Grants will always be needed, use them sparingly, retaining a few such fiscal transfer instruments to finance devolved service responsibilities that are of high national priority and require tight compliance with national standards, such as health, education and social protection.
constraints such as monsoons in Myanmar or long winters in Mongolia, which limit investment activities in rural areas; and problems in securing suppliers and technical expertise in more remote areas. As a result of the inability to carry over unspent funds, local spending on legitimate needs and priorities is unreasonably limited. A second consequence is that this tends to introduce a bias in the budget prioritization process towards easily implementable “off-the-shelf” investments, rather than those requiring a lengthier process of preparation, but for which risk extends into the next fiscal year. A third consequence is that SNGs have little incentive to make efficiency savings in implementation, since in any event they will not be able to retain these savings for the next year, if unspent funds simply revert to the central treasury.

Equity issues in fiscal transfer systems

Implementing the principle of “leaving no one behind” of the 2030 Agenda for Sustainable Development and SDG 10 to reduce inequalities means that public spending should be geographically equitable across a country, while reflecting the varying needs of different localities.

Fiscal transfers comprise the major budgetary resource at the subnational level, complementing local own-source revenues. The role of equalizing transfers (usually UCGs) within the larger fiscal transfer systems is to promote “horizontal balance” and compensate for subnational resource disparities. To get a good picture of the level of equity in the allocation of fiscal resources between provinces and districts, all resource flows need to be considered – including different kinds of transfers from the central government, and also SNGs’ own revenue streams.

Neither the overall spending per capita nor fiscal transfer levels per capita are expected to be equal across subnational governments. There are compelling reasons for differences in per capita transfer allocations between regions, such as differences in levels of poverty, or in the costs of inputs (for example in mountain areas of Nepal, the cost of cement is two to three times higher than in Kathmandu), or due to different economies of scale in service delivery between densely populated versus sparsely populated and remote regions. That aside, different SNGs will enjoy different levels of own-source revenue per capita, which should also ideally be factored into transfer allocations.

But the per capita variations should not be excessive and should reflect genuine differences in regional needs, rather than being the result of arbitrary factors. Yet it can be seen that horizontal variations in per capita fiscal transfers (which are the major determinants of variations in per capita spending) are much larger in many developing countries than can be justified by conceivable differences in need.

Such inequitable distribution of spending across provinces is due to two main factors: on the one hand, the amount of funds to be allocated as equalizing transfers is simply too small to compensate for the disparities caused by other streams of revenues to SNGs; and on the other hand, the formulae for allocation of equalization-intending transfers are not properly designed to reflect the relative needs of different SNGs. Large differences in per capita fiscal transfers between provinces may, in cases, be driven by political economy factors, while in other cases may simply remain unchanged by inertia.

Recommendations

- Allow sufficient time for subnational budget preparation. Subnational governments should be informed about the amount of transfers in the upcoming year as far ahead of their budget approval deadlines as possible, to have enough time to review the fiscal envelope, and to appraise and prioritize budget proposals and options.
- Clearly communicate what are eligible and non-eligible expenditures to subnational government personnel and other local officials.
- Strengthen subnational planning and budgeting capacities.
- Streamline funds release procedures.
- Streamline reporting requirements and other treasury procedures.
- Develop robust information systems to track funds.
- Support independent expenditure-tracking research and advocacy organizations.
- Allow subnational governments to carry over funds from one year to the next, in an accountable manner, to encourage implementation efficiencies and to avoid spending in favour of easily implemented expenditures at the expense of others.

5 This is in addition to the streams of deconcentrated spending through line ministries and other central programmes.

6 Unconditional Grants usually have equalizing objectives. In addition, Conditional Grants may also have narrower equalizing goals as they intend to ensure spending on specific services reflects the relative needs of the populations of different provinces or districts.
In some cases, own-source revenue assignments to SNGs or revenue-sharing arrangements with SNGs may be so large that the disparities generated by them cannot be offset by other “equalizing” transfers. Once such revenue assignments or revenue-sharing arrangements are in place, they may prove impossible to dismantle or reform. Furthermore, they may lead to ever-widening disparities. Consequently, serious inequities can creep into fiscal transfer systems and the variation in per capita spending between provinces can be stark in developing countries. For example, in Myanmar the ratio between the SNGs with the highest and lowest total spending per capita was 12:1 in 2016/17; in Mongolia the same ratio was 6:1 for 2017 (though this rises to 14:1 in the case of social service-related expenditures); and in the Lao People’s Democratic Republic for health sector spending it was 6.5:1 in 2017.7 However, once such inequities take hold, reform can be very difficult since the SNGs which benefit from the current arrangements will oppose any move to arrangements where they will lose, as has been seen in attempts to reform similarly inequitable transfer allocations in Indonesia.

To address inequitable horizontal allocation of fiscal transfers, it is important to establish clear rules for determining allocations to subnational governments. These rules should also help ensure the stability, predictability and transparency of transfers.

**Recommendations**

- In the mix of transfers, more funds should be allocated via (equalizing) UCGs, to ensure that these transfer amounts are sufficiently large to equalize.
- Beware of revenue assignment or revenue-sharing arrangements creating inequities that other transfers cannot compensate for.
- The allocations should also consider own-source revenues and revenue-sharing transfers, to avoid giving large transfers to subnational governments which already receive large streams of other revenues. This requires national governments to see the “big picture” by analysing all streams of revenues received by subnational governments – whether through own revenues or through various types of transfers.

**Leveraging fiscal transfers for positive performance incentives for the SDGs**

Fiscal transfers can also be designed to explicitly transmit positive incentives to promote better SNG performance for the SDGs. Historically, the focus of such incentives has been to encourage local revenue-raising efforts. This is usually done by including a variable in the grant allocation formula to provide additional resources to subnational governments with better performance in collecting own-source revenues, as seen in Mongolia.8 However, to avoid generating inequities across SNGs, this requires appropriate baseline studies and calibration.

Recent years have seen the emergence of Performance-Based Grants (PBGs) with a broader focus, many of which were initially piloted through donor-supported programmes in Asia and Africa. These PBGs are built into existing grants (UCGs or CGs) and have explicit incentives to encourage better subnational government performance in service delivery and governance. Early lessons from implementation of such transfers show that they offer promising avenues to encourage better quality spending and service delivery for the local sustainable development agenda, although with caution and caveats.

The key characteristics of PBGs are that they are given as a reward “top up” on existing grant transfers based on the results of annual performance assessments to measure SNG performance. The assessment scores are then used to reward or sanction SNGs (by transferring more or less to them) depending on their performance.

---

7 By contrast, for the United Kingdom and the United States (excluding Alaska), the ratio of per capita spending between the highest- and lowest-spending regions was 1.27:1 (2015/16) and 2.1:1 (2014), respectively.

8 In the special case of (former) socialist/transition countries, subnational governments are encouraged to raise more revenue and move from budget “deficit” to “surplus” through the reward of greater budgeting autonomy and fewer ex ante controls and restrictions (based on forecasts rather than results. However, transfers simply to fill gaps discourage local tax or revenue-raising efforts.
Broadly, PBGs can be categorized into multisectoral PBGs and sectoral/thematic PBGs.

For multisectoral PBGs, the performance criteria are generally “process” indicators related to governance, planning, budgeting, public financial management and transparency. Such multisectoral PGB initiatives have been introduced in several Asian countries: Bangladesh, Bhutan, Mongolia, Nepal and India. Indeed, the 14th Finance Commission (CFC) in India has recommended the national rollout of a PGB mechanism, whereby 10 percent of UCGs in rural areas and 20 percent in urban areas will be allocated on a performance basis, informed by experiences in West Bengal and Kerala.

For sectoral and thematic PBGs, performance criteria are usually service delivery “output” indicators in a specific sector, although “process” indicators are also used in addition to “output” indicators. In the health sector, countries such as Argentina, Brazil, Pakistan, Tanzania and Uganda, as well as India under the 14th CFC have implemented performance-based transfers. Funds are transferred to subnational governments and then further to health service units, based on measures of both general process performance and of health service outputs delivered. Ecological fiscal transfers are another type of sectoral PBGs. They have been implemented in Brazil, France and Portugal to reward subnational government performance in environmental protection, with performance measured against the size and quality of conservation measures by SNGs.

Experiences with PBGs point to many lessons in designing and implementing these transfers.

**Recommendations**

- **Process vs Service Output or Outcome Performance**: While it is tempting to link performance to service output or even outcome performance, this is very challenging and often not feasible. For multisectoral PBGs linked to UCGs, this would involve comparing very different service delivery compositions across SNGs (such variation being indeed a key rationale for decentralized decision-making). For sectoral or thematic PBGs, using “output” or “outcome” indicators of performance is possible, but requires much preliminary groundwork and can still be challenging: measuring the quantity and quality of service outputs requires a much greater, more costly and time-consuming fieldwork effort — while comparing outcomes across SNGs faces the challenge that the starting point for such outcomes will vary considerably across SNGs. Therefore, PBGs linked to output or outcome performance would require a considerable baseline study effort to calibrate rewards accordingly. In addition, many other extraneous factors come into play, outside the control of SNGs. Failure to make appropriate calibration will not provide the right rewards, and will cause inequitable allocations between SNGs.

- Ensure that basic preconditions are in place even for “process” indicators: Laws and regulations against which “process” performance is assessed should be appropriate, clear and consistent, and SNGs should be able to comply with these processes on their own initiative, independent of human or other resources outside SNG control — such as those provided by central governments or donors. Preliminary work needs to be done to determine reasonable standards and assess capacities.

- Choose appropriate performance criteria: Indicators to measure performance should be relevant, objective, verifiable and few in number. They should also be based on reasonable rather than “ideal” standards and relate to relatively recent subnational government activities (in the past two years).

- Design PBGs with appropriate size, selectivity and simplicity: It is doubtful that those (mainly urban) SNGs which have substantial own-source revenues, and for which fiscal transfers account only for a small part of overall revenues, will be encouraged to change performance by a PGB mechanism. For other SNGs, if the amount of PBGs is too small, they will not provide an incentive to improve performance (the usual rule of thumb is to calibrate PBGs to about 15 to 20 percent of the “parent” UCG or CG fiscal transfer). Similarly, if too many or too few SNGs are rewarded with PBGs, then the PBGs will also lose the ability to incentivize governments (here, the rule of thumb is to reward about 30 to 70 percent of SNGs). Lastly, the formula for PGB
allocation should be simple so that subnational governments can see the link between performance and reward.

• Conduct independent and robust quality annual performance assessments: Performance assessments should be done by outsourced institutions or audit agencies. The timing of performance assessments needs to be planned carefully alongside the government budget calendar, to ensure that assessments are done in time and the results are available in time to feed into next year’s transfer allocation decisions by the Ministries of Finance; time also needs to be allowed for queries and complaints by subnational governments. Care must be taken by donors not to set up an assessment mechanism so costly or complicated that it cannot later be sustained by the national government.

• Invest in capacity development of subnational governments: PBGs need to be accompanied by capacity development, especially if they aim to introduce innovative service delivery methods.

• Communicate and get political buy-in: The information about performance results and PBG allocations should be made public, for transparency reasons, to dispel suspicions of favouritism or influence in allocation of the extra grants, and also so that pressure can be put on poorly performing subnational governments by local citizens. PBG mechanisms will only work if politicians and central government policymakers back it up and are willing to resist the inevitable pressure from losing subnational governments.