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Policy Research Working Paper 5172

Sponsoring a Race to the Top

The Case for Results-Based Intergovernmental Finance for Merit Goods

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The World Bank
World Bank Institute
Governance Division
January 2010

Policy Research Working Paper 5172

Abstract

Intergovernmental finance is a significant source of subnational finance in most countries. In both industrial and developing countries, formula based "manna from heaven" general purpose transfers dominate but co-exist with highly intrusive micro-managed "command and control" specific purpose transfers. Both these types of transfers undermine political and fiscal accountability. Reforms to bring in design elements that incorporate incentives for results-based accountability are resisted by both donors and recipients alike. This is because the donors perceive such reforms as attempts at chipping away at their powers and recipients fear such programs will be intrusive. This paper presents conceptual and practical underpinnings of grant designs that could further simplicity, objectivity, and local autonomy objectives while furthering citizen-centric results-based accountability. The paper further highlights a few notable recent initiatives in both industrial and developing countries that embrace such directions for reform. The paper concludes that results-based intergovernmental finance offers significant potential to minimize tradeoffs between local autonomy and accountability while furthering access to merit goods.

This paper—a product of the Governance Division, World Bank Institute—is part of a larger effort in the department to reform intergovernmental finance to create incentives for accountable governance. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at shah.anwar@gmail.com.

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Produced by the Research Support Team

Sponsoring a Race to the Top: The Case for Results-Based Intergovernmental Finance for Merit Goods

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Sponsoring a Race to the Top: The Case for Results-Based Intergovernmental Finance for Merit Goods

Alternate title: Autonomy with Accountability : The Case for Performance-Oriented Grants

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1. Introduction

Intergovernmental finance is a significant source of sub-national finance in most countries as there are greater opportunities to decentralize spending as opposed to taxing responsibilities. The design of such finance has implications for efficiency, equity and accountability and therefore invites a great deal of public scrutiny and debate in most countries. Ironically, perpetual debates on these issues have not resolved even some fundamental questions as to the appropriate roles and designs of general purpose vs. specific purpose transfers. This debate is not well informed about the autonomy and accountability tradeoffs in such transfers due to the predominant mode of practice of such transfers in both industrial and developing countries. In both industrial and developing countries, "manna from heaven" general purpose transfers co-exist with micro-managed specific purpose transfers. This paper aims to: (a) clarify the debate on the practice of general vs. specific purpose transfers and propose a results-based framework for sub-national finance to create responsive, responsible, fair and

[1] The author is grateful to Dr. Niels Jurgen Mau, Ministry of Finance, Denmark, Professors Ricahrd Bird, Enid Slack, Jurgen Lotz, Junghun Kim, Roy Bahl and Georgio Brosio and other participants at the Experts' Meeting on The Practice of Intergovernmental Transfers, held in Copenhagen, Denmark, September 17-18, 2009 for helpful comments. The views expressed in this paper are those of the author alone and should not be attributed the World Bank Group or its Executive Directors.

accountable governance; and (b) make a case for greater attention to results-based finance for merit goods to marry local autonomy with citizen-centric results-based accountability for all orders of government.

The paper is organized as follows. Section 2 provides an introductory overview of the conceptual underpinnings of the intergovernmental finance. It highlights how grant design may blur the distinction between general and specific purpose transfers and underscore the futility of debate on general vs. specific purpose transfers in practice. Section 3 presents a case for results-based intergovernmental finance for merit goods and demonstrates that with appropriate design such transfers can preserve local autonomy while strengthening local accountability to its residents. Section 4 presents real world examples which come close to the idealized view of such transfers. A final section presents some conclusions.

2. The debate on general purpose versus specific purpose transfers

General purpose (unconditional) transfers augment the budget resources of the recipient without imposing any conditions on how spending is to be done. Therefore such transfers preserve autonomy. They can also enhance inter-jurisdictional equity if the allocation criterion is based on equalization principles. These transfers however act like manna from heaven and induce a lack of political and fiscal accountability if there is little discretion to raise revenues at the margin. Specific purpose transfers, on the other hand, are intended to provide incentive to undertake specific activities. These transfers can potentially undermine local autonomy and distort local priorities if, as usually is the case, there are conditions on spending and fungibility is not feasible as would be the case for spending that receives low priority in local allocation choices. Conceptually, it is possible to design specific purpose grants that advance the grantor's objectives while preserving local autonomy by having output-based conditionality only – the so-called output-based or performance-oriented grants as advocated by Shah (2006, 2009). Box 1

provides a broader framework for local finances highlighting how results-based finance fits in the overall scheme of local government finances.

<< Box 1 on Local Finances here>>

In practice, distinctions between the two types of grants are often blurred, especially in developing countries. For example, revenue sharing programs in a number of countries introduce a tax effort component (contributing to inequity) or other administrative requirements, such as requirements for a development plan, technical planning committee, internal audit requirements in Uganda and Tanzania, and submission of budget estimates to the central Ministry of Finance as in Kenya and Nepal (see Steffensen and Larsen, 2005). Even an equal per jurisdiction component of revenue sharing creates incentives for breakup of existing jurisdictions, as was observed in Brazil with the Municipal Participation Fund (see Shah, 1991).

3. Results-based intergovernmental finance as a tool to respect local autonomy while strengthening bottom-up accountability for provision of merit goods

The economic rationale for output-based grants is traceable to the emphasis on contract-based management under the new public management (NPM) framework and strengthening demand for good governance by lowering the transactions costs for citizens under the new institutional economics (NIE) approach. The NPM seeks to change the management paradigm in the public sector from permanent appointments to contractual appointment and continuation of employment subject to fulfilling service delivery contracts. It further seeks to create a competitive service delivery environment. The NIE approach argues that dysfunctional governance in the public sector results from opportunistic behavior of public officials as citizens are either not empowered or face high transaction costs to hold public officials accountable for their non-compliance with

their mandates or for corrupt acts. In this framework, citizens are the principals and public officials are agents. The principals have bounded rationality – they act rationally based on the incomplete information they have. In order to have more informed perspective on public sector operations, they face high transaction costs in acquiring and processing information. On the other hand, agents (public officials) are better informed and their self-interest motivates them to withhold information from the public domain as the release of such information contributes to their being held accountable. This asymmetry of information allows agents to indulge in opportunistic behaviors which go unchecked due to high transaction costs faced by principals and a lack of or inadequacy of countervailing institutions to enforce accountable governance. Results-based accountability through the use of output-based grants empowers citizens by enlarging their information base and lowering their transactions costs in demanding action.

Output-based transfers (used interchangeably with performance-oriented transfers in this paper) link grant finance with service delivery performance. These transfers place conditions on the results to be achieved while providing full flexibility in the design of programs and associated spending levels to achieve those objectives. This helps restore the recipient's focus on the results-based chain and alternate service delivery framework (competitive framework for public service delivery) to achieve those results. Figure 1 provides an illustration of this results-based chain for education services. In order to achieve grant objectives, a public manager in the recipient government would examine the results-based chain to determine whether or not program activities are expected to yield the desired results. For this, he needs to monitor *program activities* and *inputs* including *intermediate inputs* (resources used to produce outputs), *outputs* (quantity and quality of public goods and services produced and access to such goods and services), *outcom*e (intermediate to long run consequences for consumers/tax payers of public service provision or progress in achieving program objectives), *impact* (program goals or very long term consequences of public service provision), and *reach*

(people who benefit or are hurt by a program). Such a managerial focus reinforces joint ownership and accountability of the principal and the agent in achieving shared goals by highlighting terms of mutual trust. Thus, internal and external reporting shifts from the traditional focus on inputs to a focus on outputs, reach, and outcomes—in particular, outputs that lead to results. Flexibility in project definition and implementation is achieved through a shift in emphasis from strict monitoring of inputs to monitoring of performance results and their measurements. Tracking progress toward expected results is done through indicators, which are negotiated between the provider and the financing agency. This joint goal setting and reporting helps ensure client satisfaction on an ongoing basis while building partnership and ownership into projects (Shah, 2005).

<<insert figure 1 on results chain about here>>

Note that output-based grants must have conditions on outputs as opposed to outcomes as the latter are subject to influence by external factors beyond the control of a public manager. Public managers can only be held accountable for factors under their control. Outcome based conditions diffuse enforcement of accountability for results. Since the grant conditions are concerned with service delivery performance in terms of quality of output and access, the manager is free to choose the program and inputs to deliver results. To achieve those results, a public manager faces positive incentives by grant conditions to encourage alternate service delivery mechanisms by contracting out, outsourcing or simply to encourage competition among government and non-government providers for market share by establishing a level playing field through at par financing , or competition for the market by offering franchises through competitive bidding or providing rewards for performance through yardstick competition. Such an incentive environment is expected to yield a management paradigm that emphasizes results-based accountability to clients with the following common elements:

- contracts or work program agreements based on pre-specified outputs and performance targets and budgetary allocations
- life-long rotating employment replaced by contractual appointments with task specialization
- managerial flexibility but accountability for results
- public sector as a purchaser but not necessarily a provider of public services
- subsidiarity principle, i.e., public sector decision making at the government level closest to the people unless a convincing case can be made for higher level/order assignment
- incentives for cost efficiency
- incentives for transparency and competitive service provision
- accountability to taxpayers

Under such an accountable governance framework, grant financed budget allocations support contracts and work program agreements, which are based on pre-specified outputs and performance targets. The grant recipient's flexibility in input selection—including hiring and firing of personnel and program execution—is fully respected but at the same time there is strict accountability for achieving results. The incentive and accountability regime created by output-based transfers is expected to create responsive, responsible and accountable governance without undermining local autonomy whereas traditional conditional grants with input conditionality, on the contrary, undermine local autonomy and budgetary flexibility while reinforcing a culture of opportunism and rent seeking (see table 1).

<Table 1 – traditional vs OBG here>

Examples of output-based grants to encourage competition and innovation in education and health

Output-based grants create an incentives regime to promote the results-based accountability culture. Consider the case where the national government aims to improve access to education by the needy and poor as well as enhance the quality of such education. A commonly practiced approach is to provide grants to government schools through conditional grants. These grants specify the type of expenditures eligible for grant financing, for example, books, computers, teachers' aides, etc., and also financial reporting and audit requirements. Such input conditionality undermines budgetary autonomy and flexibility without providing any assurance regarding the achievement of results. Such input conditionality, in practice, is difficult to enforce as there may be significant opportunities for fungibility of funds. Experience has also demonstrated that there is no one-one link between increase in public spending and improvement in service delivery performance (see Huther, Roberts and Shah, 1997). To bring about accountability for results, consider an alternative, output-based design of such grants. Under this approach, the national government allocates funds to local governments based on the school-age population. The local governments in turn pass these funds to both government and non-government providers based on school enrollments. Conditions for receipt of these grant funds for non-government providers are that they must admit students on merit and provide a tuition subsidy to students whose parents do not have sufficient means to afford such fees. Conditions for the continuation of funds for all providers will be to improve or at the minimum maintain baseline achievement scores on standardized tests, improve graduation rates and reduce dropout rates. Lack of compliance with these conditions will invite public censure and in the extreme case a threat of discontinuation of funds with perpetual non-compliance. In the meanwhile reputation risks associated with poor performance may lead to reduced enrollments and associated reduction in grant funds. There are no conditions on the use of funds and schools have full autonomy in the use of grant funds and retain unused funds. Such grant financing would create an incentive environment for both government and non-government schools to compete and excel to retain students and establish reputation for quality education as in the final analysis it is the

parental choice that would determine available grant financing to each school. Such an environment is particularly important for government schools where typically staff members have life-long appointments and financing is assured regardless of school performance. Budgetary flexibility and retention of savings would encourage innovation to deliver quality education. Thus output-based grants preserve autonomy, encourage competition and innovation while bringing strict accountability for results to residents. This accountability regime is self enforcing through consumer (parental choice in the current example) choice. Such a school financing regime is especially helpful in developing countries and poorer jurisdictions in industrial countries plagued with poor quality of teaching and worse teacher absenteeism or lack of access to education in rural areas. The incentive regime provided by results-based financing will create market mechanism to overcome these deficiencies over time.

A similar example of such a grant in health care would allocate funds to local governments based upon weighted population by age class with higher weights for senior citizens (65 years and over) and children (under 5 years). The distribution by local government to providers would be based upon patient use. Minimum standards of service and access to health care will be specified for the eligibility to receive such transfers.

Is there a case for results-based finance in industrial countries?

Influential policy makers from industrial countries would argue that results-based finance in industrial countries represents overkill as in both political and bureaucratic circles there is a strong culture of citizen based accountability (see Kim and Lotz, 2008). Local politicians in these countries hold them to higher ethical standards and bureaucratic enjoy espirit de corps. Electoral accountability for the former and the internal civil service culture for the latter incentivizes both parties to aspire for better comes for their residents. Both voting by ballots and voting with their feet reinforce political and fiscal accountability. They argue that under such circumstances not much

is lost if all grant monies are pooled together as general purpose transfers. Such bundling together of all higher level assistance strengthens local autonomy without having any adverse impact on their performance.

Granted that rent seeking and opportunism by officials may be more circumvented in industrial countries, yet the impact of competition can hardly be overstated. Contrasting the experiences of the United States and Canada in school finance and their impacts on school performance highlights the importance of school finance. In the United States, in most states, government schools are financed by property taxes, fees and state grants, whereas private schools are financed by school endowments, fees and donations. This separation of government and private school finance leads to a lack of competition among government and private schools with deleterious effects on school performance. Private schools almost always outperform government schools. This is even true when government schools outspend by multiples the private schools in per pupil spending, as is the case in Washington, D.C. A recent *Washington Post* report shows that private parochial (religious) schools on average spend nearly half as much as government schools in per pupil spending but perform much better than government schools in the Washington Metropolitan area covering the District of Columbia, Maryland and Virginia. Overall in the United States, government schools perform poorer on achievement scores than their private school counterparts. This result is understandable because the government schools have assured finances and have no incentives to perform better to stay in business. Strong teachers' unions almost always succeed in forestalling any reforms that create incentives to compete and perform better.

Now consider a contrasting model of school finance as is the case in the province of Alberta, Canada (and in most provinces in Canada and Australia). Both government and private schools receive financing through aggregation of individual taxpayer's election of his contributions to the education mill rate of property tax. This election, however, does not limit parental choice for schools – government or non-government. Such a financing

regime introduces competition and places great premium on school performance and as a result government schools in Canada on average outperform private schools. Such a financing g regime also limits great disparities in individual school performance.

The contrasting experience of the United States and Canada demonstrates the need for introducing results-based finance in industrial countries (see Box 2 for an overall framework of intergovernmental finance that is relevant for all countries). In a radical reform of its intergovernmental finance system, Australia has recently made significant moves to introduce results-based intergovernmental finance system (see Shah, 2004 for a critique of the earlier Australian system that may have motivated recent reforms). In the next section, we will review recent attempts to introduce such reforms.

<< Box 2 – here>>

4. Results-based intergovenmental finance – The practice

Results-based finance can be used to influence sub-national priorities or to undertake partnership tasks. Practical examples of such practices are few and far between. A few interesting examples of such an approach are listed below. These practices are grouped in two broad categories: (a) results-based intergovernmental finance to support broader reforms and (b) assuring minimum standards in the provision of merit goods.

a. Furthering intersectoral reforms

Only a few noteworthy examples of this nature are available.

Australia: National Partnership Payments, 2009

These payments are intended to provide incentives to states either (a) facilitate reforms e.g. implementing the seamless national economy through reductions in unnecessary and inconsistent regulation across jurisdictions and to improve processes for regulation

making and review; or to reward those jurisdictions that deliver on nationally significant reforms – the National Partnership Reform Payments; or (b) to improve service delivery standards - National Partnership Project Payments. The payments are based upon intergovernmental agreements that set out mutually agreed performance benchmarks and channeled through the Council of Australian Governments (COAG) Reform Fund. The states are free to use these funds as they chose provided they can demonstrate agreed upon results. The results are to be verified on behalf of the COAG by an independent agency – the COAG Reform Council, reporting to the Prime Minister as Chair of COAG. The Australian Government has also clarified performance reporting and accountability framework for such transfers (see Chart 1). The COAG Reform Council has been authorized to monitor performance against agreements and report such information to the COAG and general public (see Australia, 2009).

"Performance Reserve Fund" of the European Union (EU) Structural Funds Program, 2000-2006

The EU set aside 4% of the total structural funds transfers and made the distribution conditional on achieving specific jointly agreed objectives. Following EU agreement, Italy set aside 4% of the structural funds it received as "community performance reserve" to be allocated to regions for improving effective utilization of structural funds. The indicators used for this evaluation included: (a) program implementation effectiveness; (b) quality of management based upon control system, selection criteria, monitoring and evaluation systems and evaluating employment impacts; and (c) having financial and project finance plans – later reflecting public-private partnerships. Italy further augmented this program by setting aside 6% of the structural fund's budget transfer to regional governments as "national performance reserve" to be distributed upon progress achieved in modernizing regional public administration. Performance indicators used emphasize (a) implementation of national legislation for public administration reforms especially reforming systems of managerial selection and evaluation; (b) innovations in enhancing effectiveness of structural funds such as monitoring and evaluation systems; (c)

implementing integrated multi-regional projects; and (d) focusing resources on a few priority areas (see Anselmo et al., 2006).

Russian Federation – Regional Fiscal Reform Fund

This fund was established in 2007 and provides special supplemental grants to regions that agree with the federal government in implementing a package of fiscal reforms (Kaiser, 2009).

Uganda – Local Development Grant

Eligibility for this grant is based upon compliance with three minimum conditions: (1) Availability of a council approved district development plan and functional planning committees; (2) proper maintenance of accounts and adherence to procurement regulations; and (3) capacity to supervise engineering works. Those districts and sub-counties who comply with these conditions are further assessed against the following criteria to determine a reward (20% of the grant) or a punishment (20% of the grant funds). The performance measures used are: (a) efforts made to improve the quality of the development plan; (b) allocation of the development grant in line with the national priority program areas – water, primary education, primary health, feeder roads, and agricultural extension; (c) timely accountability and expenditure decisions in line with actual allocation ; (d) capacity building effort; (e) staff functional capacity; (f) tendering capacity and performance; monitoring reports; (g) mentoring plans and reports of a higher local government to a lower local government; and (h) 10% co-financing being provided (Barungi, 2003).

b. Setting national minimum standards for merit goods

Setting national minimum standards in regional-local services may be important for two reasons. The first is that there is an advantage to the nation as a whole from such standards as these will contribute to the free flow of goods and services, labor and capital and reduce wasteful inter-jurisdictional expenditure competition, and will therefore

improve the gains from trade from the internal common market. Second, these standards serve national equity objectives. Many public services provided at the sub-national level such as education, health and social welfare are redistributive in their intent, providing in-kind redistribution to residents. In a federal system, lower level provision of such services – while desirable for efficiency, preference matching, and accountability – create difficulty in fulfilling federal equity objectives. Factor mobility and tax competition create strong incentives for lower level governments to under-provide such services and to restrict access to those most in need , such as the poor and the old. This is justified by their greater susceptibility to disease and potentially greater risks for cost curtailment. Such perverse incentives can be alleviated by conditional non-matching grants where the conditions reflect national efficiency and equity concerns, and where there is a financial penalty associated with failure to comply with any of the conditions. Thus conditions will not be on the specific use of grant funds but attainment of standards in quality, access and level of services. Such output-based grants do not affect local government incentives for cost efficiency but do encourage compliance with nationally specified standards for access and level of services. Properly designed conditional non-matching output-based transfers can create incentives for innovative and competitive approaches to improved service delivery. Input-based grants fail to create such accountability.

Examples of output-based (performance-oriented) grants to achieve and sustain national minimum standards for merit goods

Results-based finance has been used to sustain national minimum standards for merit goods in a few countries. Most of these practices are in the fields of education and health only; but in a limited number of cases, such finance has been used in other public goods, such as infrastructure. The following paragraphs highlight these examples.

Results-Based Financing of Education

Several countries have launched innovative programs to create results-based accountability in financing sub-national education programs. These are reviewed in the following paragraphs.

Australia: National Schools Specific Purpose Payments, 2009

The National Education Agreement specifies the following objectives for this grant program:

- ensuring that all children are engaged in and befitting from schooling, with a goal of lifting the Year 12 attainment rate to 90 percent by 2015;and
- ensuring children meet basic literacy and numeracy standards and continuing to improve overall literacy and numeracy achievements.

These are equal per capita payments for both government and non-government schooling to all states. Out of this the government schools component for each state is based upon each state's share of full time equivalent student enrollments in government schools. The growth factor for government school component is the product of the growth in average government schools recurrent costs and the growth in full time equivalent in government schools. The grant funds are required to be spent on schooling but states have full budget flexibility to allocate funds as they see fit to achieve mutually agreed objectives. The program has not set nay benchmarks for performance but as part of an overall reporting and accountability framework, states must provide performance data to the Commonwealth and to the general public. The COAG Reform Council will collate data for all states and will publish such statistics and analytical reviews of performance for government and general public use (The Australian Treasury, 2009).

United States: Race to the Top Competitive Grant Program, 2009

This $4.35 billion program was launched by President Obama on July 24, 2009 to mark a new federal partnership in education reform with states, districts and unions to

accelerate change and boost improvements. The program invites states to apply for financing by undertaking to implement four core interconnected reforms as follows:

- Raising standards: Agreeing to adopt internationally benchmarked K-12 standards
- Closing the data gap: Establish data bases to monitor advances in student achievement and identification of effective instructional practices.
- Improving quality of teachers and principals especially I high poverty schools: Establish strategies for rewarding and retaining top-notch teachers and separation of non-performers.
- Turning around lower performing schools: Introduce major reforms to change school culture and replace staff and principals.

As a part of the eligibility for financing, each state's record will be examined for its compatibility with providing a progressive environment for improving education standards and access. For example, states that limit alternative routes to certification for teachers and principals or cap the number of charter schools will be at a competitive disadvantage. States that explicitly prohibit linking data on achievement or student growth to principal and teacher evaluations will be ineligible for the grant until they change their laws (see Duncan, 2009).

United States No Child Left Behind (NCLB) Act of 2001

The NCLB provides federal financing of elementary and secondary education (K-12 schooling) provided states agree to requirements for student testing, accountability and strive for improvements in achievement scores and equity in access to education by various income and ethnic groups. NCLB requires states to test students in reading and mathematics annually in grade 3-8 and once in grade 10-12 and in science once in grades 3-5, 6-8, and 10-12. Individual schools, school districts and states must publicly report test

results in the aggregate and for specific student subgroups including low income students, students with disabilities, students with English as a second language and major racial and ethnic groups.

NCLB requires that states, school districts, and schools ensure all students are proficient in grade-level math and reading by 2014. States define grade level performance. School must make “adequate yearly progress” towards this goal, whereby proficiency rates increase in the year leading up to 2014. The rate of increase required is chosen by each state. In order for a school to make adequate yearly progress (AYP), it must meet its targets for student reading and math proficiency each year. Schools that fail to make adequate yearly progress for two consecutive years must draft a school improvement plan. A school failing to meet AYP for three consecutive years must initiate a performance improvement plan and also implement public school choice – students given option to move to other public schools. A fourth year failure requires restructuring and supplemental education services – school financed special instruction. If a school fails to make AYP in the fifth year, it must implement restructuring including changes in staff and management or converting into a charter school run by a private management company.

The NCLB Act also provides for special education finance incentive grant to (i) reward “good school finance” states – those that spend more on public education and distribute funds equitably; (ii) provide twice the amount of funds to high poverty school districts in “bad school finance states” – those which spend relatively less on education and distribute funds inequitably to school districts (see Foundation for New America, 2009).

Local governments in the Province of Alberta, Canada, use a novel approach to determine the allocation of taxpayers’ contribution to school finance. This is done by resident taxpayers through designation of their education component of the property tax bill to either public or parochial (religious, private) school boards. These declarations determine the total amounts of property tax finance available to public and provide providers. Schools receive grants on a per pupil basis and parents retain option to send

their children to a school of their choosing regardless of their exercise of voting on school finance. Higher education financing assigns weights to enrollments by different programs with medical and engineering education receiving higher weights than humanities.

Results-Based Finance of Higher Education in Industrial Countries

A handful of countries use performance basis in funding universities. Commonly used criteria include: number of credits accumulated by students; number of graduates; research publications; and number of doctoral dissertations (see Jongbloed and Vossensteyn, 2001). The following paragraphs cite specific examples of such finance.

Most provinces in Canada provide university finance based upon enrollments/graduation by types and sciences, engineering and medicine receive higher weights than social sciences and humanities. A few provinces provide supplemental grants using performance based criteria. The Province of Ontario provides 2% of total funding based upon (a) six month and two year employment rate for recent graduates; (b) degree completion by entrants. The Province of Alberta provides a special grant to recognize universities for their institutional performance on several indicators: enrollment growth; satisfaction of recent graduates; administrative expenditure efficiency; revenue generation by means other than fees; research grants; citation impact of research papers; and community and industry support of research.

Denmark provides 30-50% of higher education finance based upon number of students passing specified examinations. Each student cost is weighted based upon the subject major based upon the so-called “taxi-meter” model that takes into account differential costs associated with education and equipment, joint costs (administration and buildings, and expenses for experimental sciences and practical training as in medicine and physics.

Finland finances higher education using three components – core funding, performance funding and funding for specific initiatives. Performance funding is based upon: funding for research from external sources; assessed learning achievement,

provision of adult education; graduation time; and participation in international cooperation. To calculate the amount of performance funding, target figures are multiplied by field-specific cost factor, agreed for a three year contract period (Holtta and Rekila, 2003).

The Netherlands provides 50% of university financing based upon output criterion. Each university's grant is based upon the number of students who completed their programs multiplied by the normative study duration (4.5 years) plus the number of students who drop out multiplied by an administratively set study duration of these dropouts (1.35 years). The total amount of funding is then calculated by multiplying calculated graduation numbers by a fixed reimbursement per student with engineering receiving a higher amount per student compared to other programs (CPH and CHEPS, 2001).

Sweden specifies minimum number of students in general and in science and technology in particular for each institution to receive financing. 40% of the financing is based on enrollments and the remaining 60% based upon accumulated credits.

In the USA, most states provide a small amount of funding based upon performance. South Carolina is the only state where all university financing is based upon 37 specified indicators. The State of Tennessee provides 6% of university finances using four performance criteria: academic testing and accreditation with 60 % weight; satisfaction surveys with 15% weight; planning and collaboration receiving 10% weight and student outcomes in terms of retension, job placement and assessment implementation receiving 15% weight (Bogue, 2002).

Results-Based Education Finance: Developing and Transition Country Examples

Conditional non-matching output-based transfers to ensure national minimum standard in merit goods or for fiscal need compensation are rarely used in DTEs.

Nevertheless, one finds a few shining examples of programs that marry equity with performance orientation in grant allocation.

Brazil has a noteworthy national minimum standards grant programs for primary education. Under the 14th amendment to the federal constitution, the state and municipal government must contribute 15% each of their two principal revenue sources (state value added tax and state share of the federal revenue sharing transfers for states, and services tax and the municipal share of the state revenue sharing transfers for municipalities) to FUNDEF - special fund for primary education. If the sum of the state and municipal required contributions, divided by the number of primary school students, is less than the national standard, the federal government makes up the difference. The total amount of the FUNDEF is then distributed among the state and its municipal providers is distributed on the basis of school enrollments (see Gordon and Vegas, 2004 for a review of the FUNDEF program).

Chile's (and the State of Michigan, USA) school grants finances vouchers for school age population giving parents a choice in sending their children to public or Catholic/private schools. An additional performance grant providing 25% additional grant as salary bonus for teachers in the best performing schools based upon a National System to Evaluate School Performance (SNED in Spanish, see Gonzalez, 2005, Thorn, Nielson and Jeppesen, 2004). Central per capita transfers for education in Colombia and South Africa, and the capitation grant to Malaysian states come close to the concept of such a transfer.

The operating grant for schools (became defunct in 2000) in Indonesia used school age population (ages 7-12) as criteria for distribution of funds to district governments. This was supplemented by a matching capital grant (local government to provide land for school) to achieve minimum standards of access to primary schooling. These grants enabled Indonesia to achieve a remarkable success both in improving literacy as well as minimum standards of access across the nation.

Resulted Based Financing of Healthcare

Canada and Brazil lead the way in results-based intergovernmental finance in health as discussed below.

Canada: Canadian Health Transfers Program (CHT)

A good illustration of a simple yet effective design of such a grant system is the Canadian Health Transfers (CHT) program. Under this program, the federal government provides per capita transfers for health to the provinces with the rate of growth of these transfers tied to the rate of growth of the GDP. There are no conditions on spending but there are strong conditions on the access to health care. As part of the agreement to receive these transfers from the federal government, the provinces undertake to abide by several access-related conditions and face penalties as specified below if there was a breach of any condition. The five conditions are:

(1) Universality: To provide universal coverage.

(2) Portability: Residents have the ability to move to another province and retain health coverage in the province of origin for a transition period. Residents and non-residents have equal access.

(3) Public insurance but public/private provision: The province agrees to provide universal insurance to all but financing of public and private providers on equal footing – both get reimbursed from the public insurance system using the same schedule of payments negotiated by the provincial medical association.

(4) Opting in and opting out: All health providers have the option of opting out of the system and bill patients directly and not follow the prescribed fee schedule. The clients of

these providers get reimbursed according to government prescribed schedule of payments by submitting claims.

(5) No extra billing: All providers opting in the system cannot bill patients directly especially for charges in excess of the prescribed schedule.

Penalties include the threat of discontinuation of the grant program if conditions (1) through (4) are breached and dollar for dollar reduction of grant funds for breach of condition (5).

The program has enabled Canadian provinces to ensure universal access to a high quality health care to all residents regardless of their income or place of residence.

Brazil: Unified Heath System (SUS)

Fiscal transfers in support of the Unified Health System – SUS that operationalizes the constitutional obligation of universal right to free health services - are administered under a federal program called annual budget ceilings –TGF. The TGF has two components. Equal per capita financing to all municipalities is provided to cover basic health benefit. Funding for hospital admissions and high cost ambulatory care is subject to ceiling for each type of treatment. All registered health care providers – state, municipal, or private are eligible for grant financing through their municipal government (World Bank, 2001, Shah 1991).

Results-Based Finance of Other Services

Only a handful of examples are available, as noted below.

Indonesia - The District/Town Road Improvement Grant used as allocation criteria, length of roads, condition, density (traffic use) and unit costs as criteria for distribution of funds. This grant program helped monitoring the health of the road network on a

continuing basis and was successful in keeping roads in good working conditions in most jurisdictions (Shah, 1998).

Chile - Grants to municipal governments for water and sewer access by the poor cover 25-85% (means tested) of a household's water and sewer bill for up to 15 cubic meters a month with the client paying the rest (Gomez-Lobo, 2002).

Argentina – Federal transfers to provinces for social insurance are based upon number of poor women and children enrolled in social insurance and performance on key output measures (Eichler, 2008).

5. Conclusions

In conclusion, while output-based (performance) oriented grants are best suited to the grantor's objectives and also simpler to administer than traditional input-based conditional transfers, yet they are rarely practiced. The reasons have to do with the incentives faced by politicians and bureaucrats. Such grants empower citizens/customers while weakening the sphere of opportunism and pork barrel politics. The incentives they create serve to strengthen the accountability of political and bureaucratic elite to citizens and weaken their ability for influence peddling and building dream bureaucratic empires. Their focus on the value for money exposes corruption, inefficiency and waste and expectedly their introduction is blocked by potential losers. Citizens' activism garnered by the information revolution offers new hope to overcome these obstacles to reform, as is indicated by several recent reform initiatives in both industrial and developing countries.

Annex 1. United States No Child Left Behind Act

With its enactment in 2001 of the *No Child Left Behind Act* (NCLB), Congress reauthorized the funding of the Elementary and Secondary Education Act (ESEA) but added significant accountability provisions and other conditions to federal education aid. Most aid is referred to as Title I aid and is allocated to school districts (rather than states) based on the number of poor children who reside in the district and on the average level of school spending in the state. The program is not fully funded, which means that the amount appropriated for the program does not equal the sum of its grant obligations as determined by the formula. The current funding formula includes a "hold harmless" provision to prevent districts from experiencing declines in funding commensurate with any declines in the number of poor children, and also a "small state minimum" which ensures that the sum of district allocations in each state meets some minimum level. These provisions, in the context of the lack of full funding, disproportionately limit the amount of funds available for districts with growing poor populations as districts with relatively shrinking poor populations are held harmless.

The stated goal of NCLB is to close the academic achievement gap that currently exists among students of different races and between those from economically disadvantaged and other families. NCLB as written requires states receiving Title I funds to implement annual standardized testing in grades three through eight in reading and math (and in science as well starting in 20007/2008) and to set state standards of proficiency on those tests. The law mandated that by 2005-06, all schools in Title I states must be staffed entirely by "highly qualified" teachers, with bachelors degrees, state certification and some proof of subject-level competency in each subject they teach.

Title I schools are monitored for their annual yearly progress (AYP) in working towards having 100 percent of students and all sufficiently large "subgroups" of students (defined by racial/ethnic category, free lunch eligibility, English proficiency, and disability) meet state standards by 2014. Various penalties exist for failing to meet AYP

with the severity of the penalty depending on the number of consecutive years of failing to meet the standards. Key sanctions include giving students the option to transfer to another public school and giving low-income students the opportunity to use part of the Title I funds previously allocated to the school on their behalf. Students can use these funds with the supplemental educational services (tutoring) provider of their choice, including a private provider. All Title I schools, regardless of progress in meeting state standards, must use federal funds only for programs grounded in “scientifically based research.” This requirement is both ambiguous and highly controversial.

While states retain authority over what constitutes proficiency on their own tests, the federally-determined sanctions for failure to make AYP provide an incentive for states to set lower proficiency thresholds that schools are more likely to attain (or, alternatively, to choose easier tests that yield higher scores).

There is wide agreement that NCLB has sparked significant changes in educational practice. The Center for Educational Policy has conducted one of the most comprehensive data collection efforts tracking the impact of NCLB since its implementation. Jennings and Rentner (2006) describe major findings from this tracking effort. These include changes in activities undertaken by state education agencies, ranging from adopting standards and creating corresponding standardized tests to establishing state-specific criteria of what constitutes a highly qualified teacher. The bulk of NCLB-induced changes, however, have been at the school level. Jennings and Rentner describe schools increasing time spent teaching tested reading and math, aligning their curricula to better match state standards and tests, and increasing attention to the subgroups of students most likely to cause schools to fail to meet AYP goals.

Source: Annex write-up provided by Andrew Reschovsky in a personal communication with the author, August 2009.

Box 1. Key Considerations and Tools for Growth Oriented Local Government Finances

Key Considerations

The overall objective of local governments is to maximize social outcomes for residents and provide an enabling environment for private sector development through efficient provision of public services. This requires that local financing should take into account the following considerations:

- Local government should limit self-financing of redistributive services.
- Business should be taxed only for services to businesses and not for redistributive purposes.
- Current period services should be financed out of current year operating revenues and future period services should be financed by future period taxes, user charges/fees, and borrowing.
- Residential services should be financed by taxes and fees on residents.
- Business services should be financed on site/land value taxes and user charges. Profit, output, sales, and moveable asset taxes may drive business out of the jurisdiction.

Tools for Local Finance

- *Local taxes* for services with public goods characteristics – streets, roads, street lighting
- *User charges* for services with private goods characteristics – water, sewerage, solid waste
- *Conditional, non-matching, output-based grants* from national/state-order governments for merit goods: education and health
- *Conditional matching grants* for spillovers in some services
- *Unconditional grants* for fiscal gap and equalization purposes
- *Capital grants* for infrastructure if fiscal capacity is low
- *Capital market finance* for infrastructure if fiscal capacity is high
- *Development charges* for financing growth with higher charges for developing land on local government boundaries
- *Public-private partnerships* for infrastructure finance but keeping public ownership and control of strategic assets
- *Tax increment financing districts* to deal with urban blight. For this purpose, the area should be designated for redevelopment and annual property tax revenues frozen at pre-vitalization levels. For a specified period, say 15-35 years, all tax revenues above base are

used for redevelopment. Capacity improvements are undertaken through municipal borrowing/bonds against expected tax increments.

Source: Inman (2006) and Boadway and Shah (2009)

Box 2. Principles and Better Practices in Grant Design

Grant objective	*Grant design*	*Examples of better practices*	*Examples of practices to avoid*
Bridge fiscal gap	Reassignment of responsibilities, tax abatement, tax-base sharing	Tax abatement and tax-base sharing (Canada)	Deficit grants, wage grants (China), tax by tax sharing (China, India)
Reduce regional fiscal disparities	General non-matching fiscal capacity equalization transfers	Fiscal equalization with explicit standard that determines total pool as well as allocation (Canada, Denmark, and Germany)	General revenue sharing with multiple factors (Brazil and India); fiscal equalization with a fixed pool (Australia, China)
Compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spill-out of benefits	Grant for teaching hospitals (South Africa)	Closed-ended matching grants

Set national minimum standards	Conditional non-matching output-based block transfers with conditions on standards of service and access	Road maintenance and primary education grants (Indonesia before 2000) Education transfers (Brazil, Chile, Colombia) . Health transfers (Brazil, Canada),	Conditional transfers with conditions on spending alone (most countries), pork barrel transfers (USA e.g. $200 million earmark in 2006 for a “bridge to nowhere” in Alaska), ad hoc grants
	Conditional capital grants with matching rate that varies inversely with local fiscal capacity.	Capital grant for school construction (Indonesia before 2000), highway construction matching grants to states (United States)	Capital grants with no matching and no future upkeep requirements
Influence local priorities in areas of high national but low local priority	Open-ended matching transfers (preferably with matching rate varying inversely with fiscal capacity)	Matching transfers for social assistance (Canada before 2004)	Ad hoc grants
Provide stabilization and overcome infrastructure deficiencies	Capital grants, provided maintenance possible.	Capital grants with matching rates that vary inversely with local fiscal capacity	Stabilization grants with no future upkeep requirements

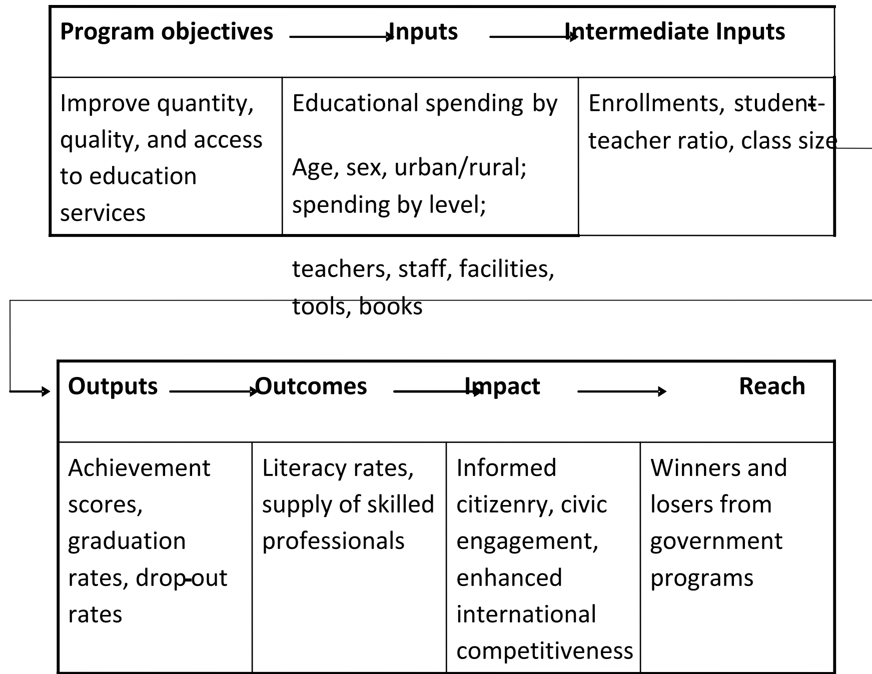
Source: Anwar Shah, "A Practioner's Guide to Intergovernmental Fiscal Transfers," in Robin Boadway and Anwar Shah (eds.), *Intergovernmental Fiscal Transfers* (Washington, D.C.: World Bank, 2007), pp. 1-53.

Table 1. Traditional and output-based (performance-oriented) conditional grants

Criterion	Traditional conditional grant	Output-based grant
Grant objectives	Spending levels	Quality and access to public services
Grant design and administration	Complex	Simple and transparent
Eligibility	Recipient government departments/agencies	Recipient government provides funds to all government and non-government providers
Conditions	Expenditures on authorized functions and objects	Outputs -service delivery results
Allocation criteria	Program or project proposals approvals with expenditure details	Demographic data on potential clients
Compliance verification	Higher level inspections and audits	Client feedback and redress, Comparison of baseline and post-grant data on quality and access.
Penalties	Audit observations on financial compliance	Public censure, competitive pressures, voice and exit options for clients
Managerial flexibility	Little or none. No tolerance for risk and no accountability for failure.	Absolute. Rewards for risks but penalties for persistent failure
Local government autonomy and budgetary flexibility	Little	Absolute
Transparency	Little	Absolute
Focus	Internal	External, competition, innovation and benchmarking
Accountability	Hierarchical and to higher level government, controls on inputs and process with little or no concern for results	Results-based, Bottom-up, client-driven

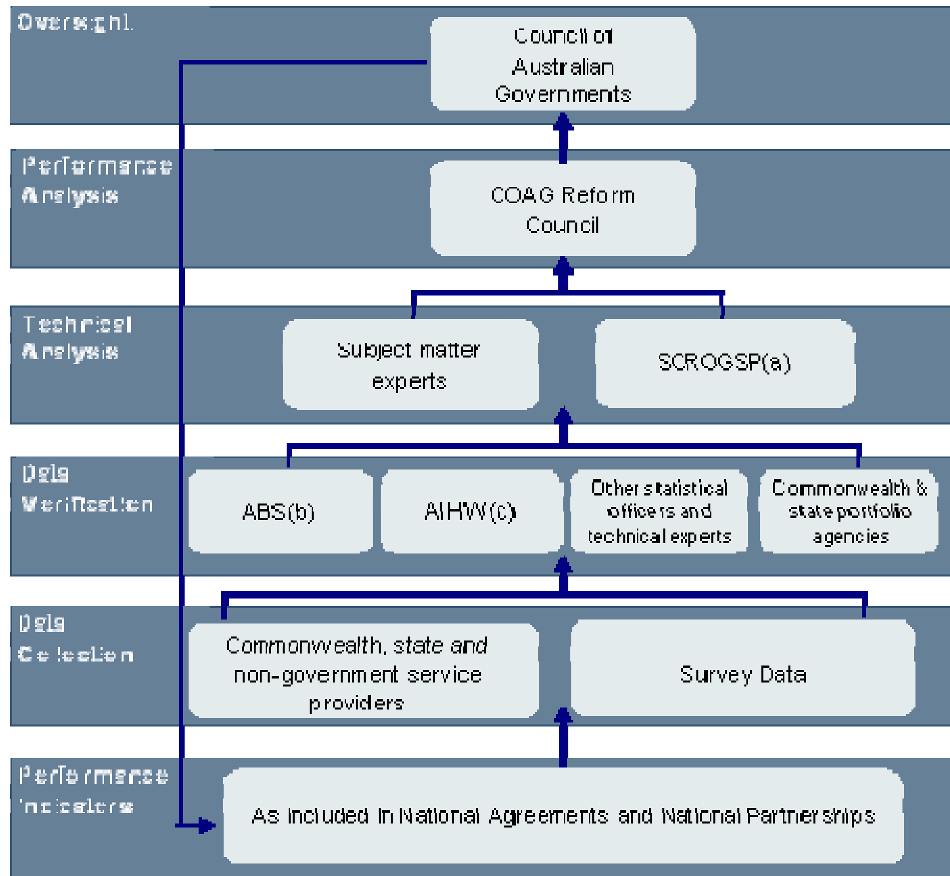
Source: Boadway and Shah, 2009.

Figure 1 Results-based Chain - Application in Education



Source: Shah, 2005.

Chart 1: Performance reporting information flows



Notes: ABS: Australian Bureau of Statistics,

Source: Australian Treasury (2009), Budget Paper no.3, p.

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