

## POSSIBLE DIRECTIONS FOR PERFORMANCE GRANTS TO LGUs IN THE PHILIPPINES

*(largely based on the “Key Issues on Performance Based Grant Design Parameters” study undertaken by Jesper Steffensen, August 2005)*

---

The intergovernmental transfer system is vital to the operation of LGUs in the Philippines. The transfers contribute more than 65% of aggregate LGU revenues and take up a significant share of national government public expenditure. As the overall fiscal position of government is constrained, these expenditures have invited increasing scrutiny, either as a potential source of savings to government and/or to ensure that delivery efficiencies are maximized. While the Internal Revenue Allotment (IRA) accounts for by far the largest component of these flows, this note focuses on the *non-IRA* part of intergovernmental transfers.

The existing intergovernmental transfer system faces two key challenges:

- The system currently provides few incentives for improving LGU performance.
- The non-IRA component of the system is fragmented, complicated and non-transparent, making it difficult for LGUs to access this support in a predictable manner. The information about the size and the allocation of these sources is rather limited.<sup>1</sup>

There are therefore good reasons for (a) rationalizing the existing intergovernmental transfer system and (b) introducing more a performance orientation into it. There is also a need to provide incentives for the National Government Agencies to phase out their service delivery in devolved service areas. However, this paper does not intend to address this issue.

### Performance Grants: Concept and Key Features

“Performance Grant” transfers differ from other intergovernmental transfers as they *incentivize improvements in performance by linking the sub-national government’s performance in pre-determined areas with the access to and the size of funding*. Within this broad category, Performance grants may be designed in different ways to achieve different things. The following are some of the typical design issues and choices related to performance grant systems.

Multi-sectoral versus sector focus. Under *multi-sectoral performance systems*, the performance grant tries to leverage broad improvements in overall institutional capacity and performance. Examples of this could be requirements to have clean audit reports, submissions of development plans in time, transparency and open citizen access in budget preparations, improvement in revenue mobilization, etc. In *sector specific systems* the performance criteria would tend to focus on achieving certain service-delivery targets, such as number of classrooms constructed or measures of various unit costs. Choosing between these emphases involves a decision about the extent to which

---

<sup>1</sup> A Study has been initiated to get a better overview of the Non-IRA sources allocated for LGUs functions. Preliminary results are expected in late June.

one wishes to focus on developing institutional capacity, versus a more output-oriented focus on sectoral delivery goals.

Usage of funds. Invariably, national governments apply some limits on *local discretion* to the usage of funds to ensure adherence to national targets – e.g. specifying that funds should be used for capital investment and/or disallowing certain types of expenditures. On the other hand, tight control and earmarking of funds may constrain resource allocation efficiency based on local priorities. Systems with more autonomy in resource utilization will typically be supported by stronger incentive systems/performance measures.

Grant size. In the context of other funding flows to LGUs, performance grants need to be large enough to give LGUs a real incentive. The aggregate transfer amount will obviously be partially determined by the total number of LGUs that is being targeted, but each LGU needs to benefit (or lose) meaningfully, at least relative to other discretionary expenditures, if it complies (or does not comply) with the system.<sup>2</sup>

Grant allocation. In general, performance grants should tend in the direction of *formula based* systems, in order to be transparent, predictable and equitable. There may be some tension between focusing on performance and *poverty targeting*. One way of reconciling these objectives within a constrained budget environment would be to restrict a performance-oriented grant only to poorer LGUs<sup>3</sup>, develop a design that focuses on more weakly capacitated LGUs, or design the basic allocation formula using certain poverty indicators.

Assessment system and administration. The mechanism through which LGU performance is assessed is vital to the functionality of the performance grant system: if it doesn't work properly, or if it lacks integrity and objectivity, the incentive structure can be fatally weakened, and the grants will be robbed of their core purpose. Structuring the administration of the grant to minimize conflicts of interest – through keeping the assessment as *independent*, and as far away from the rest of the grant administration machinery as possible is therefore very important. There are a number of ways: the assessment process can be contracted out, carried out as team-work, it can be audited and surrounded by transparency. For a performance grant to be effective, the performance of the targeted units has to be regularly assessed. Overall, performance grants require more substantial administrative infrastructure than, for example, an unconditional block grant.

Capacity-building. To be most effective, performance grant systems needs to be linked to capacity-building support to enable LGUs to improve performance, and support the LGUs to prepare appropriate capital projects (planning, feasibility studies, monitoring etc.). One way of doing this is to introduce, alongside the capital component of the performance grant, a capacity-building grant. LGUs can be allowed significant discretion both over what sort of capacity needs to be built and where the inputs should be sourced. For quality control purposes, certain constraints may be placed on this, with central Ministries playing a role in determining training standards and perhaps vetting suppliers.

---

<sup>2</sup> It should be noticed that many countries have started rather modest and then gradually expanded the performance grant system, cf. Annex 3.

<sup>3</sup> Poor LGUs should include LGUs with greater share of poor population. These do not necessarily correspond to LGUs with low income classes, as the classifications are based on LGU revenue instead of poverty indicators.

## Options for Performance Grants in the Philippines

From the point of view of central government, allocating scarce LGU resources without clear and transparent allocation criteria (ad hoc) is neither efficient nor fair. A process of steady grant rationalization is therefore important. There is a strong case for introducing a performance grant system in the Philippines as a measure to increase performance incentives for LGUs and more efficiently utilize limited budget resources for non-IRA fiscal transfers. In order to strengthen the overall, cross-cutting institutional and governance capacity of LGUs in a systematic and sustainable manner, there is an urgent need to introduce a *multi-sectoral* performance grant. Simultaneously, stronger performance incentives can be introduced to sector / program-specific grants to make them more effective. Below is a brief outline of some of the main issues to be considered for both the multi-sectoral and sectoral performance grant systems.

### *A Multi-Sector Performance Grant*

Objectives. The grant should focus on incentivizing institutional strengthening in key areas of LGU performance. Various studies have identified weaknesses in planning, revenue mobilization, financial management, organizational structuring and functioning, good governance and transparency, but there is a need further to define the specific performance areas to be targeted by the performance grant system;<sup>4</sup> It is important that these areas are within the control of the LGUs, and LGUs should have the necessary latitude to adjust on the inputs to affect this performance;

Grant funding. Given the country's fiscal situation the Multi-Sector Performance Grant could begin with a relatively modest budget allocation, of the order of \$5 to \$10 million, and this could be supplemented with international development grants (a number of development partners have indicated interest in supporting such an initiative). This need not be too problematic and the experiences from other places have been that systems like this will attract gradually greater support and become much more extensive over time. However, the detailed design should be adjusted to the available resources, including the type and number of LGUs to be eligible for the new performance grant.

Beneficiaries. Given that amounts available to fund the performance grant will initially be limited, and that borrowing will be more available to larger, richer areas for capital investments, the performance grant could be focused on the poorer LGUs. If funds permit, performance incentives can also be valuable to promote more effective governance also among less poor LGUs.

LGU contribution. In order to ensure ownership and local commitment, the performance grant should require a LGU contribution. However, given that poorer LGUs are being targeted, this should be set at a level where the contribution does not require that the grant beneficiary borrow in order to fund it.

Grant administration. The grant should be administered directly by a central government department. In order to shelter the assessment process from political influence it might be best to place administrative responsibility in DoF, DBM or DILG. The temptation to

---

<sup>4</sup> Please refer to Annex 2 for examples of criteria applied in other countries.

place this under the new MFC should be avoided – as grant administration responsibilities are unlikely to be conducive to the agency’s mission as a specialized LGU lender, and handling these dual responsibilities might generate conflicts of interest at some point.

### *Sector grants*

While working on a multi-sectoral performance grant, measures may also be taken to rationalize the existing sector/program specific grants. As mentioned earlier, the design and funding of sector specific performance grant are complex in the existing framework and expectedly varied. They are also an important mechanism for achieving some of the country-wide sectoral objectives specified in the MTPDP.

Introducing stronger performance criteria under sector grant programs could strengthen LGU incentives to improve sector performance and contribute toward national priorities. In this case, the grants would function as a sort of earmarked LGU performance grant for a sector. However, in considering the way forward, the following factors should be considered:

- In order to reduce complexity and fragmentation, stronger oversight from NEDA, DBM and DOF would be required to ensure clear transfer schemes for the sectors, and that transfers from national sector agencies to LGUs are within the appropriate framework of transitioning eventually into full devolution as enunciated in the Local Government Code;
- The respective national sector departments should institutionalize, within their Department Major Final Outputs, their commitments to support and deepen decentralization;
- Within a sector agency, there is a need to consolidate the different and fragmented grant programs, moving toward clear performance criteria, transparent grant allocation process, and sound monitoring and evaluation measures;
- Resources for financing such projects would be budgeted within the sector agency budget ceiling, and appropriate donor contributions under the same sector grant framework should be explored.

To strengthen the performance orientation, the key to designing these grants lies with the selection of the areas to be measured and the indicators. A number of points are important:

- As with multi-sectoral grants, performance within the areas that are monitored should lie within the control of the LGUs, and not include indicators (e.g. certain outcome indicators) which are greatly affected by other factors like poverty, revenue potential etc.;
- Sector indicators will tend to differ significantly across the sectors and are typically targeted towards key national priority outputs/targets. Benchmarking and assessment is likely to be easier in some sectors (e.g. where there are clearly identifiable service delivery units) rather than in others;
- Indicators should be practical and realistic with regard to available data, and should provide a realistic incentive for LGUs to move incrementally forward towards better practice.