Linking Regions and Central Governments

CONTRACTS FOR REGIONAL DEVELOPMENT

OECD
OECD PUBLISHING

Linking Regions and Central Governments

CONTRACTS FOR REGIONAL DEVELOPMENT

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

Also available in French under the title:

Régions et gouvernement central

DES CONTRATS POUR LE DÉVELOPPEMENT RÉGIONAL

Foreword

Regional development policy takes place in a complex environment involving many sectors and many actors, in an increasingly decentralised context. The trend toward decentralisation in OECD countries means that sub-national actors now find themselves accountable for the provision of more public goods and services than in the past. Rarely, however, can these governments achieve regional policy objectives by "going it alone". For legal, financial, informational, or policy reasons, sub-national governments and higher levels of government must co-operate and co-ordinate their decisions and actions. How can governments make the most of these arrangements? How can they maximise effectiveness? How can they achieve objectives when only one (or perhaps neither) party has the expertise or information needed to implement a policy or programme? How can one party be sure the other will follow through on its commitments? This book answers these and other questions by using a contractual approach to examine multi-level governance arrangements, incorporating ideas of new institutional economics and new political economy.

Using a contractual approach provides important and interesting insights into the arrangements between levels of government. This is particularly valuable in the case of regional policy, which is characterised by complex interactions among many levels of government. This book offers a unique analytic framework by conceptualising arrangements of multi-level governance as "contracts". It demonstrates that there is no "optimal contract" for a multi-government context. Rather, the book explores how four aspects of the co-ordination environment should be considered in the design and use of contractual arrangements: the relative expertise among contracting parties, the complexity of the policy domain, the degree of inter-dependence among the actors, and the enforcement context in which the contract operates.

The analytic framework developed in Part I of this book is subsequently applied to five case studies of regional development policy in Part II: France, Italy, Germany, Spain, and Canada. The case studies demonstrate the substantial variety of contractual arrangements that currently characterise regional development policy. The systematic assessment of these different cases in order to identify both common themes and unique experiences is the hallmark of regional policy analysis at the OECD. Responding to a need to study and spread innovative territorial development strategies and governance in a more systematic way, in 1999 the OECD created the Territorial Development Policy Committee (TDPC) as a unique forum for international exchange and debate. This report contributes to the substantial body of research describing the challenges and opportunities for regional policies developed by the TDPC and the OECD Directorate of Public Governance and Territorial Development.

Acknowledgements. *This report was co-ordinated and produced by Claire Charbit of the Regional Competitiveness and Governance Division of the OECD, directed by Mario Pezzini. The document was edited by Claire Charbit and Lee Mizell, and prepared for publication by Erin Byrne. Professor Eric Brousseau, Université de Paris X, contributed to co-ordinating this work and to preparing the first chapter on methodology inspired by contractual theories. Alain Marciano, Université de Reims, contributed both to the chapter on methodology and to Chapter 2 on the case of France. The report also draws on material prepared for the OECD for the case of Italy by researcher Maria Alessandra Rossi, Siena University and Professor Ugo Pagano, Siena University; for the case of Germany by Professor Stefan Voigt, University of Marburg and researcher Lorenz Blume, University of Kassel; for the case of Spain by Professor Albert Solé-Ollé, Universitat de Barcelona; and for the case of Canada by Professor James Bickerton, St. Francis Xavier University. Special thanks are extended to Fabrizio Barca, former Chair of the OECD Territorial Development Policy Committee for his insightful comments.*

Table of Contents

Boxes

Tables

Figures

ISBN 978-92-64-00873-1
Linking Regions and Central Governments
Contracts for Regional Development

Executive Summary

I. Aim of the study

This study examines how contracts can be efficiently used to manage relationships among levels of government.

This report aims to identify ways in which contracts between a central government and sub-national levels of government can be efficiently used to manage relationships among them, in particular with respect to regional development policies.

The analytic framework of this paper is the economic analysis of contracts.

The study of the economics of contracts has been developing for 30 years and has been successfully applied to policy questions, especially to the regulation of industries and to public-private partnerships. The economics of contracts points out how mutual duties between two parties can be efficiently managed, highlighting in particular the possible strategic behaviours by the parties, the side effects of the outcome of their interactions, and the dynamic of relationships.

According to this framework, a contract is any arrangement that reorganises the rights and duties of governments, other than by way of the constitution.

In the economics of contracts, a contract is a set of mutual promises by which the parties commit themselves either to take actions or to follow the prescription of a mutually agreed decision mechanism. In the latter case, the contract corresponds to an agreement by which decision making rights are transferred among parties.

In the case of contracts among levels of government, contracts allow the reorganisation of the rights and duties of governments other than by changes to the constitution. The aim can be a transfer of authority or the establishment of a joint authority over a policy issue. The policy issue can be narrow or broad and the horizon can be short-term (to run a project) or very long-term (with the idea that it can be "constitutionalised" by the end of the process).

Contracts are used in the framework of decentralisation policies or of co-operation among the levels of government, both in unitary states and in federal states.

Contracts are useful both in unitary and federal states. In unitary states contracts are often used in the framework of decentralisation policies as a way to complement the constitutional delegation of authority. In federal states, contracts are often used to manage co-operative policies in those domains where the policy has to be managed by both levels because, even when the federal logic is strong, the policy domain affects both national and sub-national levels of government in intricate ways.

II. The methodology: a combination of analytical reasoning and case studies

Analytical reasoning based on contract theories reveals a continuum of contracting logic that ranges from "transactional" to "relational".

Contract theories point out that there are two polar forms of contracts that correspond to highly contrasted logics.

- On the one hand "transactional" contracting corresponds to a logic by which the respective duties of both parties can be stated in advance. All co-ordination problems can be stated *ex ante* (before the signature of the agreement) and the arrangement between the parties states the reciprocal duties of each of them. The resulting contracts are "contingent" and "complete" in the sense that they set the obligations of each of the parties as a function of external events (*e.g.*, the economic climate) and of the actions of the other party. This guarantees *ex ante* an effective co-ordination and the only challenge is to encourage the parties to enforce their obligations. As a result, such types of contracts implement "incentive

schemes" and are supervised by external third parties (such as the judiciary).

- On the other hand, "relational" contracting corresponds to a logic by which the parties commit to co-operate *ex post* (after the signing of the contract) and design a "governance mechanism" for that purpose. The parties agree to follow *ex post* the instructions of a common decision mechanism and to implement a specific bilateral mechanism to manage their potential conflicts. Co-ordination problems are solved *ex post* and supervision of the enforcement of the agreement tend to be bilateral and to rely on co-operative spirit.

The two logics of contracting lead to focus on contrasted issues and to implement different types of co-ordination mechanisms:

- Transactional contracting leads parties to implement (often financial) incentive mechanisms and to check whether the judiciary is really able to guarantee the agreement in the last resort (*i.e.*, to constrain the parties).
- Relational contracting leads parties to implement bilateral negotiation mechanisms and to guarantee the dynamic of co-operation among the levels of government over the long-run (especially because they are involved in a win-win co-operative game).

In fact, most contracts are characterised by both transactional and relational elements and fall somewhere on a continuum from pure transactional to pure relational contracts. Notable are contracts having transactional characteristics (where commitments concerning existing clauses have to be achieved) but in contexts where mutual obligations remain "open-ended" and have to be revealed in the implementation phase.

Alternative "governance" mechanisms (types of contracts) fit different co-ordination contexts which are characterised by co-ordination issues and by implementation issues.

The "optimal" type of contract is highly dependent upon the purpose of the co-ordination between the parties, upon the resulting nature of the co-ordination process to be managed, and upon the implementation context (constitutional framework that organises the relationship among levels of government). It is shown that four characteristics matter in the case of contracts between levels of government:

1. **The respective expertise of both parties in the contracted policy and its implementation.** Indeed, respective expertise constrains parties' ability to design ex-ante a complete contract. Moreover, when expertise is

asymmetrically distributed, one purpose of the contract can be the transmission of knowledge between levels of government in order to empower the lesser skilled party. Lastly, parties can be in a logic of co-development.

2. **The complexity of the policy domain** matters because it will have a strong effect on the ability to write a complete contract. The more complex the policy domain, the more difficult it is to write a complete contract.
3. **The degree of inter-dependence between the national and local policies in the policy domain** is important because the greater the levels of inter-dependence the more strategic it will be for the parties to establish a negotiation mechanism.
4. **The existence of an independent administrative justice mechanism and the clear delimitation of responsibilities** among the levels of government facilitate the enforcement of promises and, as a consequence, more efficient contracts.

Case studies are presented that describe how contracts are used in five national contexts of regional development policies.

To understand how the logic of contracting between levels of government performs in various institutional contexts in the area of regional development policy, five case studies are presented.

The case studies cover the examples of Canada, France, Germany, Italy, and Spain. Each case presents four key elements:

1. The country-specific institutional and political context in which contracting occurs;
2. A description of regional policy and the use of contracts among levels of government;
3. One or more examples of contracting arrangements in terms of 1) the co-ordination context; 2) the contractual mechanisms; and 3) the performance of the contractual practices; and
4. Policy recommendations and lessons to be derived from each case.

III. The specificities of contracting between levels of government

Three key elements make the contracting between levels of government different than contracting generally: an absence of regulation by competition, an institutional lock-in effect, and no resource to vertical integration to solve co-ordination problems.

Before pointing out the main conclusions of the report, it is important to highlight the specificities of contracting among levels of government (as compared to contracting between two independent agents, or even between a firm and a government).

First, there is an absence of regulation by competition. In cases other than between levels of government, parties have always the option to contract with other potential counterparts. As a result, their mutual behaviours are influenced by potential competition. This does not exist among levels of government (especially regarding the choice of the partner made by the regional level) which tend to engage in a repeated game.

Second, when contracting occurs between levels of government, the two contracting parties are locked-in their relationship by the institutional situation. In many cases, they do not choose to interact. Rather they must.

Third, as compared to firms, government contracting parties have no recourse to "vertical integration" to solve co-ordination problems.

The range of contractual choices is therefore more limited in the case of contracts among levels of government than in the case of contracts in general.

There are two major consequences of the specific context in which contracting between levels of government occurs. First, theory suggests there should be co-operation rather than optimisation of a transaction. Second, assessment should be oriented toward learning and improving efficiency.

The logic of contracting between levels of government means that co-ordination mechanisms must be built to manage a co-operation that is unavoidable. Contracting mechanisms have to be thought of in a dynamic perspective as tools which enhance co-ordination.

In contrast to tools aimed at retaliating when a party does not behave as it initially promised, incentives should be designed to facilitate the adoption of

more efficient behaviours and mutual obligations should be understood as ways of making clear both objectives and means so as to clarify accountability.

In that spirit, assessment of contractual performance should not be dedicated to punish poor performance, but rather to identify the factors of success and potential weaknesses so as to "learn" from the process and enhance the management of the specific relationship or of similar ones.

IV. Main results

A. The logic of contracts among levels of government

Contracts among levels of government are unavoidable "governance" mechanisms rather than "optimal" co-ordination tools. They should be selected and evaluated using specific criteria.

Contracts are unavoidable because levels of government must deal with one another to achieve policy goals for reasons outlined above. As such, contracting is not chosen. What is chosen is the design of contract. Feasible alternative contract designs should be compared to each other on the basis of criteria relevant for performance (*e.g.*, administrative costs, speed of implementation, ability to learn) since the outcome of alternative modes of governance vary in nature. In turn, contractual performance should be evaluated relative to previous actual situations, rather than to an optimal theoretical situation.

Contracts among levels of government are justified either by "exogenous" reasons (because many policies domain require both sub-national and national intervention) and by endogenous ones (because the political responsibilities of levels of government overlap).

Contracts among levels of government can be justified for two reasons. First, there are inherent inter-dependencies among levels of government because many public policies require the intervention of various levels of government. Second, the assignment of responsibilities among levels of government can be "imperfect". This occurs either because there are overlaps leading to shared responsibilities and therefore the need for co-operation, or because some policy domains are not specifically assigned to any level of government and co-operation is thus required. Contracts are thus necessary to manage inter-dependencies and to control for some institutional weaknesses. Contracting often proves substantially easier than amending a constitution.

Contracts allow a customised management of inter-dependencies.

As compared to constitutional and legal remedies, the advantage of contracts is that they allow parties to take into account the specificities of a local or regional situation.

Thus, contracts are useful either in unitary or in federal contexts.

In unitary states, contracts are often used in the framework of decentralisation policies, in particular to empower sub-national levels of government. They may also be used (more simply) to delegate tasks. In a unitary state contracting is a tool to decentralise without having to deeply amend the constitution. In this situation, contracts are often broad in scope with multiple goals leading to framework contract complemented by set of implementation contracts. One of their goals is to allow a future clarification of responsibilities.

In a federal state, contracts are tools to allow co-operation because there are inherent inter-dependencies that need to be managed even if the constitution contains a very clear distribution of prerogatives. Therefore, contracts tend to be focused and short-term. They can be very useful for managing innovations in the management of joint policies.

Contracts among levels of government are tools for dialog that could be used as clarifying and learning tools.

Contracts often make explicit the bargains made among levels of government and thus contribute to transparency and to accountability of the various levels of government. In addition to clarifying bargains, they can also clarify responsibilities. This provides incentives to various levels of government to learn, to transfer knowledge, or to develop knowledge. One of the explicit goals of contracts is to manage reforms and their role should be assessed from that dynamic perspective.

Contracts are useful either or both to clarify responsibilities (and therefore rely on political accountability) and to make mutual commitments explicit (and therefore rely on judicial enforcement).

Since most contracts are characterised by both "transactional" and the "relational" elements, contracting among levels of government allows for learning and co-operation but within a framework that is formal and public. Formal commitments play a role because contracting among levels of government does not behave in the same way as in the private sector. Judicial oversight allows parties to move beyond a pure bargaining power game and forces them to be more responsible and make their commitments more credible. In this regard, publicity of contracts plays an important role because the citizens are better able to identify the responsibilities of respective parties. Political accountability increases and decision makers are subject to clearer

incentives systems by the citizens. In turn contracts can improve the institutional framework either by revealing the need for a more skilled and independent judiciary or for a clearer or different assignment of responsibilities between levels of government.

B. Efficient contracting principles to be implemented

B.1. Contracting logics and contrasted co-ordination contexts

Four dimensions of the relationship between the levels of government are identified as having a major impact on the contractual logic to be implemented:

1. *The distribution of knowledge between the parties*
2. *The complexity of the policy domain*
3. *The degree of inter-dependence between the national and local policies in the domain*
4. *The enforcement context resulting from the institutional framework*

It is important to point out that contracts can have endogenous effects on these characteristics, meaning that they might change after a contract is implemented. In particular, the distribution of knowledge can evolve because contracts can be used as learning tools. Moreover, the enforcement context can also be changed because contracts clarify the conditions in which various levels of government interact, which affects political accountability.

The distribution of knowledge among the parties: contracts as learning and training tools

Delegation of authority can be motivated by the willingness to benefit or transfer skills/information among the levels of government.

When the sub-national level of government is unskilled or uninformed in a policy domain, the central government can choose to empower it in order to promote the acquisition of knowledge. In this case, it could be ineffective to develop a transactional contract to "delegate" the implementation of a central policy, or a relational contract aimed at managing a co-operative process between the two levels of government. It would be more efficient to implement a contract aimed either to monitor the other party or to let it experiment before progressively evolving toward the "optimal" contractual logic that corresponds to a situation in which both parties are skilled.

By contrast, when it is the central government which is unskilled (in a policy domain or in the implementation of a policy in a given context), contracting should be used as a way to experiment and learn. In such cases, contracts have to be used as revelation mechanisms in a first step and designed in a co-operative logic so as to really encourage both parties to share knowledge. Once learning has occurred, the central government can then switch to more

command and control type of contract (if appropriate). Importantly, the central government should also transfer what has been learned to relationships with other sub-national governments. In that spirit, a competitive call for tender can encourage sub-national governments to innovate and reveal information about best practices in the first step.

When the two levels of government have the same level of skill in a particular policy domain, either they are in a situation of innovation and discovery (in which case they should implement an incomplete contract aimed at managing a co-operative relationship) or they are in a situation which is perfectly clear (in which case a complete contract should provide both parties with the "optimal" incentives to jointly perform the tasks that have to be managed at both levels).

The degree of complexity: the wider the scope, the more relational

When co-ordination is about complex matters (which also refers to the scope of the policy in question) complete contracting and precise control of the behaviour of the sub-national government by the centre is difficult. This leads to incomplete contracting. This can be a problem if the contracted policy covers a wide set of domains because the slack of sub-national authority might be too wide, particularly if the central government is ultimately accountable for the policy.

The degree of vertical inter-dependence: the complex trade-off between efficiency and credibility of parties' commitment

Everything else equal, when governments are contracting about policy domains that correspond to prerogatives shared both by the central and the local government, they should use a co-operative logic and implement a rather incomplete contract and an associated governance mechanism. However, the resulting fuzziness of the duties of each party could be exploited by both to escape political accountability. It is therefore essential to make the bilateral commitment as "verifiable" as possible, either by insuring efficient oversight by the judiciary or by building mechanisms aimed at informing the citizens on the performance of the co-operative process.

The enforcement context: institutional context matters

An important difference between countries (and an important policy variable) is the enforcement context which determines how well contracts can be implemented and their credibility. Enforceability of contract strongly depends both on the organisation of the judiciary (particularly its independence and its skill) and on the political accountability of the various governments from the perspective of the citizens. In turn, both depend upon the design of the constitution and on the political tradition.

With respect to the judiciary, when the administrative justice is not independent and not sufficiently skilled, contractual commitments between levels of government are not credible. In particular, it is complex for the sub-national government to force the central one to comply with its obligations. With respect to political accountability, when the assignment of responsibilities between levels of government is unclear for the citizens, it is always possible for one of the parties to cheat. The use of contracts as tools to control the behaviour of the other party is therefore highly dependent of the institutional context.

The design of the contract should anticipate these enforcement difficulties. Building mechanisms aimed at informing the citizens of the mutual duties and their completion is a way to raise political accountability and to guarantee enforcement. Contracts should be designed to implement "verifiable" objectives so as to frame both parties' behaviours in a way to reinforce the ability of the judiciary to oversee the co-operation process. Some national cultures are more oriented towards trust and mutual responsibility, which can influence the type of contractual choice and the request for more informal than formal enforcement mechanisms.

B.2. Contracts in a dynamic perspective

Contracts should often be considered as tools to dynamically build a more consistent framework to govern the relations between levels of government.

Contracts are tools to explore new governance mechanisms, to transmit skills, and to clarify the responsibilities among the levels of government. In some cases, successful contracting arrangements may results in no need of further co-operation between levels of government, or it can result in constitutional clarifications of the respective roles of each party. Alternatively, the success of a contract between two levels of government can lead to its replication in similar relationships between other parties or between the same parties but on another topic.

Contracts among levels of government should often be considered as laboratories for best practice.

When contracts are used to promote learning and effective policy design, their use can lead to an evolution and proliferation of contracts. In all the cases where contracts are developed in the context of knowledge asymmetries between the levels of government, the experiments made by the two parties about the management of their relationship in the course of the completion of the contract can lead them to progressively discover the best way to co-ordinate. In turn, this leads a previously incomplete contract to become more complete. In addition, the experiences of parties can be generalised and contracts thus become a tool for the diffusing of best practices.

When these learning processes have occurred and when best practices are known, the need for contracting between levels of government can decrease. Indeed, a contract may become far less useful in the case of empowerment of one of the parties. Contracts can also lead to the implementation of constitutional reforms in the case where both parties have clarified or discovered good assignment of responsibility and good co-ordination rules between them, thus reducing *ex post* the need to contract.

Auditing should be considered from the perspective of learning.

An important consequence of these findings is that performance assessment and audit should not be considered from the perspective of controlling opportunistic behaviour only. In many cases it should be considered from a learning perspective. Audit should aim at evaluating the source of efficiency of the innovative governance practices and at assessing how what was learnt could be useful in different context.

B.3. Contracting and regional development policies

The various surveyed national cases correspond to a continuum of contracting aims and practices.

In France, a strongly unitary state, the logic of contracting is clearly to jointly manage policies in the framework of a decentralisation policy in which the central government remains an essential partner of the sub-national one.

In Italy, the logic is mostly to empower sub-national governments. Contracts aim therefore at transferring responsibilities so as to train and make more accountable sub-national government, although relevant examples exist of both actors learning, as the case of complex projects for which the exchange of knowledge among parties is a condition for the effectiveness of the contract.

Germany is in the middle of the road. On the one hand, it is a federal state. On the other hand the central government retains the initiative in many policy domains and "delegates" tasks without negotiating specific arrangements with the sub-national levels. In that case, it seems that more contracts that are tailored to particular place-based characteristics would be needed.

In Spain, the logic is clearly to jointly run structural policies because, despite the strong decentralisation of the last years, many policy domains require co-operation. Contracts are a way to manage these inter-dependences and to manage the antagonisms that characterised the decentralisation of Spain.

In Canada, contracts among levels of government are typical of what would be expected in a federal state with strong inter-dependencies among the levels of government and clear distribution of responsibilities. In this case, contracts permit governments to manage the unavoidable inter-dependencies in the cases where several policy domains – assigned among levels of government –

have to be combined. Although contracts organise the co-operation of many agencies running various components of complex structural policies, they tend to be of a specific duration and focus on precise political objectives.

Contracts aimed at addressing development policies tend to be relational.

In all of the national cases studied in this work and in the majority of OECD countries, regional development policy is a shared responsibility between central and regional levels of government. The nature of this sharing varies according to countries but tends to be characterised by strong inter-dependencies between levels of government in terms of decisions to be taken, tasks to be implemented, and the implications of policy success (or failure). Consequently, regional development policy, which requires *ex ante* co-ordination among levels of government, often employs contractual mechanisms for dealing with co-ordination needs.

Regional development policies are also complex. They are often characterised by a mix of various policy areas (innovation, social policy, infrastructure, etc.). This complexity is also due to a notable degree of uncertainty about the best opportunities to be selected, the precise targets to be reached, and the best strategies to be applied. This complexity suggests the need to use relational instead of transactional types of contracts. In effect, the former are better adapted to situations which aim to foster identification of good practices and learning.

However, while general contracts for regional development tend to be relational, they often encompass precise tasks to be fulfilled that can be clearly negotiated through transactional contracts (in particular for supporting infrastructure projects). Thus, an important twofold recommendation is to:

1. Take the opportunity to assess framework agreements among levels of government with care in order to determine which elements can be managed through transactional contracts and which should remain relational.
2. Design performance indicators adapted to these different types of contracts instead of using just one instrument of evaluation for the whole framework contract.

ISBN 978-92-64-00873-1
Linking Regions and Central Governments
Contracts for Regional Development

Chapter 1

A Contractual Approach to Multi-level Governance[1]

This chapter develops an analytic framework for understanding how the economic theory of contracts applies to multi-level governance and what these theories suggest with respect to the selection of a contractual approach. It begins with an overview of the relevant theories, presents an analytic typology of contracts, and assesses the most effective contract design for different co-ordination contexts. The analytic framework developed in this chapter is applied to each of the case studies in subsequent chapters.

1. Introduction

For the last 15 years, a dramatic change has been occurring in public decision making and public policy building. Decentralisation of tasks by central government and attribution of prerogatives to lower institutional levels have been increasing. From a theoretical perspective, decentralisation seems to be justified for many reasons: more decentralised jurisdictions can better reflect heterogeneity of preferences among citizens; multiple jurisdictions can facilitate credible policy commitments; multiple jurisdictions allow for jurisdictional competition and they facilitate innovation and experimentation.

Decentralisation has, in the first place, a financial dimension. Increased local responsibilities has been leading to an augmentation of sub-national expenditures, while the taxing power of sub-national governments has been declining or at best remaining stable. "Decentralization seems to result in more regional responsibility, at the same time with an increased dependence on the central government for resources" (Bergvall *et al.*, 2006). As stressed by Oates (2005), decentralisation requires therefore the design of specific devices to govern the increasing transfers from central to sub-national institutional levels.

Decentralisation implies the assignment to sub-national governments the power to choose the nature and content of public policies. This increasing burden on the sub-national governments has given rise to the need to build local competence, which has constituted a further characteristic of decentralisation policies that they should generate and benefit from "learning by doing" effects.

The necessity to manage financial transfers and the empowerment of sub-national levels of government led central ones to design new devices to manage interactions among levels of government. Multi-level governance has gained importance and resulted in institutional changes and innovations. Central governments were led in particular to propose contracting relationships across levels of government. Within OECD countries, these evolutions correspond to the use of new, more co-operative arrangements aimed, both, at managing more efficiently (and more clearly) the relationships among levels of government and at adapting national policies to local contexts.

However, contracting among levels of government is not only linked to decentralisation. In a federal (and confederal) states with *ex ante* well-established assignment of responsibilities among the levels of government (*e.g.*, Canada), many policy issues require co-operation among levels of government and contracts are useful tools to deal with these inter-dependences. Thus, contracting among levels of government is linked to multi-level governance and not to decentralisation policies alone. To put it another way, in unitary regimes contracting is useful to manage decentralisation policies and empower progressively sub-national levels of government (*e.g.*, France, Italy). When decentralisation is already in place (*e.g.*, Canada) or has been achieved (*e.g.*, Spain), contracting is useful to manage co-operation, especially in cases of innovative policies and in cases in which policies have to deal with inter-dependencies (rather than competition).

The goal of this study is to develop an analytical model to explain the efficiency of the alternative modes of contracting between central governments and sub-national levels of government, and to assess how performance could be enhanced. This paper focuses on the non-financial aspects of "contracts", that is on the governance of the relationship between the levels of government. The organisation of tax collection and financial transfers is therefore not analysed in detail, considering that this analysis is detailed in a complementary OECD analysis (Bergvall *et al.*, 2006).

Two sets of economic theories are used to analyse relationships among levels of government through the lens of "contractual" approaches. First, new institutional economics (agency theory, transaction costs economics) provides a toolkit to analyse contracting practices among parties. Second, new political economy (public choice analysis, constitutional political economy, including social contract theories) provides tools to understand the context in which these bilateral contracts perform. It is important to note that the term "contract" here is employed in a conceptual sense (see Brousseau and Glachant, 2002).

In contemporary economics, the notion of "contract" refers to the bilateral agreements between two parties (decision makers) – whether individuals, firms, governments, etc. – concerning their mutual obligations to govern their relationship. To co-ordinate or co-operate parties have to agree on:

- An assignment of decision rights (authority), which could include shared rights leading to a negotiation procedure.
- A distribution of contributions, which include funding, human capital, assets, etc., and lead to the setting of mutual duties.

- Mechanisms guaranteeing the enforcement of their mutual promises, leading to the implementation of supervision mechanisms and agreement on conflict resolution procedures.

The economic notion of contracts employed here is therefore broader than its legal counterpart, even if the difference between the definitions given by economists and lawyers is not so large. It suits the type of situation being addressed since in practice the mechanisms that govern the relationship between two levels of government are made up of a mix of formal contracts, constitutional arrangements, laws, and administrative rules. In this document these various legal tools are used to understand contractual arrangements between governments in a common analytical framework allowing for comparisons between practices implemented in countries characterised by different constitutional regimes and legal traditions.

The goal of this paper is to understand how contracting practices in various contexts can be effective. It relies strongly on the perspective proposed by the American theoretician of law Ian Macneil (1974) according to which there is a continuum of contractual practices among two contrasting co-ordination logics: "transactional contracts" and "relational contracts". The former state precisely and completely the rights and duties of both parties *ex ante*. By contrast, "relational contracts" simply design the framework of an *ex post* co-operative process. "Transactional" contracts are very secure, but might be complex to design because every future contingency has to be dealt with in advance. In addition, they suppose that both parties know *ex ante* all the solutions to the project they will undertake. "Relational" contracts are less secure, since mutual commitments are incomplete and can be interpreted in various ways *ex post*. They are more flexible, however, and therefore better suit complex and evolving projects. Moreover, they make it possible to accumulate knowledge and invent, because their flexibility enables them to experiment and to implement solutions that are learnt by doing.

What follows will attempt to characterise more precisely the various forms of contracts that can be implemented between a central government (CG) and sub-national authorities (SNA) (for definitions used in contract theories, see Box 1.1). It will be pointed out that the various alternatives suit different co-ordination situations that are characterised by the types of projects that are jointly operated and the context of the relationship between the two levels of government (distribution of skills relevant for the project, ability of both levels to credibly commit themselves *vis-à-vis* the other party, etc.).

This report shall adopt a costs/benefits type of analysis to compare the advantages and the costs associated with a contractual mode. On one hand, the benefits can be expressed in terms of enhanced effectiveness (*e.g.*, it can

Box 1.1. **The "language" of contract theories**

This paper is based on contract theories, through which the governance of relations between levels of government will be analysed. Thus, it relies on the specific wording of contract theory, which must therefore be clarified so as to avoid misunderstanding. Some essential definitions follow:

Contract: This term refers to any agreement between two parties aimed at stating mutual and respective obligations (which can be linked to financial compensations), granting decision rights and liabilities, implementing audit and reporting systems (generally associated with bonuses and penalties), and designing conflict resolution mechanisms (or stating what are the authorities and the procedures to solve potential conflict). The "contract" analysed in this report between the two levels of government might therefore be partly "constitutional" and partly "contractual" from a legal point of view.

Contractual hazards: Most contracts expose parties to risk because each party promises something in exchange for an expected return from the other party. Many reasons can explain why mutual commitments are not met: unexpected events – contingencies – can prevent one party from giving what it promises; a party may be unable to provide something – *e.g.*, a level of quality – that was promised because of a lack of skills; a party can decide not to provide what it promised because it is no longer its best interest to do so, etc. Whatever the reason, the doubts about the fulfilment of promises are central in contracting. To make co-ordination between the parties possible, the contract has to be designed to guarantee the *ex post* (see below) enforcement of promises made *ex ante* (see below).

***Ex ante* and *ex post*:** In contract theories *ex ante* refers to everything concerning the period before a contract is signed, particularly to the information the co-ordinating parties know about their future interactions. *Ex post* refers to everything concerning the parties during the performance of the contract. These categories are widely used because, by establishing mutual rights and duties, contracts change the bilateral relationship between the two parties. *Ex ante* and *ex post* can also be used to contrast the contract negotiation phase with the contract performance phase.

To align: Contracts seek to make the interests of the two parties compatible *ex post*, as opposed to *ex ante* (otherwise efficient co-ordination would be guaranteed and contracting useless). A contract seeks therefore to "align" both parties' interests by manipulating the relationship between the actions taken by the parties and what they get from the interaction (a financial reward, a symbolic benefit (such as reputation), wealth resulting from the consumption of a service, etc.). This alignment has to take into account the various situations the parties could face *ex post*.

Informational environment: Contractual difficulties partly derive from the fact that the two parties do not share the same information (information

Box 1.1. **The "language" of contract theories** *(cont.)*

asymmetries) and do not know all the relevant information to co-ordinate in the future, such as the list of potential contractual hazards (information incompleteness). The informational environment therefore partly states the co-ordination difficulties the parties try to solve by way of contracts and the constraints they face when doing so.

Delegation: This generic term is used throughout this report to describe situations by which the central government assigns the realisation of a task or the performance of a policy to a sub-national government. It captures the concepts of devolution, deconcentration, decentralisation, and delegation.

Repeated game: A relationship between two parties can last much longer that the period for which a contract is set. This being the case, a new contract, or a set of new contracts will follow. The contracting "game" is repeated and the relational situation between the parties can evolve from one period to another, in particular because the parties learn.

Residual (rights and claimants): A contract can state in advance the return to be acquired by each party (their remuneration). It can also set the remuneration of all the parties but one, which will benefit from the surplus remaining after the completion of the contract and after each party benefiting from an *ex ante* fixed remuneration is paid. This party becomes the residual claimant, and is the holder of the residual rights (to be remunerated). Such a risk is generally accepted by the residual claimant in exchange of the right to decide what the parties should do during the performance of the contract.

Adverse selection (and also "hidden information"): occurs *ex ante*, when one agent uses its informational advantage on a variable that cannot be manipulated during the completion of the exchange. For example the central government can delegate the building of infrastructure but may not know the local technical constraints. If only the sub-national government possesses this information, it may use this informational asymmetry to its advantage (*e.g.*, by requesting more than the minimal amount required to fulfil its obligation). This leads to inefficiencies since the central government will pay more than necessary. In certain circumstances – depending on the skills of the sub-national government – local welfare can also be improved if the agent misrepresents its own characteristics (see discussion on Incentive Theory).

Moral hazard (and also "hidden action"): occurs *ex post*, when one agent benefits from an informational advantage on a variable that he can manipulate during the completion of the delegation. For instance, the central government delegating the provision of a public service of a certain quality might be unable to measure precisely the quality of this service *ex post*, perhaps because it is costly or because it is difficult to observe. In this case, the sub-national government may deliver a low quality, thereby lowering its costs while simultaneously benefiting from the grant that was calculated based on the costs of high quality (see discussion on Incentive Theory).

be assumed that SNAs have a better knowledge of the actual local implementation constraints, which will result in a more efficient implementation of a policy), including indirect effects (*e.g.*, a successful assignment policy can impact positively on the development of local capabilities and can also have a positive effect on accountability with decision making being is closer to citizens). On the other hand, costs have to be understood broadly, both in terms of the cost of setting and running the contractual arrangement and the inefficiencies that it can generate. For example, delegation to SNAs can result in an inefficient implementation, either because sub-national authorities strategically manipulate the means provided by the CG to pursue their own goals, or because they are not skilled enough. The analytical framework developed by New Institutional Economics and New Political Economy facilitates understanding regarding how to maximize benefits and minimise costs in various contexts.

The document provides a framework to analyse the problems raised by contracting among levels of government, which is developed in steps:

- First, the nature and the context of the co-ordination problem between the CG and the SNA is identified through a descriptive framework (Section 3).
- Second, the nature of the implemented governance solutions (*i.e.*, the contracts) is analysed in contractual terms by describing how the co-ordination problems are solved through the process by which the two parties contribute, make decisions, renegotiate, supervise implementation, solve conflicts and make sure that promises made *ex ante* will be enforced *ex post* (Section 4). The objective of this section is to match co-ordination contexts with effective contractual solutions.

Thanks to this framework it is therefore possible to characterise co-ordination problems and solutions through common analytical perspectives. It enables us to compare national experiences – namely in Canada, France, Italy, Germany and Spain – and to assess performances of alternative mechanisms, so as to suggest policy recommendations to design efficient contractual/governance mechanisms among levels of government.

Before developing the framework, a rapid overview of the theoretical tools used in the analysis is provided to enable the reader to understand how they can be combined to address policy making issues in the context of the management of co-operation between levels of government (Section 2).

2. The contractual approach to multi-level governance

For the past 20 years, economics has been developing several complementary analytical frameworks aimed at understanding co-ordination problems in terms of delegation of authority, and the design of incentive and enforcement mechanisms within the framework of the so-called "contract

theories". Indeed, any co-ordination mechanism between two parties can be understood as a deal setting mutual rights and duties between them. These theories have been successfully applied to a wide number of questions ranging from inter-firm co-ordination to the optimal design of constitutions, and encompassing a broad set of issues relevant for policy making. The fields of application include anti-trust and competition policies, regulation/deregulation of public utilities, regulation/self-regulation of markets, institutional design, and in particular relationships among regulatory agencies, the government, legislative bodies and the judiciary.

This section presents the analytical tools that are relevant in analysing the relationship between a central government and a sub-national one when the former decides to assign the realisation of a policy to the latter or when both governments wish to co-operate in the implementation of a common policy. The tools provided by contract theories (Section 2.1) and those developed by the new political economy (Section 2.2) are both reviewed. A detailed presentation of these theories is available in Brousseau and Glachant (2002).

2.1. Contract theories

Contract theories propose economic models to explain the rationale of the co-ordination mechanisms built by agents when they interact. All theories focus on contractual hazards. The basic idea is that most exchanges, and particularly co-operative processes, expose parties to risk because each party gives something in exchange for an expected return from the other party. Many factors can explain why mutual expectations can be not met. Generally speaking, incentives to fulfil obligations can change with the passing of time and it is no longer in the best interest of one of the parties to do what it promises.

Contract theories can be interpreted as if three dominant modes of contracting existed along a continuum ranging from complete transactional to incomplete relational contracts. The best contract to be implemented depends upon the nature of the co-ordination problems to be solved between the levels of government and upon the institutional context in which the contract is drawn up.

Transactional contracting corresponds to a situation in which all co-ordination problems can be solved *ex ante* (at the time the contract is signed). It corresponds to a contract stating precisely the various tasks to be operated by the parties and the rewards they will get in return. In contrast, relational contracting corresponds to a situation in which co-ordination problems are predominantly solved *ex post* (during the performance of the agreement) because the parties decide how they should behave when they observe the situation they actually face. It corresponds to contracts that do not state what

actions will be implemented *ex post*, but who will have decision rights on what (and in addition how benefits and costs should be split between the parties). Thus contract theories (and contractual logics) differ among each other by stating whether co-ordination problems can be solved or not before the start of the contracting period, and by stating whether precise tasks to be carried out by the parties can be decided *ex ante*, or whether the parties can only contract on rights to make decisions.

- Incentive Theory refers to contracts that solve coordination problems *ex ante* by stating precisely the actions to be taken by the parties.
- Incomplete contract theory analyses how co-ordination problems can be fully solved *ex ante* by distributing adequately decision rights between the parties.
- Transaction costs economics point out how co-ordination problems can be solved *ex post* by designing and allocating decision rights that result in an adequate "governance" mechanism.

2.1.1. Incentive Theory: delegation and its costs

The Incentives Theory framework envisages the relationship between a central and a sub-national government as a problem resulting from the delegation of a task by the latter to the former because the central government is unable to efficiently implement its policy at the local level due to a lack of information about the specificities of the local situation. Unfortunately, this lack of information may cause imperfect delegation in which the central government is unable to perfectly monitor the sub-national authority. Since the latter can anticipate this inability, it can try to strategically exploit its informational advantage to use the resources provided by the central government to its own advantage and/or for purposes that are not those targeted by the central government.

The theory points out that if the central government has a good knowledge of what might be the local implementation constraints; it can then design an incentive scheme that will guarantee *ex post* the best possible performance of the sub-national government. A subtler "strategic" game can be organised through the delegation process – or the negotiation phase of the contract – by which the central government leads the sub-national one to reveal its private information about its "local" implementation constraints and its costs. Such contracts allow the central government to benefit from the advantage of decentralisation by relying on the capabilities of the sub-national government, which is better informed of local constraints, while minimising costs – which translates into looser control by the centre of the decentralised policy, thus allowing the local government to target its own ends. However, the ability to implement the contracts is subject to strong conditions, and in

particular to a reliable enforcement environment and to a high level of skill of the local government. Such conditions are not met in every decentralisation policy.

2.1.2. Incomplete Contracts Theory (ICT)

The purpose of ICT is to analyse how optimal incomplete contracts are designed. These contracts are incomplete because some relevant tasks cannot be specified. They are nevertheless optimal, since solutions are available to motivate the parties to behave in a mutually optimal way in the future. The theory focuses on the way to distribute decision rights (by way of managing accountability between the parties), so as to guarantee optimal *ex post* decision by them.

The theory focuses on situations in which it is impossible to settle a complete list of required actions *ex ante*, which leads to the idea that a renegotiation mechanism – based on the distribution of rights to make decisions *ex post* – should be implemented. However, it refers to context in which the results of alternative distributions of decision rights can be anticipated because the incentives of the decision makers can be forecasted. An adequate distribution of decision rights *ex ante* guarantees therefore the quality of the decisions that are made *ex post*.

Incomplete contracting refers to situations in which both parties contribute to implementation of a joint policy, while the optimal contribution of each of the parties depends upon the contribution of the other and of the general economic and political climate. The problem occurs when the contribution of both parties are uncontractable because no court would be able to state whether each party fulfilled its obligation (which would require a perfect assessment of the contribution of each and of the climate mentioned). When this occurs, the central government can propose an incomplete contract to the sub-national authority by which it guarantees a contribution to realise a minimal plan, while the sub-national authority is free to implement an enhanced plan should it be needed. The key point here is to let the sub-national level be the "residual claimant" of the decentralisation process, and to let it propose an enhanced project to the central government once a "minimal plan" (default option) has been realised. These incomplete contracts are the "best response" when complete incentive schemes are not implementable (in particular because the enforcement environment does not allow it (inadequately skilled courts, for instance). However, they have a higher cost in terms of loss of control for the central government. Moreover, their implementation is also subject to strong constraints, especially to high capabilities from both levels of government.

2.1.3. *Transaction costs*

Transaction Cost Economics (TCE) relies on the idea that any interaction (transaction) between economic agents is costly and that they should therefore seek to implement co-ordination mechanisms that minimise these so-called transaction costs, which are of two types. First, there are costs that are borne *ex ante* by the parties to reach an agreement. They include the cost of negotiating the agreement and writing it (*i.e.*, deciding what will be the best responses to future contingencies). Second, there are costs that are borne *ex post*, when the parties co-ordinate in the framework of the contract they agreed on. These latter costs are twofold. On the one hand they correspond to the costs necessary to manage co-ordination; *e.g.*, making decisions, supervising parties' behaviours, settling disputes. On the other hand, they correspond to the inefficiencies that can be generated by the contractual arrangements, if it happens that the *ex ante* stated obligations are found to be poorly adapted to the actual co-ordination issues faced by the parties in the performance of the agreement. It is assumed that imperfectly rational agents that have in addition an incomplete vision of the future can make mistakes when designing mutual obligations, resulting *ex post* in maladaptation (or misalignment) of the solutions decided on *ex ante* for the actual situations faced by the contracting parties.

Transaction Cost Economics, points out that when it is not possible (or too costly) to set *ex ante* the list of tasks that should be carried out *ex post* (in particular because the future and complex strategic games among parties are too complex to let actual contract designers to make sure that they would be able to implement in the contract all the "best responses" to these situations), the parties should design a governance mechanism based on the delegation of authority between the parties, that includes *ad hoc* enforcement mechanisms and specific conflict resolution procedures. TCE insists in particular that two levels of government should co-operate in the management of joint and innovative policies. The issue for the central government is no longer to avoid losing control, but to share it. Parties are no longer organised in hierarchy, but co-operate on joint projects. Contracts are not "optimal", but "enabling".

2.2. *New political economy and delegation as a constitutional process*

While the models discussed above analyse the contracts between levels of government, "new political economy" utilises the concepts of contract theories to analyse the delegation of political responsibility by the citizens among levels of government. It questions the division of powers, the allocation of authority and the assignment of tasks across the different institutional levels. It is, however, beyond the scope of this paper to develop these issues here.

New political economy leads, however, to a clearer understanding of the contrasted co-ordination logics between levels of government in a federal state and in a unitary state. Even if there are no pure forms of these two polar cases, it is enlightening to point out that in a federal state, levels of government tend to be more independent from each other and more accountable than in a unitary regime. Indeed, in a federal state, the power of sub-national governments draws directly from a delegation of power by the citizens, who delegate different responsibilities to the sub-national and to the federal governments. In a unitary regime, the citizens delegate power to the central government, which then can assign responsibilities to sub-national levels of government. As a result, in a unitary regime, the central government is considered by the citizens as accountable in last resort for the whole politic, while accountability is divided across levels of government in a federal state.

Of course, political reforms may seek to increase the accountability of sub-national government in a unitary state. However, sub-national governments are structurally more accountable in a federal state than in a unitary one. This is because distribution of responsibilities among levels of government tends to be clearer in a federal state and draws from the institutional arrangement between the citizens and the (national and sub-national) governments, and not just from the central government's desire to delegate some of its prerogatives to sub-national levels. In turn, sub-national governments tend to be more sensitive to horizontal competition in federal states and are more inclined to co-ordinate with their citizens to satisfy them (because they are clearly identified as responsible for a given set of policy domains).

The main consequence for the analysis of contracts between levels of government is that the enforcement environment differs in both types of regimes. In federal states political accountability constitute *de facto* an enforcement mechanisms for contracts between the levels of government. The contract indeed makes publicly clear the mutual duties of levels of government when they need to co-operate in a given political domain. The citizens can therefore state whether the various levels fulfilled their promises and credit each party for its contribution to a joint project (which might result in electoral sanction in case of failure to comply). Since the distribution of political accountability is less clear in a unitary regime, the enforcement of contracts tends to rely more on the judiciary than in a federal state.

This raises the issue of the independence and the efficiency of the judiciary responsible for settling contractual disputes between levels of government. At first glance, both independence and competency should tend to be higher in a federal state. It is indeed essential to implement independent courts since potential conflicts among levels of government are high and could be damaging. However, in actual fact, there are many federal states

without such courts that could create an efficient judicial enforcement environment for contracts. By contrast, a unitary regime seeking to compensate for the weaknesses of an excessively centralised structure and lack of sub-national political accountability can require an independent and skilled court system to supervise the enforcement of contracts among levels of government.

These elements in mind, it is important to point out that there are neither pure federal states nor totally unitary regimes. In reality, the division of prerogatives, of political accountability and the political independence of the various levels of government are never totally clear. This leads to manifold inter-dependencies across levels of government. One of the purposes of contracts is to make these inter-dependencies explicit and to control their effects.

2.3. Contracts between levels of government

Economic theories of contracts were initially developed by scholars focused on the co-ordination problems to be solved between totally independent individual agents oriented toward the maximisation of their individual preferences. The analytical categories that were relevant in that context have to be adapted to the specificities of the relationship among the levels of government. Indeed, governments are:

- *Organisations and not individuals*: They are characterised by compromises among coalitions of interests: those of their constituency (the citizens), but also those of the political decision makers, of the civil servants, etc. The objectives of the contracting parties might be multiple and complex and might actually be biased by some predominant interests. In what follows, this report will make the simplifying assumption that each level of government seeks to maximise its constituency's wealth, but it is clear that there is a potential for "capture" of contracts by particular interest groups. At the same time, contracts among levels of government play a strong role in contributing to transparency. By being explicit and public, contracts among levels of government tend to weaken the ability of interest groups to capture the relationship among the levels of government in favour of their sole interests.
- *Intertwined*: The various levels of government are not totally separate with completely different constituencies and prerogatives, even in a federal state. As a result there are commonalities and fuzziness in the relationships among the levels of government. These result both in common interests and in conflicts of competences that impact on contractual practices since co-ordination problems may arise from and be solved by other means than the contractual means per se. For instance, the reactions of citizens (from

demonstrations to voting) provide incentives for the governments beside those provided by reciprocal promises. Again, it is important to point out that contracts make things explicit. One of their advantages in the context of the relationships among levels of government is that they allow for controlling inter-dependencies/co-ordination problems that are hardly resolved by the assignment of responsibilities and organisation of the relationship among powers organised by the constitution. Whether the state is federal or unitary, contracts can be seen as complements to the constitution. They allow for an adaptation of it to manage specific needs and at the same time do it formally, which matters with regard to political accountability. Also, contracts can highlight and manage the consequences of common interests among the levels of government. This will be illustrated later with the idea that central governments might seek to empower sub-national ones.

- *In addition the relationship between the two levels of government is endless*. This statement must be qualified since the governments can co-operate on a specific matter for a short period of time only. In addition those in charge can have a high turnover, which impacts when contracts rely on informal mechanisms (*e.g.*, social networks) to perform. However, it is clear that governments are in a repeated game situation, which could hinder any need for contracting according to theory (Axelrod, 1984; Kreps, 1990), since the pure logic of potential retaliation should in principle lead parties to co-operate optimally. Again, in actual fact, contracts are useful since they make explicit the mutual promises among the levels of government. In a world of imperfect (and manipulated) information they might be useful to sustain co-operation.

Contracts among levels of government can vary along a continuum ranging from pure transactional contract to relational one. In the case of relationship among levels of government, it should be highlighted that decisions have to be made about the objective of the jointly operated policy and about its implementation. Implementation refers to the tasks/actions that have to be taken.

- In the spirit of the Incentive Theory, a pure transactional contract refers to situation in which the CG set in the contracts both the objectives and the action to be taken by the local government. The only problem is to ensure that the latter acts accordingly.
- In the spirit of the incomplete contract theory, the intermediary situation corresponds to a situation in which the CG assigns objectives to the sub-national one, but lets it design the actions it should take to fulfil them. Of course, the complexity here draws from the fact that the implementation

capability of the sub-national authority depends on the means provided by the CG and also from its action at the national level.

- In the spirit of transaction cost economics, pure relational contracting refers to situations in which neither the objectives nor the tasks to be taken by both levels of government are defined in advance. The two governments decide to co-operate on an issue, but they need to learn and to negotiate further to define a strategy and a tactic to deal with it.

In what follows, the report aims to identify the drivers of the choices between the three contracting logics.

3. A typology to characterise co-ordination problems

The purpose of the present section is to draw a typology of co-ordination difficulties/context that characterise joint-implementation of policies between a central and a sub-national government in case either of delegation or of co-operation. Four characteristics/dimensions are highlighted: the distribution of knowledge between the parties: (Section 3.1); the complexity of the policy domain (Section 3.2); the degree of inter-dependence between the national and local policies in the domain (Section 3.3) and the enforcement context resulting from the institutional framework (Section 3.4). A conclusion will discuss the increasingly risky/complex situations that lead to evolving away from complete transactional contracting to incomplete relational contracting (Section 3.5).

3.1. The distribution of knowledge

The levels of government benefit from different skills or competences to implement specific public policies in certain domains and contexts. This depends on the policy in question and on their accumulated experience. Indeed, the ability to implement various forms of contracts depends upon the respective capacities of both parties to establish relevant objectives in the domain and to forecast and decide actions to be taken to reach them. Furthermore, the various levels of government may have different capacities to gather the information required to implement a policy. To simplify the analysis, four possible distributions of information and knowledge, corresponding to four co-ordination situations, are proposed.

Table 1.1. **Four types of knowledge distribution**

		Central government	
		High	Low
Local government	**High**	HH	LH
	Low	HL	LL

Thus:

- **HH:** corresponds to what Incentive Theory describes. The central and the sub-national government are equally skilled. An optimal incentive scheme can then be implemented. The contract can be complete because the principal is able to determine *ex ante* how to solve all the co-ordination problems likely to arise *ex post*. This corresponds to the delegation of the implementation of a rather standard policy (*e.g.*, building standard infrastructures as roads). For whatever reasons the central government is responsible for the policy, it relies only on the local government capability for implementation and tries to control potential rent extraction.
- **LH:** the central government ignores the constraints that the local government face. Neither incentive scheme, nor any complete contract can be implemented. However, an information revelation mechanism can be implemented to learn from the sub-national government, especially if the central government intends to deal again with the same type of issues with this or another sub-national government in the future. This corresponds again to a situation in which the central government is responsible for the given policy, but would like to benefit of the sub-national expertise to implement it. This is the case when the central government is seeking an innovative technique to implement a policy. However it might fear capture of its means (or misuse of its contribution) by the sub-national government, while being accountable in last resort of the policy in question.
- **HL:** a skilled central government delegates tasks to a sub-national authority that is not skilled. The central government therefore does not fear strategic behaviours of the sub-national authority, which might occur in the two former cases. Here the issue for the central government is to train and empower the sub-national one. This is typically the situation faced by unitary regimes carrying out decentralisation policy.
- **LL:** both parties are unskilled. Neither of the parties knows precisely how to deal with the policy issue. They must therefore to co-operate in identifying more clearly how the problem can be addressed (*i.e.*, stating policy objectives) and how to implement the policy. The only certainty is that the parties are involved in a common venture, in which they will share costs and benefits. This obviously calls for relational contracting aimed at managing new and innovative projects.

Thus, the distribution of knowledge strongly influences the choice of optimal contracting practice due to the fact that it is highly correlated with the logic of the relationships among the parties (delegation *versus* co-operation). However other factors matter. Before getting turning to these factors, it is important to point out that knowledge distribution is partly endogenous.

By definition the (absolute and relative) levels of skill of governments may evolve with the passing of time because parties can "learn by interacting". Accordingly, the ability to re-shape the governance mechanism in relation to accumulated experience is essential: contractual arrangements may have to evolve because agents increased their knowledge. This has three main implications.

First, the "optimal" contract (*i.e.*, an incentive *versus* a relational contract) that should be implemented given the features of the contracted policy is not always a "feasible" solution. In such case, the parties shall play on the scope of what is contracted and on the degree of incompleteness of the contract to manage a learning process leading progressively to the optimal contractual practices (and possibly the elimination of contracts). For instance, when a complete contract should be preferred, everything being equal, and when incomplete contracting or renegotiation provisions might decrease the credibility of mutual commitments, their contractual implementation provides the opportunity to redraft the agreement with the accumulation of experience. Optimal contracting should therefore allow mutual learning. This gives rise to the idea that contracts among levels of government should rely on tools that allow experimentation and the dynamic implementation of the accumulated knowledge in the contract, which, by the end of the process, may become more complete, but which should be incomplete at the very beginning.[2]

A corollary of what has been written applies more specifically to decentralisation policies. When the sub-national government is unskilled in implementing a policy, the problem of the central government is not "opportunism". Complete contracting could at first sight appear as the best option to guarantee efficient implementation. It would, however, fail to motivate the sub-national government to invest in learning. A second strategy rests on a mechanism aimed at training the sub-national government to manage new policy domains. In such a dynamic vision, the contract between the central and the sub-national government is no longer a matter of "optimal incentive scheme" to control for possible opportunistic behaviour. It is rather a tool enabling the progressive assignment of responsibilities to the sub-national government after training has occurred. Two strategies can then be implemented by the central government. Either it chooses to delegate wide policy domains to the sub-national authority from the very beginning and to co-operate (on the basis of a relational contract) to train and co-manage the delegated policy. Or, before delegating wide policy domains to a relatively low-skilled sub-national government, a central government can narrow the scope of delegation and implement a relatively complete and incentive contract, the performance of which can be the basis of wider delegation (see the Italian case). In any case, the most effective contract depends on the experience

accumulated by the parties. As a result, the contract may need to be revised over time.

Second, in a dynamic learning environment, experimenting is also essential. However, before generalising contractual practices, it may be useful to test and learn on specific cases.

Third, as contracts are learning tools, audit mechanisms should not only aim to verify that the parties comply with their obligations, but it should also assess the performance of the co-ordination among the levels of government.

3.2. The degree of complexity of the delegation

The policies that a central government can assign to sub-national institutional levels display different degrees of "complexity". Complexity refers here to the number and interactions existing among objectives and tasks. For example, managing unemployment is a complex policy domain since it involves policy actions in very different domains (*e.g.*, education, the labour market, industry dynamics, etc.) to reach a wide set of objectives which also interact (level of unemployment for various sub-categories of workers, level of income, etc.). By contrast, building infrastructure like a road or a bridge tends to be a less complex policy domain, even if it is a technically sophisticated operation. Complexity impacts on contracts because it is difficult to observe behaviours and to verify commitments when complexity is high.

Complexity depends upon the nature and upon the scope of the political domain associated with the delegation or co-operation. In a democracy, elected officials have to transpose political programmes chosen by the citizens into policy goals to be reached (objectives), which in turn have to be translated into actions to be implemented. Complexity is then linked to whether the relationship among the levels of government concerns the settlement of the objectives or the implementation only. Moreover, in some domains, the link between objectives and actions is clear and straightforward (*e.g.*, infrastructure development is strongly linked to the financial means dedicated to its construction). In other it is fuzzy because policy actions can have side effects and because they can be inter-dependent. In this case, several options are generally available to reach a goal (*e.g.*, the reduction of air pollution in urban areas can be achieved through bans of automobiles in city centres, on the reduction of CO_2 emissions by vehicles, and also on a mix of these and other strategies) and the policy goal (reduction of air pollution) is not independent of other goals (*e.g.*, growth, equitable distribution of income, etc.).

Complexity impacts both on the ability to write a complete contract and on the enforceability of contractual commitments. The greater the complexity,

Box 1.2. **Degree of complexity and types of delegation: the Italian example**

Italy has opted in particular for two types of contracts that illustrate well the contrasts between complex and simple projects and how contracts can be adapted to each situation.

First, the ways negotiated programmes organise evaluation (with top-sliced funds and mid-term evaluations and comparisons between the relative performances of the regions) indicate that these were explicitly built to deal with complex matters. Significantly, these programmes have integrated several tools of structural development policies and concentrated on a single developmental goal. In other words, these programmes have explicitly chosen complexity rather than simplicity. This can be interpreted as follows: 1) simplicity is always difficult to obtain; and 2) to accept complexity and to put complexity in the forefront means that central government remains involved in the game. It will not only control the realisation of the programme but also participate in its elaboration (through co-operation).

By comparison, Programme Contracts (*Contratto di Programma*), as well as Location Contracts, recently instituted, are built to deal with "simple" projects: they are aimed at promoting investments of relevant dimension with an anticipated high financial, economic and occupational impact and are mostly based on "top down" programming principles.

the harder (more costly/longer) it is to assign quantifiable objectives *ex ante* and therefore to establish the relevant information which will be required *ex post* to evaluate the behaviour of contracting parties (see Box 1.2):

- When the relationship between the two levels of government refers to a policy that is simple to implement, complete contracts can be used because a set of precise, non-ambiguous and controllable tasks to be realised without fearing interactions among them (and with the decision made by the central government) can be established. Transport infrastructures, schools and hospitals or garbage collection and road repair belong to this category.
- Alternatively, complexity increases when co-ordination is about "soft" tasks, such as mental health and childcare, support to innovation, promoting economic development, increasing the well being of the citizens, or reducing local unemployment. In these matters, policies are not easy to establish and describe. Each area corresponds to wide set of policy targets and multiple implementation tasks. As a result, it becomes difficult to establish a list of observable and "measurable" targets.

The greater the complexity, the harder it is therefore to implement a complete contract controlling *ex ante* the behaviour of parties. In case of delegation, the central government might therefore be led to implement an incomplete contract theory (ICT) type of contract by which the sub-national government is responsible for the implementation. However, since the policy domain is complex not only in terms of the action to be taken but also the policy objectives to be targeted, ensuring compatibility between national goals and sub-national implementation implies choosing an effective local implementation scheme. Implementing an ICT type of contract therefore requires a high level of expertise from both sides. As a result, the use of relational contracts may be preferred in many circumstances.

What separates complex and simple transactions is therefore the ability to credibly and precisely commit *ex ante* on *ex post* verifiable tasks/targets. Contracts must also be checked to assess if they create a multi-task problem – that is a situation in which the agent is asked in to perform more than one action or to target more than one goal. In presence of multi-tasking, incentive mechanisms may have pernicious effects:

- If some of the targeted actions/objectives are more "measurable" than others, there is a high risk the agent will focus only on these more "measurable" objectives.
- If some of the targeted actions/objectives are less costly than others, it is likely that the sub-national government will focus on them.

At first sight, it would be preferable for a central government to divide complex policy domains in sets of simple tasks and to delegate only simple tasks to avoid the problems raised by loose objectives and multi-tasking. However:

- First, if the central government really lacks information about the local specificity, it would be difficult (costly) to acquire the necessary information to translate generic political goals into concrete simple operations.
- Second, whether or not the costs of "translation" are bearable, if the problem is really of a complex nature, the sub-goals would be inter-dependent. This reintroduces the multi-task problem: the sub-national authority would be likely to focus on the commitments that are the easiest to fulfil.
- Third, (administrative) transaction costs could become prohibitive with the multiplication of contracts.

Complexity tends therefore to be a non-reducible type of problem. Moreover, most public policies interact in a complex way, highlighting a kind of "super-complexity" that frames the performance of any policy. It is clear, for instance, that public order is dependant both on the security policy, but also

on education, employment, urban and territorial development policies. The difficulty for a central government is that delegation does not – or rarely – concern a single task. Most of the time, wider policy prerogatives are delegated to lower levels of government. Some are simple and independent and can be associated to measurable objectives. Others are complex and interacting with other policy domains. No precise objectives can be associated to them. In the latter case implementing incentive contracts (either complete or incomplete) might result in bad performance. Co-operation is needed.

Generally speaking, more slack is given to the sub-national authority in the presence of an incomplete contract, raising the risk of incompatibility between the national policy and the local one. By contrast, completeness raises the costs of establishing the contracts and might result in perverse effects in terms of enforcement, with the sub-national government focusing on policy targets that are the more visible and less costly to achieve.

3.3. Vertical inter-dependencies between levels of government

While levels of government are embedded in an almost endless relationship, which results in a repeated game situation, each time they interact in a policy domain they have to consider the degree of inter-dependence between their actions. This refers, first, to the clarity with which competences are assigned to the various levels of government (Section 3.3.1). It also refers to the inter-dependences that can be created in the long run by their co-operation in specific domains (Section 3.3.2).

3.3.1. Vertical inter-dependencies

Vertical dependence or independence corresponds to the degree to which the results of the decisions made by the sub-national authority depend on the decisions made by the national government independent of the domain concerned by the contract. Indeed, decentralisation and federalism do not suppress the inter-dependencies that exist among policies managed at different levels of government. This is true, for example, when the central government delegates only "implementation" tasks or when delegated tasks concern a domain – *e.g.*, unemployment – connected to other policy domains governed by the centre, such as economic affairs, taxes, education and training. The issue is therefore to determine to what extent the local and the national policies depend on each other.

The problem is as follows. On the one hand, if decentralisation implies that the results of the local policy are highly dependent upon the decisions made by the central government, then the implementation of an *ex post* co-ordination mechanism may be required to guarantee efficient mutual adjustment and co-operation. On the other hand, if the contract between the

sub-national authority and the central government is incomplete, both parties could fear an "under-investment" of the other level of government. The central government may seek to free itself from its accountability by delegating tasks to the local one. In particular, it could attempt to "free ride" on local resources, by delegating tasks without corresponding resources, or without providing the necessary accompanying measures. Alternatively, the sub-national authority could divert national support to meet specific local interests (to internalise the political benefits resulting from its policy) and try to reject the burden of the accountability of any policy failure on the central government (since through incomplete contracting its commitments can be unclear). Thus, everything being equal, an incomplete contract could be inefficient to lead both parties to credibly commit when inter-dependencies are high. Since both levels of government might manipulate loose commitments to escape their accountability, the implementation of mutual safeguards and complete contracting could be requested.

When the contracted policy intervention can be made independent from the other actions of the central and local government, then the contract should follow an incentive logic by which the sub-national government would be the residual claimant for the implementation of the policy. If its accountability is high, and if it's needed due to the other characteristic of the transaction, then an incomplete contract should be implemented. If its political accountability is weak, then a complete contract has to be preferred.

In other words, potential vertical inter-dependencies among policies raise issues of potential distrust between levels of government that might use decentralisation policies to escape from their political accountability and pursue their own "local" objectives. This therefore raises the issue of the credibility of potential guarantees that can be implemented in the contract, while the ability to credibly mutually commit is linked to the actual degree of separation of power between the levels of government. Since the latter depends on both the design of the institutional framework and upon the clarification made though contracts, there is a "dog and tail" issue generating cumulative effects.

The larger responsibilities clearly assigned to the sub-national government, the higher the degree of independencies between the two levels, the easier it is to implement an incomplete contract. By contrast, the narrower the responsibilities assigned to the local government, the more likely it is to observe the persistence of complete contracts and of dependence. Thus, the higher the number of tasks/decisions assigned to the sub-national levels of government, the lower the vertical inter-dependencies and the easier it is to decentralise additional tasks on the basis of incomplete contracting assigning large responsibilities to sub-national government. This is obviously reinforced by the associated learning effects mentioned above.

It follows that the optimal contractual practices in an already highly decentralised country might not be efficient in a country that is highly centralised. Thus, contractual benchmarking across countries can be misleading if these dynamic and structural effects are not taken into account.

3.3.2. *Temporal inter-dependencies*

The temporal dimension relates to the duration of the potential inter-dependence between the two levels of policy making. Many public policies have long-term persisting influences. First, because public policies contribute to the production of institutional frameworks; they structure the environment of many collective and economic activities. Second, when public policies do not target the building of intangible assets in a society, they nonetheless may impact on them. For instance, employment policies impact on individual's skills and therefore influence the long-term employability of the workforce.

The contracting parties cannot ignore therefore the long-term effects of their present policy decisions. In particular, a policy chosen by the sub-national government influences the future set of strategic choices available to the central government. In effect, it affects the local capabilities to manage decentralised public policies and therefore influences the possibilities and the costs of future de/centralisation.

Like vertical inter-dependencies, temporal ones depend on the degree of accountability of the levels of government. When, the sub-national government is less accountable than the central one, it can behave sub-optimally because it anticipates that the citizens will consider the central government either as responsible (for an inefficient decentralisation policy), or as the last recourse for solving the induced problems.

Let us consider two examples. First, an opportunistic or inexperienced sub-national government can implement a policy that generates dissatisfaction in the public. In the short-term, the local policy makers may be "punished" and, as the long-term consequences of the poor policies emerge, citizens may mistrust decentralisation policies, thus hampering in the central government's inability to decentralise further – and might even result in recentralisation. Second, the sub-national government can choose to invest in infrastructure that would be costly to maintain *ex post*, or decide not to maintain optimal infrastructure under its responsibility, because it knows that in the last resort the central government will eventually maintain or invest in its place if the citizens consider that the decentralisation failed.

Given these elements, and especially when local accountability is low, the central government can fear being committed in the long run by the local policy of the sub-national government. It is therefore encouraged, everything

being equal, to implement complete contracts to reduce the risk of sub-optimal behaviour by the sub-national government.

3.4. *Enforcement context*

Enforcement mechanisms determine the incentives of parties to comply with their contractual obligations. They rely on supervision and retaliation capabilities. To a large extent, the institutional framework results in an enforcement context since it determines both the efficiency of oversight of the relationship between the parties and the credibility of the retaliations they might expect in cases of detected infringement of their obligations. In the context of contract between levels of government, enforcement depends both of the organisation of the (administrative) judiciary (Section 3.4.1) and of the clarity of the assignment of political accountability among levels of government (Section 3.4.2).

3.4.1. *Judicial enforcement*

The realisation of the objectives set by the contract has to be verified and enforcement or supervision mechanisms have to be incorporated in the contract. These mechanisms may be internal to the contract (performed by the parties) or involve an external supervisor, hereafter referred to as a "judge". Control is internal when the parties are able to check each other behaviours.

The mechanism relies on the capacity to retaliate against the other party when the other party opportunistically does not fulfil its obligation. In certain political regimes, the central government can legitimately punish the sub-national government while the reverse is not true. In these cases, since sub-national governments are not protected against unilateral action by the central government, the former cannot take for granted the commitments the latter has made. Alternatively, in other regimes, each level of government possesses means of retaliation. This can result in a situation of "balance of terror" in which neither of the parties is motivated to engage in conflict. Contractual commitments are therefore poorly credible in the absence of a third-party enforcer.

A "judge" who externally supervises the behaviours of the parties may be considered as the guarantor of the credibility of the mutual commitment. The role s/he plays depends on the nature of the contract. When contracts tend to be transactional, the "judge" need only evaluate *ex post* if these duties have been enforced. This is made easy because parties agree *ex ante* on the *ex post* evaluation criteria to verify and measure completion of contractual duties (meaning that the parties anticipate the capacity of a third-party supervisor and design their contract accordingly). By contrast, in relational contracting,

enforcement is more delicate, especially since mutual obligations can evolve through time. The absence of precise *ex ante* objectives and *ex post* evaluation criteria change the role of the supervisor. Rather than evaluating the performance of the parties, the "judge" has to assess whether the parties have enforced the spirit of their commitments by staying co-operative. This raises issues of "interpretation" that are not resolved by formal procedures and criteria. Therefore, when the nature of the relationship (complexity, uncertainty) imposes relational contracts, external control by the judiciary may not be efficient. Incentives to fulfil obligations can then be better provided by supervision and retaliation by both peers and citizens. Put another way, political accountability may lead to strong incentives to fulfil obligations.

3.4.2. From legal enforcement to political accountability

Different illustrations can be provided to show how political accountability, here understood as supervision/punishment by the citizens, may substitute for third-party oversight. Recent "constitutional" reforms have been implemented, with the purpose of facilitating the control of the implemented policies by citizens, either on the local or on the national level. The purpose is to allow citizens to observe the behaviour of local and central government, and to express their views. Such mechanisms are not legally binding for governments, but they nonetheless allow citizens to "voice" their opinions (see Hirschman, 1970) and to influence the making and the diffusion of reputation effects among citizens. In democratic regimes, authorities are sensitive to these effects and they might motivate them to act the right way. However, it remains possible to attempt to manipulate public opinion and transfer the burden of the accountability to the other levels of government when problems are complex and the distribution of responsibilities is fuzzy. By making the informational environment more transparent, the mechanisms described below make these manipulations relatively more difficult and costly.

First, many reforms have facilitated the access to public services and tried to modify the relationship between citizens and public services providers by concentrating public services providers in one location ("one-stop shops"). Furthermore, several countries have created citizens' or public services user's charters (the Public Services User's Charter [Belgium], the Public Service Charter [France], the Public Service Quality Charter [Portugal], and the Citizen's Charter [UK]). The terms employed reveal that these charters basically concern the citizen in his/her limited role as the consumer or respectively user of services, and sometimes as co-producer. These charters were designed as a tool to influence the degree of responsiveness of public services, but often create the impression of being used for the purpose of

administrative control rather than for establishing an open democratic administration.

Second, decentralisation results in higher accountability of the sub-national level of government. Between 1994 and 1996, the California Constitution Revision Commission (CCRC) worked on the possible revision of the governmental institutions in California. Among the different recommendations, the CCRC insisted on the link between decentralisation and accountability by positing that is necessary to "improve accountability and responsiveness of government at all levels from the state to the smallest community" (CCRC, 1996).

Third, the introduction of the "new council constitutions" in England was aimed at revitalising local democracy "by providing clear and readily accountable leadership, capable of speedier and more decisive decision making. At the same time, the government sought to reconnect councillors with local people by emphasising the importance of representation. A separation into two kinds of councillor roles was introduced: that of executive members, primarily concerned with setting policy; and that of non-executives, mainly concerned with reviewing and scrutinising decisions." (United Kingdom, Office of the Deputy Prime Minister, 2005; see Box 1.3).

When delegation involves complex tasks and/or a complex environment and thus when it takes the form of incomplete contracts, then political accountability has also to be decentralised. In effect, when delegation is complex, the actions of the sub-national government are not easily verifiable. Thus, there is no way to reward or punish a government according to its performance except by deciding whether or not to re-elect it. Then, to grant electors of each region or locality the power to decide the government's re-election increases political accountability and thus enhances the government's incentive to act in the interests of the citizens of that region (see a formal and more complete demonstration in Seabright, 1996).

Importantly, political accountability also depends on the citizens' beliefs concerning who should be in charge of solving various collective problems. These beliefs are hardly able to be manipulated by the governments and thus constrain the capacity of the central government to delegate tasks to a sub-national government. In turn, sub-national governments can rely on contractual commitment to be protected against the discretionary power of the central government (in the framework of an incomplete contract setting mutual obligations), if and only if constitutional and contractual arrangements make clear for citizens how responsibilities are split and/or shared.

On the margin, mechanisms can be implemented to make the commitments and actions of both parties more visible. It is clear, however,

Box 1.3. **Overview and scrutiny in England: "external" supervision and political accountability**

The Sub-national Government Act 2000 in England modified the way powers are divided at the local level. Among the changes this Act brought about, one can find provisions regarding "overview and scrutiny". Interestingly, the councilors in charge of this double function are not involved in decision making: "Across all four models of political management the principle underlying overview and scrutiny is that a decision should not be scrutinised by a person who was involved in making that decision" (Gains, Greasley and Stoker, 2004, p. 10). On one hand, one may be tempted to interpret the reform as a move towards external supervision. In fact, the evaluation of the reform insists on that point: non-executive councilors contribute to the improvement of public policies "through trying to influence decision makers through evidence and debate" (*ibid.*). The reform thus illustrates that the role of non-executive external "supervisors" is to improve the debate around public policy issues. "Overview and scrutiny" are thus moved closer to political and democratic debate than pure external supervision. One of the results of the reform seems to be that overview and scrutiny by councilors has indeed resulted in policy changes. From the perspective suggested in this paper, it may well be that "political debate" is more efficient than supervision when complex matters are at stake.

Source: Gains, Francesca, Stephen Greasley and Gerry Stoker (2004) "A Summary Of Research Evidence On New Council Constitutions In Sub-national Government", ELG Research Team, University of Manchester, mimeo, 24 – see also *www.elgnce.org.uk*.

that the primary is the citizens' beliefs and the constitutional logic. Indeed, it also influences the ability to benefit from an independent third-party enforcer. In unitary states, however, it is always possible to increase the independence of relevant courts and political accountability by implementing *ad hoc* constitutional mechanisms reinforcing the independence of supervision mechanisms and the transparency of public decision and action.

3.5. A typology of co-ordination contexts

In developing a typology of co-ordination contexts, four elements have to be emphasised (see Table 1.2).

- The ability to implement a complete/transactional contract strongly depends upon the central government's knowledge about the local needs and the local implementation constraints. When it is not skilled the contract that links the centre to the periphery is necessarily incomplete. It can however include a revelation mechanism, which may allow designing complete contracts in the future. The level of competences and information

of the sub-national government is of similar importance. When it is low, the purpose of the contract is no longer to use a perfect incentive scheme to control its behaviour, but rather to improve the sub-national government's competence and knowledge. When both parties are equally unskilled and uninformed, the issue is to co-operate and share information, not to tightly control each other, but to co-ordinate efficiently, learn and innovate. In any case, lack of information and knowledge prevents implementation of "optimal" incentive/revelation schemes guaranteeing *ex ante* efficient co-ordination *ex post*.

Table 1.2. **A typology of co-ordination contexts**
(Where CG means Central Government and SNA is used for sub-national authority)

Dimension	Possible values	Interpretation
Knowledge distribution (discrete variable) (central/sub-national government)	HH	Both parties are equally skilled. The CG decentralises to benefit of the SNA private information and specific skill. It fears opportunistic behaviour by this later.
	HL	The CG decentralises to empower the SNA. It may fear its lack of capability.
	LH	The CG decentralises to benefit of the SNA's skills in one domain in which it is unskilled. It fears potential opportunism, but can learn from the SNA.
	LL	The CG experiment and innovate with a SNA.
Complexity (continuous variable)	High	The CG delegates wide policy domains.
	Low	The CG delegates restricted prerogatives.
Vertical inter-dependencies (continuous variables)	High	The output of the policies/tasks delegated by the CG remains highly dependent of the CG's overhaul policy.
	Low	The actions delegated and taken locally result in local outcomes, with little impact on the overhaul national performances.
Enforcement context (discrete variable)	Unitary Regime	Neither the SNA, nor the judiciary, are independent from the CG. In turn the SNA's political accountability is low. The SNA can hardly be contractually protected against the CG potential opportunism.
	Unitary Regime with Administrative Court	Being dependent of the CG, the SNA's political accountability is low. However a skilled and independent court can protect the SNA against the potential opportunism thanks to formal means.
	Federal State without adapted Administrative Justice	Being granted with clear responsibilities the SNA is independent of the CG. Both parties cannot rely on an adapted judiciary to oversight their contractual commitments. Only political accountability is really operational. Contracts clarify the relationships but cannot be enforced strictly speaking.
	Federal State with Administrative and Constitutional Court	Being granted with clear responsibilities the SNA is independent of the CG. Both parties can rely on independent and efficient courts and political accountability to have their mutual commitments enforced.

- Generally speaking, complexity calls for more relational and incomplete contracts. There is however strong path dependence in the ability for a central government to delegate complex tasks to the local one. On the one hand, the central government can contractually assign wide responsibilities to the sub-national entity only if it is accountable and skilled enough to efficiently manage them. On the other hand, the less skilled and the less accountable the local government, the narrower the contractual delegation, which calls for complete contracting.
- Strong vertical and temporal inter-dependencies – *i.e.*, the sensibility of the results of a sub-national (respectively national) policy to the policy carried out by the central (respectively sub-national) government – favour the implementation of relational contracts. But, in a rather unitary state, inter-dependencies tend to restrain decentralisation policies and to favour the simple delegation of implementation of tasks to lower levels of government through complete contracting.
- The government's ability to mutually commit and therefore to implement contracts that protect it against *ex post* contractual hazards depends upon the quality of the institutional environment. The latter is a complex matter because it depends both on structural factors that are only slightly manipulable by the government in the short run (citizens' beliefs and the nature of the constitutional regime) and upon factors implemented in the constitutional design (in particular the organisation of a skilled and independent administrative/constitutional courts) on which the government can act, but that nevertheless requires time to reform and to build capacities.

4. Choosing contract designs

This section analyses the best contracts that can be designed to address the continuum of situations ranging from very simple co-ordination problems to highly complex ones identified above. It will be shown that that there exists a continuum of available contractual forms – from transactional to relational contracting (see McNeil, 1974) – by deconstructing the contracts into decision-making mechanisms and enforcement mechanisms and pointing out the benefits and the costs of alternative designs. This analysis will make clear the relationship between the typology of co-ordination contexts and the more efficient contractual solutions.

It must be highlighted that there are clearly two contrasted co-ordination logics – transactional and relational – leading to contractual mechanisms that rely on very different perspectives of the main issues to be addressed. However, most co-ordination situations mix these two logics. The design of an efficient contract among levels of government should therefore be based on an

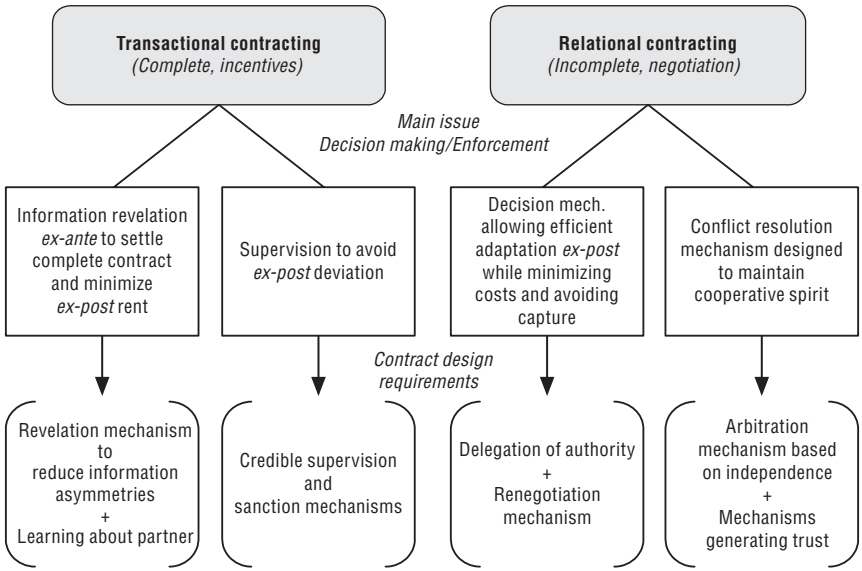
in-depth understanding of the situation and of the goals of the contract (*e.g.*, is it to control or to empower the other level?). The detailed economics of contractual logics described above should allow decision makers to identify the main dimensions that should be taken into account.

In brief, transactional contracts correspond to market-like exchanges. These contracts are thus used to solve the problems that occur when the informal rules (beliefs, moral rules, etc.) that exist in a society are not sufficient to allow the spontaneous co-ordination of individuals' plans of action. Thus, individuals use transactional contracts as co-ordination devices that rely on the formal institutional framework – namely the law and the judiciary – and complement it. Provisions are then established through negotiations that only relate to what is specific to the transaction. The rest of the exchange relies on the existing formal rules. A contract tends to establish a list of tasks contingent to each other and to external events to be fulfilled by the parties.

In contrast to transactional contracts, relational contracts correspond to agreements settled between parties engaged in a long-term process of co-operation. Parties know that they are complementary and that co-operation could result in increased wealth. However, due to a long time horizon and to the fact that they cannot figure out *ex ante* what will result from the co-operative process, they are unable to state the precise goal of their interactions and, therefore, even less able to anticipate all the concrete problems they will have to solve *ex post*. From this perspective, the role of the contract is not to establish detailed list of actions to be taken by both parties, but rather to create a governance framework that will allow co-operation. The contract then tries to build a virtuous circle based on the building of trust and mutual confidence, through the permanent enhancement of the governance mechanism and the development of common knowledge and the production of mutually beneficial outcomes. The mechanisms that are needed in the two situations are therefore different and summarised in Figure 1.1.

The analyses is organised as follows: First the contractual tools used to monitor the behaviours of the parties and to lead them to efficiently share information and knowledge are analysed (4.1); second, enforcement mechanisms are investigated (4.2). The typology of co-ordination features is matched with the resulting typology of contracts in the concluding Section 5.

Figure 1.1. **Transactional *vs.* relational contracting**



4.1. The organisation of decision making and information sharing

Contracts are designed to organise decision making and information sharing. More precisely, there exists a continuum of contracts that depends on what the central government decides to decentralise:

- A complete incentives scheme: the central government chooses the objectives and only delegates decisions of implementation (the means) to the sub-national government.
- An optimal incomplete contract: the central government delegates a larger share of the policy making to the agent who in turn chooses the sub-goals of a policy in addition to the way of implementing it. The principal's problem is to decide on the degree of control to be attributed to the sub-national government and the re-negotiation procedure to be established to re-negotiate both parties' commitments.
- A relational contract: the policy goals as well at the implementation procedures are chosen in co-operation. The contracts rely on a negotiation structure.

It must be emphasised that this continuum corresponds to different forms of delegation. In the first two situations, objectives are set at the central level as well as (at least part of) the implementation (Section 4.1.1). In these situations, the problem for the central government is therefore to design mechanisms that optimally frame the sub-national level of authority

(Section 4.1.1.1). In a dynamic perspective, the sub-national government should reveal information to enable the central government to design optimal monitoring mechanisms (Section 4.1.1.2). These two situations correspond to delegation. The third situation corresponds to the establishment of a co-operative framework in which the parties negotiate both the objective and the implementation. The problems are then radically different since the issue is to guarantee efficient information sharing and decision making in a co-operative setting (Section 4.1.2).

4.1.1. Delegation: degree of assignment and information revelation

4.1.1.1. The dilemma of authority delegation. Delegation may or may not imply the transfer of authority and discretionary power to the agent (that is, to the sub-national government). When no authority is transferred, the central government chooses both the objectives and the means of implementation. By contrast, the transfer of a part of the central government's authority means that a right of control over means and or policy variables is transferred to the agent.

The choice between transferring or not transferring authority to sub-national governments depends on a cost/benefit analysis. It may be beneficial to give prerogatives to an agent to benefit from the gains that come from an increased motivation and more accurate information to design and implement objectives and solutions. The transfer of authority may also be useful because it reduces the *ex ante* costs of designing a complete contract and reduces the costs of *ex post* control. However, granting an agent with authority is costly: it increases the loss of control. The variables that have to be taken into consideration are the degree of complexity of the task to delegate, the inter-dependency between the principal and the agent, and the asymmetries of information or of expertise that exist between them.

Then, the reasoning is as follows: when the complexity of delegation is low, inter-dependencies are low and when there are no asymmetries of expertise, then no authority has to be transferred. The central government is sufficiently skilled and informed to determine *ex ante* precise objectives to reach, to evaluate the costs that the sub-national government will incur in the realisation of the objectives and to set control variables that will be checked *ex post*. By contrast, when complexity is high, inter-dependencies are low and asymmetries of expertise important, then the central government may have difficulties in implementing a complete contract. Then authority has also to be delegated to the agent. In this context, the central government can use two forms of incomplete contracts. First, an incomplete contract in which the control over means only is delegated; the central government defines the objectives to be reached by the sub-national government, which in turn

chooses means. Second, in an incomplete contract the central government delegates the choice of local objectives and of their means of implementation.

When complexity increases, authority has to be transferred, while the difficulty to contract on precise objectives leads to granting the sub-national authority with discretionary power. In the most extreme cases, the principal and the agent know that the contracted targets do not summarise the expected performance since it is particularly difficult to turn a complex set of objectives into criteria of performance. Targets can nonetheless be set in the contract with the purpose of structuring a dialogue between the parties to make the sub-national government aware of the expected outcome of the policy. It is also the basis of an *ex post* dialogue about the assessment of the agent's and of the policy's performance. In such cases, quantitative targets should be only used to structure the dialogue between the principal and the agents. This type of situation can generate specific contracts in the continuum between transactional and relational ones. It is for instance the case in Italy (Barca, *et al.*, 2004) where this type of transactional contract, for which commitments concern final objectives/actions that the parties are supposed to achieve/perform, is attached to open-ended clauses. This makes the contracts non complete since both parties just have partial information. These contracts have transactional features (leading for instance to bonus and sanction mechanisms attached to performance). However, because there is a need for implementation of the contracts in order to know better the real meaning of these "open ended clauses", they also exhibit features of relational contracts, allowing production of knowledge to both parties as a result of co-operation.

When the discretionary power of the agent increases, dialogue becomes prominent and concerns all dimensions of the co-operation. It goes far beyond the simple dialogue around the objectives and their measurability. Formal procedures of information sharing and collective decision making must then be implemented. There is therefore a shift in which the notion of delegation loses its very meaning since the parties tend to be equal and linked by their joint involvement in a co-operative process. The purpose is no longer – as in transactional contracting – to motivate the agents to use their private information for the benefit of the principal, or to minimise its information rent. The purpose is now to combine cognitive assets to design and manage innovative projects, or at least to build procedures to share information that was previously unknown by the principal and by the agent and to build common knowledge and competences.

4.1.1.2. Revelation and incentive mechanisms. Since the central government often leads decentralisation policy in a long-term perspective, the choice of the optimal contract at a point of time depends upon the path of

development it wants to promote, and especially the learning effect it would like to guarantee.

The central government's lack of knowledge may prevent it from implementing a complete contract when, everything being equal, it would be optimal. It can therefore be optimal to implement an incomplete contract, and to audit its implementation carefully, not to avoid shirking by the concerned sub-national authority but to learn what actions are required and what verifiable objectives can be implemented in more complete contracts with other sub-national authorities. This will happen when the central government is unskilled as compared to the sub-national authority in terms of the local implementation of a national policy. Such learning strategies are of course more useful in a national setting when sub-national authorities face comparable local situations in the targeted public policy.

The sub-national government's lack of knowledge may prevent the central government from implementing an incomplete contract when, everything being equal, it would be optimal to do so. It can therefore be useful to design a more complete contract aimed at progressively delegating authority in the course of the contract completion. The central government, in that case, trains the sub-national one and increases its delegation of authority, if and only if it assesses that the sub-national government has developed its skills and implementation capabilities. The progressive assignment of increasing power to the sub-national authority is a strong incentive for the sub-national government to learn. In addition, the central government learns a lot about the local constraints of implementation, which enhance its ability to design, and supervise *ex post* delegation contracts.

4.1.2. Negotiation procedures

When complexity is high – that is if both the central and the sub-national government do not know (at least partially) how to accomplish their respective tasks, how to translate them into clear and easily verifiable objectives and which means have to be used to reach the general policy objectives chosen by their constituencies – as well as when the levels of policy making are highly (vertically or temporally) inter-dependent, then the parties have to establish a device that allows common decision making, dialogue and collective innovation (as illustrated by the provision of health services in Minnesota, see Box 1.4).

The design of an optimal common decision-making mechanism has to take into account that co-decision certainly favours information sharing, mutual understanding and generates trust but it also leads to the duplication of cognitive efforts and slows down the making of decisions. In addition, it can lead to strategic behaviour aimed at transferring the burden of the decision

Box 1.4. **Dialogue between levels of government in the provision of health services**

Through the Community Health Services (CHS) partnership, state and local public health departments share authority and responsibility for protecting public health in the State of Minnesota. *Minnesota Statutes Section 144.05* describes the commissioner of health's general duties and Chapter 145A describes the purpose of the Community Health Boards. These two sections of statutes highlight the inter-dependency of state and sub-national governments in meeting their public health responsibilities:

The commissioner of health has statutory authority relating to several environmental health programmes. Through the *Food, Beverage and Lodging (FB&L) Delegation Agreements,* the commissioner may delegate his authority for inspections of food, beverage and lodging facilities to a CHB. The standard FB&L agreement was developed collaboratively by the MDH and the State CHS Advisory Committee.

State government

"The state commissioner of health shall have general authority as head of the state's official health agency and shall be responsible for the development and maintenance of an organized system of programs and services for protecting, maintaining, and improving the health of the citizens…" (MN Stat. 144.05). The state also plays a critical role, both in monitoring county responsibilities and also in ensuring that sub-national governments have the resources they need to carry out those responsibilities.

Mutual accountability for public health means that the state must: clearly and consistently communicate the legal expectations of the sub-national government and the benefits of maintaining a strong public health system; work with sub-national governments to identify effective tools for management; and assist sub-national governments to secure the financial resources necessary to effectively protect and promote the public's health.

Sub-national government

"The purpose of sections 145A.09 to 145A.14 is to develop and maintain an integrated system of community health services under local administration and within a system of state guidelines and standards." (MN Stat. 145A.09) When counties form Community Health Boards, they retain their sub-national governmental responsibilities for basic health protection. In addition, they are required to assess the health problems and resources in their communities, establish local public health priorities, and determine the mechanisms by which they will address the local priorities and achieve desired outcomes.

The commissioner of health also may direct local health boards to take public health action. For example, in the case of communicable diseases, "a board of health shall make investigations and reports and obey instructions on the control of communicable diseases as the commissioner may direct…" (MN Stat. 145A.04, Subd. 6). In addition, the commissioner may enter into formal or informal agreements with local agencies, such as when the commissioner delegates duties to CHBs (MN Stat. 145A.07).

The ability to define shared roles between state and sub-national government has eliminated duplication of efforts and seems to have provided a cost-effective means of delivering public health services that are customised to meet the needs of local communities.

making and of the costs of implementation to the other party. The optimal solution is therefore to implement a revisable negotiation procedure. In the course of the development of the project, one of the goals of negotiations should be to specialise the parties in decision making by delegating authorities between the two of them, and designing mutual reporting procedures to guarantee a continuous accumulation of knowledge.

4.2. Enforcement mechanisms

Enforcement mechanisms are totally different in delegation/transactional (4.2.1) and in co-operation/relational contracting (4.2.2).

4.2.1. Incentives/penalties and supervision (for enforcing delegation/transactional contracts)

In transaction contracts, verifiable objectives are assigned to the sub-national government. The principal who designs the contract seeks to minimise the cost of the incentive mechanisms implemented in the contract in order to motivate the agent to follow the contractual requirements. First, he balances the cost of a positive incentive scheme with the costs of a loss of control (Section 4.2.1.1). Second, he balances between cost of supervision and the implementability of possible sanctions (Section 4.2.1.2). In addition, he can rely on the fact that he plays a repeated game, or that he faces several agents to reduce the cost of the incentive mechanism.

4.2.1.1. Designing optimal incentives/revelation schemes. In the Incentive Theory framework, enforcement rests on the idea that, since the principal is unable to observe (at no cost) variables that are essential

for co-ordination – like the quality of the service provided by the agents – and since it is costly to extract information from the agents by audit, the principal can nevertheless get information that is influenced by the behaviour of the agent, albeit randomly.[3] On this basis, he is able to design an optimal incentive/revelation scheme, by which the principal motivates the agent to behave efficiently and to reveal information in exchange of a reward.

The optimal reward is determined by taking into consideration that central and sub-national governments are engaged in repeated interactions. Then, in the first period, the central government provides the sub-national authority with a certain amount of money. The agent has to be the residual claimant its effort in the first period as it leads him to behave efficiently to maximise the part of the grant that can be used for other purposes than those set by the principal. The principal then observes how the grant was spent and the results. The central government does not only benefit from the increased motivation of the agent, but also from the information about his true costs to provide a certain level and quality of service. In a second period (and for the

each repetition of the situation), the principal can design a complete incentive contract since he knows how to compensate precisely the sub-national government for his efforts. The "optimal" grant is then provided if the sub-national authority reaches certain observable objectives.

The risks of this revelation strategy arise from the fact that the information gathered during the first period is used by the central government to reduce the slack which benefits the agent. The latter is then led to hide information, which deprives the centre from any benefit. It is therefore a better strategy for him to capture part of this slack only. If at later periods the central government provides grants that are a bit above the one that just compensate the agent's efforts, the latter can confidently reveal part of its information by maximising its efforts (therefore minimising its costs) and spending the difference between the grant and its costs for other purposes. Since in the real world, the likelihood of learning everything that is relevant – *i.e.*, the relevant cost function of the agent – in one (contract) period is low, the central government's optimal strategy is to repeatedly contract on the basis of the same principle: one grant, a set of observable targets, an obligation to report. Of course, each time the contract is renewed, the new level of grant should be based on the knowledge accumulated in the previous period so as to leave a rent to the agent, but a smaller one from period to period.

The game between a central government and a sub-national authority as it has been described in the preceding paragraph can also be understood as a game between the central government and different sub-national authorities. In that case, what the central government learns from the interaction with one sub-national government can be used to implement an optimal incentive scheme when interacting with other sub-national governments. As a result, the revelation/capture dilemma is softer than in the repeated game. At the same time, the central government can adopt this strategy if and only if the concerned policy can be implemented the same way in the different sub-national jurisdictions.

This leads us to consider another type of self-enforcing incentive scheme: yardstick competition. This is a process by which the central government has no need to extract information. It compares the relative performances of the sub-national authorities. The advantages are twofold. First, it can rely on easily observable variables, and if the competition among the sub-national government is strong, no information rent is left to the agent because the latter is motivated to do its best and because the principal's supervision costs are low because assessing "relative" performance is much easier than measuring individual performance. Second, the penalty/reward system has no cost for the principal. If he knows what the average productivity of its agents should be – *i.e.*, the average cost for the targeted level of public service – then it can provide the more efficient sub-national governments with bonuses by

removing penalties from the grants paid to the low performing sub-national authorities (see the example of the EU Structural Funds; Box 1.5).

Nonetheless, the system has limits. First, incentives would not work if the sub-national authorities were to collude; and they may be very likely to do so to avoid the negative impact of competition among them. Second, competition among sub-national authorities could be destructive, especially by ruining their ability to co-operate, which can be necessary in many policy areas where strong horizontal externalities exist. Third, yardstick competition may result in strong inequalities among levels of services across regions.

It is thus essential to point out that yardstick competition linked to incentive mechanisms should be reserved to situations in which the agents

Box 1.5. **Compared EU Structural Funds and incentives**

The evaluation of the Structural Funds allocated to the different institutional levels proposed and performed by the European Union is particularly interesting because it reveals a mix between the use of the incentive allocation of resources, evaluation (mid-term) and relative evaluation of the performance of the different regions (yardstick or benchmark). Thus, the project proposed by the DGXVI in 1998 envisaged that 10% of Structural Fund allocations was to be top-sliced and kept as a reserve for additional allocations to programmes at a later stage. Then, at the mid-term (end 2003), the programme was to be divided into three groups on the basis of a number of performance criteria (effectiveness, management and financial, criteria – see below): under-performing, well-performing, and high-performing. The Commission would undertake the ranking on the basis of implementation and mid-term evaluation reports. Finally, programmes would get an extra allocation from the reserve amounting to 10-20% for the high-performing ones, at least 10% for the well-performing, and 0% for the under-performing programmes. After the criticisms rose by several member states, the size of the performance reserve was reduced from 10 to 4% and to compare programmes only within member states and separately under each Objective. Member states were also given the option as to the level at which performance comparison would take place (national or regional). Three sets of criteria were to be used to measure performance, relating to effectiveness, good management and financial performance. The principle underlying the performance reserve, as outlined by the Commission was "not to penalize a program seen as being unsuccessful after several years, but to create favorable conditions to ensure that as many programs as possible are considered successful in the year 2004." (European Commission, DG Region, "Working Paper 4: Implementation of the performance reserve", The programming period 2000-2006: methodological working documents.)

are assumed to be skilled and even equally skilled. In that case, it can result in an efficient outcome. Otherwise, it could have counterproductive effects.

In addition, schemes focusing on observable variables have two limits. First, observable variables can be manipulated by the sub-national government. Second, observable variables can be equated with measurable variables (that are considered as more objective, less subject to manipulation, easier to observe). An incentive system that leads the agents to focus on measurable objectives leads them to neglect more complex prerogatives. When complexity is strong, the central government must not put too much emphasis on the performance realised on the most measurable target/tasks.

This is typically one of the problems that limit the use of benchmarking procedures. In effect, benchmarking may lead governments to focus their attention on the most measurable objectives, such as rate of growth or unemployment rate, to the detriment of alternative important but less measurable objectives such as equity, diffusion of knowledge, or environment quality.

4.2.1.2. Supervision, incentives and penalties. When the central government ignores the sub-national government's production costs and cannot ground incentives and enforcement on observable variables, it can rely on supervision or audit procedures to extract accurate information on its performance or behaviour and to prevent it from cheating. The procedures rest on the use of rewards or penalties.

However, supervision or auditing is costly. The principal has to balance the sanctions imposed on the potential cheater and the costs of control; given that higher costs of control should increase the probability of detecting cheaters. To determine the optimal supervision and audit mechanisms, then, the principal has to determine three elements that allow him to minimise the expected cost of collecting accurate information on local parameters: the frequency of controls, the size of reward, and the amount of penalty.

These different elements complement each other. Thus, for instance, a large reward for telling the truth can be offset by a very small audit probability and will thus lead to audit cost savings. Therefore, it is preferable for the central government to reward the agent when the audit costs are high and the audit procedure is costly. In contrast, when the audit cost is low, the central government may have interest to increase the probability of auditing and in offering a small corresponding bonus, rather than awarding a large bonus and auditing with a small probability (Rocaboy and Gilbert, 2004).

Major and frequently ignored aspects of evaluation are the implementation constraints. First, the nature of the contracted project influences the type of "criteria" that can be used to evaluate the

implementation of these projects. Often measurable variables are insufficiently correlated to the political objectives. For instance, the "performance reserve" scheme used both by the European institutions and Italy to motivate sub-national governments to behave efficiently focuses mainly on technical criteria that do not guarantee the realisation of the objectives. Second, measure and assessment should not be affected by the administration managing the programme. More generally independent evaluation and assessment procedures and the human resources and skills to administer the system are important constraints.

As the Austrian Federal Chancellery (Federal Chancellery, Austria, June 2003) has argued, there exists a contradiction between attempts to control the behaviour of sub-national governments by using "objective quantitative indicators" or "to use the Performance Reserve as a credible incentive for raising effectiveness". The point is that many contractual tools – and in particular the "performance reserve scheme" – is that they are used with a double purpose (in particular because regional policies are a mix of simple and complex projects): both as incentives to reach achievable and measurable targets and as learning tools.

4.2.2. Conflict resolution and last resort retaliation (for enforcing co-operation/relational contracting)

When two parties are co-operating the issue at stake is to maintain trust among the parties. Indeed, the parties are linked by a very loose and incomplete contract that does not protect them against co-ordination hazards. In particular, one of the two governments might not conform to what it promised or might attempt to capture all the political benefits from a joint project. Trust is necessary because both parties rely on information released by the other and because – unless all decisions are jointly made, which can generate inefficiency – each of the parties relies on initiatives taken by the other. In a context of innovation, therefore characterised by high uncertainty, both parties can make mistakes or decide not to disclose some information considered not essential by one party, while the other could consider it useful. There are then many chances to assess that the other party is no longer co-operative, which could engage both parties in speculations about the other party's intents, leading both to decide to stop co-operating.

To avoid such a pernicious loop of distrust, it is essential to build mechanisms aimed at maintaining trust between the parties. In many cases, distrust can derive from misunderstandings between the parties, the wrong interpretation of the other's intent, or divergent interpretation of what was brought to the "joint-venture" by each party and what both should get in

return. Three kinds of mechanisms can be implemented to try to resolve the problem of distrust:

- First arbitration can be used to solve potential conflict. In such a situation, the role of the arbitrator is not to establish responsibilities and to sentence a faulty party to paying damages. The very logic is to restore mutual trust by enabling the parties to expose their visions and to try to reconcile them.
- Second, social networks are also essential tools. Ian Macneil (1974) pointed out that a relational contract relies on social networks or other forms of networks and informal institutions because margins of negotiations and interpretations are often too wide when the contract is incomplete and only organise a negotiation procedure. Parties are seen to spend their time negotiating, and are never be able to rely on any reliable enforcement mechanism if they were to rely on contractual and legal tools alone. Social networks often establish norms and generate informal enforcement mechanisms based on ostracisation that guarantee informal conventions and also mutual commitment, because a community would consider it unfair not to conform to these norms and to not fulfil its own commitments. Co-operation between levels of government can be therefore be sustained by the existence of social networks among politicians or civil servants across the levels of government.
- Third, constituencies can force public authorities to co-operate. Again transparency provided by contract and by reforms aimed at increasing public awareness about public governance might help.

In addition it has to be considered that the relationships among levels of government are repeated, which provides an environment favourable to co-operation. There are also positive incentives to co-operate. Indeed both parties can be interested in the learning they gain from co-operation which empowers both parties and increases collective efficiency. A context of trust can thus favour the emergence of co-operation through contractual practices, especially relational ones. The repeated aspect of relationships between parties is an important factor for trustful relations that can be jeopardised by a high degree of personal mobility in institutions.

It should be highlighted that in the case of co-operative relationships, supervision should not be considered in a way to avoid deviation. It should be used as a tool to assess collective performance in order to enhance it. Thus, when vertical inter-dependencies and complexity are high, it is irrelevant to implement supervision procedures aimed at rewarding or punishing deviation from the rule. Supervision and reporting should be developed to assess the efficiency of the co-operative process and of its outcome so as to reframe the co-operation if needed, identify the successful governance solutions to test

them in other context, and make efforts to innovate in matter of inter-governmental co-ordination.

5. Conclusion: from co-ordination contexts to contractual solutions

Contractual agreements or governance mechanisms are devices that can be designed to reduce the risks and costs associated with asymmetries of information, difficulties or impossibilities to verify the behaviours of the parties, the lack of skills, and the defaults of credible commitments. Section 3 identifies the salient features of co-ordination problems that may occur when the realisation of a policy implies co-operation between a central government and a sub-national one, with the objective to draw a typology of co-ordination difficulties.

Four main dimensions/features were proposed to analyse and compare the different contexts of co-ordination:

- The distribution of knowledge among the parties. This criterion permits comparison of situations in which delegation is motivated by the willingness to benefit from the skills/information of the local authorities (HH and LH), with situations in which the central government seeks to empower the local authority (HL), with situations in which the two parties are co-operating to experiment and innovate (LL).
- The degree of complexity. When co-ordination is about complex matters – which also refer to the scope of the policy in question – complete contracting and precise control of the behaviour of the sub-national government by the centre is difficult. This leads to incomplete contracting, which can be a problem because if the contracted policy covers a wide set of domains, the slack of the sub-national authority might be too wide, especially if this is the central government which is accountable for the policy.
- The degree of vertical inter-dependence. Vertical inter-dependence may lead each level of government to use decentralisation to escape from political accountability, which favours opportunistic behaviours, either on the part of the sub-national or on the one of the central government, and generate reciprocal distrust. This problem therefore raises another one, namely the credibility of potential guarantees that can be implemented in the contract.
- The enforcement context. First, an independent and specialised judiciary is necessary to protect sub-national governments against possible deviation from its own commitment by the central government. Second, political accountability is essential to influence the ability of central and sub-national governments to enforce their mutual arrangements. What matters is that governments will be considered by citizens as accountable for the

decisions that are delegated (or not) through contracting. Sub-national governments can rely on contractual commitment to be protected against the discretionary power of the central government if it is clear to the citizens what government is in charge of what policy domain. In turn, the central government can rely on the citizens to encourage sub-national government doing their best efforts if it is clear that citizens consider the sub-national authority as fully responsible for decision making in a specific policy domain.

A given context of co-ordination can always be characterised along these four dimensions, which suggest the type of contractual solutions to be implemented.

It is important to point out that contracts can have endogenous effects on these characteristics, meaning that they might change after a contract is implemented. In particular:

- The distribution of knowledge can evolve because contracts can be used as learning tools.
- The enforcement context can also be changed because contracts are clarifying the conditions in which various levels of government interact, which impact in particular on political accountability.

Section 4 has demonstrated that different forms of contracts can be used to address the many situations ranging from very simple co-ordination problems to highly complex ones. There exists a continuum of contractual forms that stretches from transactional to relational contracts. To see how and how far these different contracts can be adapted to different contexts of co-ordination, it is important to bear in mind that transactional and relational contracts respectively rest on opposing mechanisms:

- On the one hand, the purpose of a transactional contract is to organise a simple delegation of tasks between two parties, very similar to a market transaction. A transactional contract is thus made of rules designed to solve co-ordination problems *ex ante*. These contracts are assumed to be enforceable through the use of the existing and explicit legal rules; no specific rules have to be tailored to guarantee the realisation of the mutual obligations involved by the contract. Therefore, transaction contracts are particularly well adapted to co-ordination situation in which both parties know *ex ante* – that is with a high probability or with a low degree of uncertainty – the problems to be solved *ex post*.
- On the other hand, relational contracts have to be implemented when parties are engaged in a long-term co-ordination process. They are unable to figure out *ex ante* all the concrete problems they will have to solve *ex post*. Parties should therefore build a negotiation mechanisms aimed at stating

ex post how to solve co-ordination problems, and aimed at accumulating knowledge.

Alternative ways to build these two mechanisms are analysed in Section 4. This is done through a review of contractual provisions setting and granting decision rights and/or procedures for negotiation, designing payment mechanisms, delimitating and granting audit rights, establishing conflict resolution mechanisms, etc. On this basis, a systematic link between a collection of optimal contractual provisions and various relational situations is established.

The mechanisms that can be designed to drive governments' behaviours as well as to help them to make decisions range from complete contingent contracts, setting in advance the tasks to be performed in various contexts, to very incomplete/relational contracting that design a negotiation procedure. More precisely:

- On the one hand, there is a choice among a continuum of solutions corresponding to increasing delegation of authority by the central government to the sub-national government. It ranges from a complete-contingent contract, where no delegation of authority occurs, to the delegation of authority over a whole area of policy; and goes through delegation of the simple rights to choose the policy tools or to decide how a policy should be implemented to reach objectives designed by the central government.
- On the other hand, the two governments can co-operate in the making of all decisions regarding the policy in question.

The mechanisms that have to be designed to guarantee that the parties will behave as requested by the "driving behaviours mechanisms" just mentioned above, belong to a set ranging from self-enforcing incentive scheme to arbitration mechanism. Again, implementable solutions range along a continuum of "transactional" solutions that turn to be increasingly "relational".

- In the former case, one party assigns verifiable actions or objectives to the other. In the case of an incomplete contract, these verifiable obligations are mutual. Enforcement is then a matter of cost and credibility. The central government that designs the contract seeks to minimise the cost of the incentive mechanisms implemented in the contract in order to motivate the agent to follow the contractual requirements. First, it balances the cost of a positive incentive scheme with the costs of a loss of control. Second, the central government balances between the cost of supervision and the implementability (acceptability) of possible sanctions. In addition, it can rely on the fact that it plays a repeated game, or that it faces several agents

to reduce the cost of the incentive mechanism. To do so, the central government plays on two "enforcement" logics.

- ❖ On the one hand, it relies on observable signals only to reward the sub-national government through an "optimal incentive scheme". In concrete terms: the principal acknowledges that it is costly to extract information from the agents by audit. It therefore implements an incentive/revelation scheme by which the principal seeks to get either the right action or the right revelation voluntarily made by the agent, in exchange for a reward. This reward, qualified as "information rent" by theory, is the shadow price of the information that is bought by the principal to the agent. It can take the form of a payment or of any transfer in favour of the agent; the principal can leave a rent to the agent, or he can transfer knowledge to him. The issue is then to acquire enough information to implement an efficient self-enforced incentive mechanism.
- ❖ On the other hand, the principal relies on his ability to extract information from the agent by auditing his activity. In this case the principal balances the net benefit of auditing – *i.e.*, the gains in efficiency obtained from the "right" behaviour by the agents minus the costs of investigating and rewarding or punishing the agent – with the net benefit of not doing so – *i.e.*, the results obtained when the agent does not operate and behave optimally.

- In the latter case, the mechanism aims at monitoring for the start of a vicious circle of distrust that will ruin the co-operative process. Parties should prevent conflict by deciding on procedures to share information and to collectively analyse failures. When conflict nevertheless arises, parties should agree on trying to settle them via an independent third party whose role is not to identify a guilty party and to sentence it, but to restore trust and a co-operative spirit by reconciling both parties' visions of common goals when they fail to reach them.

Table 1.3 summarises out how the various co-ordination contexts tend to favour the implementation of various mechanisms and provides a general synthesis of what has been developed in this paper. For a given a co-ordination context characterised by four "values" corresponding to each of the four relevant dimensions to describe such a context, it is possible to assess which co-ordination solutions can be implemented. It then appears that, when several co-ordination problems can receive the same solution, then a rather pure relational or transactional contract can be implemented. Alternatively, if several co-ordination solutions generate contradictory effects, then hybrid contracts, that mix relational and transactional, have to be used.

Lastly, it is important to point out that in several cases, contracts are used with the purpose to improve the set of knowledge of the parties, either to train

Table 1.3. **From co-ordination contexts to contractual solutions**

Dimension	Possible values	Contractual solution decision enforcement	Possible evolution
Knowledge distribution	HH	Complete contract *Self-enforced Incentives*	
	HL	Complete contract *Arbitrage*	Incomplete contract *Audit*
	LH	Incomplete contract *Audit*	Complete contract *Incentives*
	LL	Co-decision *Arbitrage*	
Complexity	High	Co-decision *Arbitrage*	+ Complete contract + *Incentives/supervision*
	Low	Complete contract *Incentives*	
Vertical inter-dependencies	High	Co-decision *Arbitrage*	
	Low	Incomplete contract *Audit*	
Enforcement context	Unitary regime	*Arbitrage*	
	Unitary regime with administrative court	*Supervision*	
	Federal state without court	Incomplete contract *Arbitrage*	
	Federal state with court	Incomplete contract *Supervision*	

the sub-national government, or to acquire information and knowledge from it. With the passing of time, the optimal solution tends to evolve.

Notes

1. This chapter draws on the contributions of Professors Eric Brousseau, EconomiX, Université de Paris X & CNRS, Institut Universitaire de France, and Alain Marciano, EconomiX, Université de Reims.
2. As pointed out by contract theory – *e.g.*, Brousseau (2000) – in order to sustain necessary mutual trust in the long run, parties involved in a co-operative process in which they progressively discover problems and solutions have to accept to negotiate in the course of the performance of the contract, and to implement new obligations resulting from what they learn. A negotiation mechanism has therefore to be organised both to guarantee sharing of knowledge and to progressively complete an initially incomplete contract.
3. The principal supposedly knows all the possible values of this variable (*e.g.*, the list of possible actions by the agent), the probability law by which it varies (*e.g.*, the probability that the agent will take any of these actions), and the way it impacts on the agent's wealth (*e.g.*, the net benefit for the agent of any of these actions).

Bibliography

Aghion, P., M. Dewatripont and P. Rey (1994), "Renegotiation Design with Unverifiable Information", *Econometrica*, Vol. 6, pp. 257-282.

Aghion, P. and J. Tirole (1997), "Formal and Real Authority in Organizations", *Journal of Political Economy*, Vol. 105, pp. 1-29.

Akerlof, G.A. (1970), "The Market for 'lemons': Quality, Uncertainty and the Market Mechanism", *Quarterly Journal of Economics*, Vol./No. 84, pp. 488-500.

Anderlini, L. and L. Felli (1994), "Incomplete Written Contracts, Undescribable States of Nature", *The Quarterly Journal of Economics*, Vol. 109(439), pp. 1085-1124.

Anderlini, L. and L. Felli (1999), "Incomplete Contracts and Complexity Costs", *Theory and Decision*, Vol. 46, pp. 23-50.

Arrow, K.J. (1985), "The Economics of Agency", in J.W. Pratt and R.J. Zeckhauser, *Principals and Agents: The Structure of Business*, Boston, Harvard Business School – Research College, pp. 37-51.

Averch, H. and L. Johnson (1962), "Behavior of the Firm Under Regulatory Constraints", *American Economic Review*, Vol./No. 52, pp. 1052-1069.

Axelrod, R. (1984), *The Evolution of Cooperation*, Basic Books, New York.

Barca, F., M. Brezzi, F. Terribile and F. Utili (2004), "Measuring for Decision Making: Soft and Hard Use of Indicators in Regional Development Policies", *Materiali Uval, analisi e studi*, No. 2, November-December.

Barnard, C. and S. Deakin (2001), "Market Access and Regulatory Competition", Jean Monnet Working Paper, Harvard Law School.

Baron, D. and D. Besanko (1984), "Regulation and Information in a Continuing Relationship", *Information Economics and Policy*, No. 1, pp. 267-330.

Baron, D. and R. Myerson (1982), "Regulating a Monopolist with Unknown Costs", *Econometrica*, Vol. 50, pp. 911-930.

Baron, D.P. (1989), "Design of Regulatory Mechanisms and Institutions", in R. Schmalensee and R.D. Willig (eds.), *Handbook of Industrial Organization*, Vol. II, Elesevier Science Pub., Amsterdam, pp. 1347-1447.

Baron, D. and D. Besanko (1984), "Regulation and Information in a Continuing Relationship", *Information Economics and Policy*, Vol. 1, pp. 267-330.

Baron, D. and D. Besanko (1992), "Information, Control and Organizational Structure", *Journal of Economics and Management Strategy*, Vol. 1, pp. 237-275.

Baron, D. and R. Myerson (1982), "Regulating a Monopolist with Unknown Costs", *Econometrica*, Vol. 50, pp. 911-930.

Bergvall, D., C. Charbit, D. Kraan, and O. Merk (2006), "Intergovernmental grants and decentralized public spending,"*OECD Journal of Budgeting*, Vol. 5, No. 4., pp. 111-158.

Breton, A. (2002), "An Introduction to Decentralization Failure", in Ehtisham Ahmad and Vito Tanzi (eds), *Managing Fiscal Decentralization*, Routledge, London and New York, pp. 31-45.

Brousseau, E. (2000), "Confiance ou Contrat, Confiance et Contrat", in F. Aubert and J.-P. Sylvestre (eds.), *Confiance et Rationalité*, INRA Edition, Les Colloques, No. 97, pp. 65-80.

Brousseau, E. (1993), "Les Théories des Contrats: Une Revue", *Revue d'Economie Politique*, Vol. 103, No. 1, January-February, pp. 1-82.

Brousseau, E., and M. Fares (2000), "The Incomplete Contract Theory and the New-Institutional Economics Approaches to Contracts: Substitutes or Complements?", in C. Ménard (ed.), *Institutions, Contracts, Organizations, Perspectives from New-Institutional Economics*, Edward Elgar Pub.

Brousseau, E. and J.M. Glachant (eds.) (2002), *The Economics of Contracts: Theory and Application*, Cambridge University Press.

Bryntse, K. and C. Greve (2002), "Competitive Contracting For Public Services: A Comparison of Policies and Implementation in Denmark and Sweden", mimeo, 21.

Caillaud, B., R. Guesnerie, P. Rey, and J. Tirole (1988), "Government Intervention in Production and Incentives Theory: A Review of Recent Contribution", *RAND Journal of Economics*, Vol./No. 19-1, Spring 1988, pp. 1-26.

California Constitution Revision Commission [CCRC] (1996), "Final Report and Recommendations to the Governor and The Legislature," pg. 2.

Coase, R.H. (1937), "The Nature of the Firm", *Economica N.S.*, Vol. 4, pp. 386-405, reprinted in O.E. Williamson and S. Winter (eds.) (1991), *The Nature of the Firm: Origins, Evolution, Development*, Oxford University Press, New York, pp. 18-33.

Comanor, W.S. and H.E. Frech III (1985), "The Competitive Effect of Verticals Agreements?", *American Economic Review*, June.

Crémer, J. (1995), "Arm's Length Relationship", *Quarterly Journal of Economics*, Vol. 110, pp. 275-296.

Donahue, J.D. (1997), "Tiebout? Or Not Tiebout? The Market Metaphor and America's Assignment Debate", *Journal of Economic Perspectives*, Vol. 11(4), pp. 73-81.

Engel, C. (1995), "Legal Experiences with Competition among Institutions", in Lüder Gerken (ed.), *Competition among Institutions*, Hayek Symposium 1994, London 1995, pp. 89-11.

Ferris, J. and E.E. Graddy (1996), "Institutional Economics and Government Contracting: Lessons for the New Public Management", paper prepared for the conference on "The New Public Management in International Perspective", Institute of Public Finance and Fiscal Law, 11-13 July 2006, St. Gallen, Switzerland.

Freixas, X., R. Guesnerie, and J. Tirole (1985), "Planning Under Incomplete Information and the Ratchet Effect", *Review of Economic Studies*, Vol. 52, pp. 173-192.

Fudenberg, D.,D. Kreps, and E. Maskin (1990), "Repeated Games with Long-run and Short-run Players,"*Review of Economic Studies*, Vol. 57(4), pages 555-73.

Green, J., and J.-J. Laffont (1977), "Characterization of Satisfactory Mechanisms for the Revelation of Preferences for Public Goods", *Econometrica*, Vol. 45, pp. 427-438.

Grossman, S.J. and O.D. Hart (1986), "The Costs And Benefits Of Ownership: A Theory of Vertical Integration", *Journal of Political Economy*, Vol. 94(4), pp. 691-719.

Hart, O.D. and B. Holmstrom (1987), "The Theory of Contracts", in Bewley (ed.), *Advance in Economic Theory*, Cambridge University Press, Cambridge, pp. 71-155.

Hart, O. and J. Moore (1988), "Incomplete Contracts and Renegotiation", *Econometrica*, Vol. 56, pp. 755-786.

Hart, O. and J. Moore (1999), "Foundations of Incomplete Contracts", *Review of Economic Studies*, Vol. 66(1), pp. 115-138.

Hart, O.D. and B. Holmström (1987), "The Theory of Contracts", in T.R. Bewley (ed.), *Advances in Economic Theory*, Fifth World Congress, Cambridge University Press, Cambridge, pp. 369-398.

Hirschman, A.O. (1970), *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*, Harvard University Press, Cambridge, Mass.

Inman, R.P. and D.L. Rubinfeld (1996), "Designing Tax Policy in Federalist Economies", *Journal of Public Economics*, Vol. 60(3), pp. 307-334.

Inman, R.P. and D.L. Rubinfeld (1997a), "Rethinking Federalism", *Journal of Economic Perspectives*, Vol. 11(4), pp. 43-64.

Inman, R.P. and D.L. Rubinfeld (1997b), "The Political Economy of Federalism", in Dennis C. Mueller (ed.), *Perspectives on Public Choice*, Cambridge University Press, Cambridge, pp. 73-105.

Josselin, J-M. and Alain Marciano (2003), "Federalism and Subsidiarity in National and International Contexts", in Juergen Backhaus and Richard E. Wagner (eds.), *Handbook of Public Finance*, Kluwer Academic Publisher, Dordrecht, pp. 477-520.

Josselin, J-M. and A. Marciano (1995), "Constitutionalism and Common Knowledge: Assessment and Application to a Future European Constitution", *Public Choice*, Vol. 85(1-2), pp. 173-188.

Josselin, J-M. and A. Marciano (1997), "The Paradox of Leviathan: How to Develop and Contain the Future European State", *European Journal of Law and Economics*, Vol. 4(1), pp. 5-21.

Josselin, J-M. and A. Marciano (2004), "Federalism and Conflicts over Principalship: Some Insights into the American Constitutional History", *Constitutional Political Economy*, Vol. 15(3), September, pp. 281-304.

Josselin, J-M. and A. Marciano (2005), "Administrative Law and Economics", in J.B. Cheltenham (ed.) (1999), *The Elgar Companion to Law and Economics*, Elgar, revised version, first edition.

Josselin, J-M. and A. Marciano (2006, forthcoming), "Economic Analysis of Administrative Law (agencies)", in David S. Clack (ed.), *The Sage Encyclopedia of Law and Society: American and Global Perspectives*, Sage, New York.

Joumard, I. (2005), "Getting the Most out of Public Sector Decentralisation in Mexico", OECD, Economic Department Working Paper No. 453.

Konisky, D.M. (2005), "Regulatory Competition and Environmental Enforcement: Evidence from the US States", mimeo, paper presented at the annual meeting of the Midwest Political Science Association, Chicago.

Kreps, D. (1990), *Game Theory and Economic Modelling*, Oxford University Press, Oxford.

Laffont, J.J. and J. Tirole (1993), *A Theory of Incentives in Procurement and Regulation*, MIT Press, Cambridge, Mass.

MacNeil, I.R. (1974), "The Many Futures of Contracts", *Southern California Law Review*, Vol. 47(688), pp. 691-816.

North, D.C. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge, Mass., p. 152.

Oates, W.E. and R.M. Schwab (1988), "Economic Competition Among Jurisdictions: Efficiency-Enhancing or Distortion-Inducing?", *Journal of Public Economics*, Vol. 35, No. 3, April, pp. 333-354.

Oates, W. E. (1999), "An Essay on Fiscal Federalism", *Journal of Economic Literature*, Vol. 37, No. 3, September, pp. 1120-1149.

Oates, W. E. (2005), "Toward a Second-Generation Theory of Fiscal Federalism,"*International Tax and Public Finance* 12, 349-373.

OECD (1989), *Economies En Transition: L'Ajustement Structurel dans les Pays de l'OCDE*, OECD Publications, Paris.

Perrot, A. (1992), "Asymétrie d'Information et Contrats", *Annales des Mines, Gérer et Comprendre*, mars.

Posner, R.A. (1986), *Economic Analysis of Law*, 3rd edition, Little Brown, Boston, p. 666.

Rocaboy, Y. and G. Gilbert (2004), "The Central Government grant allocation problem in the presence of misrepresentation and cheating", *Economics of Governance*, 5, 137-147.

Rey, P. and J. Stiglitz (1988), "Vertical Restraints and Producers' Competition", *European Economic Review*, Vol./No. 32, pp. 561-568.

Salmon, P. (1987b), "Decentralization as an Incentive Scheme", *Oxford Review of Economic Policy*, Vol. 3, No. 2, Summer, pp. 24-43.

Salmon, P. (2000), "Decentralization and Supranationality: the Case of the European Union", in Ehtisham Ahmad and Vito Tanzi (eds.), *Managing Fiscal Decentralization*, Routledge, London and New York, pp. 99-121.

Seabright, P. (1996), "Accountability and Decentralization in Government: an Incomplete Contracts Model", *European Economic Review*, Vol. 40, pp. 61-89.

Simon, H.A. (1976), "From Substantive to Procedural Rationality", in S. Latsis (ed.), *Methods and Appraisals in Economics*, Cambridge University Press, pp. 129-148.

Stiglitz, J.E. (1977), "Monopoly Nonlinear Pricing and Imperfect Information: the Insurance Market", *Review of Economic Studies*, Vol. 44, pp. 407-430.

Tirole, J. (1999), Incomplete Contracts: Where Do We Stand?, *Econometrica*, Vol. 67(4), pp. 741-782.

Trachtman, J.T. (1993), "International Regulatory Competition, Externalization, and Jurisdiction", *Harvard International Law Journal*, Vol. 34.

United Kingdom, Office of the Deputy Prime Minister (2005), "Councillors and the New Council Constitutions," pg. 7.

Vanberg, V. and W. Kerber (1994), "Institutional Competition among Jurisdiction. An Evolutionary Approach", *Constitutional Political Economy*, Vol. 5(2), pp. 193-219.

Vickers, J. (1985), "Strategic Competition among the Few: Some Recent Developments in the Economics of Industry,"*Oxford Review of Economic Policy*, Vol. 1, October.

Weitzman, M. (1980), "The Ratchet Principle and Performance Incentives", *Bell Journal of Economics*, Vol. 11, pp. 302-308.

Williamson, O.E. (1975), *Markets and Hierarchies: Analysis and Antitrust Implications*, The Free Press, New York.

Williamson, O.E. (1985), *The Economic Institutions of Capitalism*, The Free Press, New York.

Williamson, O.E. (1991), "Comparative Economic Organization: the Analysis of Discrete Structural Alternatives", *Administrative Science Quarterly*, Vol. 36, June, pp. 269-296.

Williamson, O.E. (1996), *The Mechanisms of Governance*, Oxford University Press, Oxford.

ISBN 978-92-64-00873-1
Linking Regions and Central Governments
Contracts for Regional Development

Chapter 2

The Case of France[1]

This chapter applies the analytic framework presented in Chapter 1 to the use of Contrats de Plan Etat-Région *(CPER) as the primary mechanism for regional planning in France. It begins with an overview of the organisation of French government and the recent history with regard to decentralisation. It then provides an in-depth look at the overarching co-ordination context and the CPER as a contractual mechanism, before turning to an analysis of the CPER in practice.*

1. Introduction

Over the last two decades, the central government in France has devolved specific tasks to regions, departments, and to a far lesser extent, to municipalities. This process of decentralisation has been accomplished in two stages: the first began in the 1980s and the second (called "Act II") followed in 2003. In France, the process of decentralisation has been accompanied by a corresponding increase in the competences of the representative of the central government at the sub-national level – namely the prefect. In other words, the process of decentralisation (assigning competences to sub-national actors) has been reinforced by deconcentration (increasing the responsibilities of these actors and the agents of the central government in regions).

One purpose of the decentralisation in France was to reform the system of central planning. For this reason, a system of regional planning was created in the 1980s. The primary mechanism for regional planning thus became the "*Contrats de Plan Etat-Région*" (CPER), which is the focus of this case study. After providing a brief overview of the institutional structure of government and the history of decentralisation, this paper examines the co-ordination context and contractual mechanisms upon which the CPERs are based.

2. Decentralisation in France

The relationship between the State and sub-national authorities in France is established by the constitution, as well as by the laws on transfer of central government powers. In France, there are three types of sub-national authorities (*collectivités territoriales*). In order from smallest to largest, they are:

- Municipalities (*communes*): are the lowest sub-national authorities in France. There are 36 500 communes in France, of which 89% have less than 2 000 inhabitants. Each municipality is governed by an elected municipal council (*conseil municipal*). After the passage of the "Chevènement" Law in 1999, there has been a new effort to increase the competences of the communes and their means by improving co-operative links between them. These structures, which are not elected, aim at organising, improving and facilitating co-operation between the different communes.
- Departments (*départements*): are mid-sized sub-national authorities. In total, there are 100 French departments, of which four exist on overseas

islands. The average population of a department is approximately 300 000, ranging from 2.1 million (Paris) to 73 500 (Lozère). The department is run by a council (*conseil général*) consisting of elected officials. In parallel to this elected body, the central government is represented by the prefect, who is an agent of the central government, and by deconcentrated ministerial services.

- Regions (*régions*): there are 26 regions in France (22 metropolitan regions are in mainland France, including Corsica, and four are overseas regions). Regions have an average population of approximately 2.5 million inhabitants, and range in size 10 952 000 (Ile-de-France) to 710 000 (Limousin) and 260 000 (Corse). Each region is governed by an elected regional council (*conseil régional*). As in the case of the departments, the central government represented by a regional prefect in parallel to the elected regional council.

The central government retains the power to grant competencies to these sub-national jurisdictions and also to remove these competences. More precisely, the central government retains three major sets of activities:

- Defence, security and diplomacy: the central government retains control over these basic and usual activities of the State. It is the only level with the right to represent France. The sub-national jurisdictions have no international power. They can have agreements with jurisdictions from other nations, which is often done through decentralised co-operation, but cannot have their own diplomacy.
- Control and arbitration activities: the central government retains sovereign power and therefore it has the right to control the actions of the sub-national jurisdictions (*a posteriori* financial control through the *Chambres régionales des comptes* – regional audit courts).
- Social and solidarity actions: the central government develops all of the activities related to social justice, inter-territorial justice and equity. The criteria according to which national resources are redistributed among citizens are decided in Paris. The focus is put upon national cohesion and "equity" among citizens and inhabitants of the different regions.

The process of decentralisation in France consisted of the re-assignment of responsibilities across the different institutional levels using two important approaches. First, competences were assigned globally, in which "blocks" of competencies were granted to each level. This approach was taken to avoid duplication of competencies between the different levels of government. However, overlapping competences do, in fact, remain (*e.g.*, education; for more details see *OECD Territorial Reviews: France*, OECD, 2006). Second, no hierarchy was established among sub-national authorities (*non tutelle d'une collectivité locale sur l'autre*). Only the State has the right to arbitrate the possible

conflicts or overlaps that may arise between the different sub-national authorities.

The tasks assigned to the different sub-national authorities occurred in two stages. The first stage took place in the early 1980s, following the passage of a parliamentary act in August 1981, which was implemented in March 1982. The second stage corresponds to what is called "Act II" of the decentralisation process. It took place in 2003 (following The Constitutional Law of 28 March) and in 2004 (following the Law on local freedoms and responsibilities of 13 August). Those laws not only reinforced the transfer of powers and responsibilities but they also entailed a constitutional reform. The region is now recognised in the constitution. Moreover, the financial autonomy that sub-national governments already enjoyed (in the form of freely disposable resources) was reinforced. The laws provide that taxes and other own-revenue sources must represent "a determined portion of all resources". Finally, the transfer of responsibilities from the central government to sub-national authorities must be accompanied by the allocation of equivalent resources. The blocks of responsibilities assigned to the sub-national governments can be described as follows (for more details see Table 2.1; see also OECD, 2006):

- Communes: urban planning (*urbanisme*), land-use control (*droit des sols*) and security (municipal police).
- Departments: roads, social services, school transportation, fire, assistance, construction of middle school, and rural planning.
- Regions: regional planning, economic development, vocational training, building of high schools.

While responsibilities appear to be clearly delineated, in fact, most are shared (except for vocational training which is a regional competence). Because no hierarchy was established among sub-national authorities, the allocation of competences is not always clear. Therefore, conflicts regarding freedom of action at each level can occur even if there is an assigned co-ordination role (*e.g.*, regions are responsible for co-ordinating economic development).

Two points are worth mentioning about the control of the behaviours of the sub-national levels of government.

First, the control of the behaviours of any sub-national jurisdiction is "legal" in the sense that each sub-national authority has to strictly observe the law. The prefect ensures that any act contrary to the law or in abuse of regulations be reported to a supervisory judge. But, as a corollary, since the control is legal it means that is it not political: regional or departmental governments are politically responsible for their choices. Decentralisation has thus replaced the possibility of an *ex ante* or *a priori* political control of the

Table 2.1. **Responsibilities of regions and departments**

Responsibilities of the regions	
Economic development	Co-ordination role in economic development
	Full responsibility for vocational training
	Registration of apprenticeship contracts
	Management of in-house training and of individual and collective employment training programmes
	Co-ordination of information and settlement programmes for new arrivals
	Co-ordination of tourism policies and assistance
Roads and large-scale infrastructure	Development and maintenance of fishing ports
	Preparation of a master plan for infrastructure and transportation
	Responsibility for school transportation in Île-de-France
	Management of European Union programmes (on an experimental basis)
Social services, solidarity and housing	Participation in the financing of health facilities
	Responsibility for social and paramedical trainings
	Definition of a regional health programme
Education and culture	High school buildings and facilities
	Technical, operating and service staff of high schools
	Ownership of historic monuments, heritage inventory
Responsibilities of the departments	
Economic development	May provide subsidies (alone or jointly) for SMEs, commerce and crafts
Roads and large-scale infrastructure	Creation, management and maintenance of airfields (on-demand)
	Creation, management and maintenance of fishing ports
	Establishment of non-urban transportation services
	Ownership and management of 20 000 km of national highways; use of highway tolls for financing and construction of express highways
Social services, solidarity and housing	Assistance in the construction of rural social housing
	Departmental plans for low-income housing
	Solidarity Fund for Housing (FSL)
	Departmental master plan for social and medical services
	Co-ordination of assistance to indigents
	Assistance fund for at-risk youth (FAJ)
	Social and medical assistance for the elderly, definition of a master plan to increase human and material resources for care for the elderly
	Responsibility for local information and co-ordination centres (CLIC)
	Education assistance measures (on an experimental basis)
	Management of minimum income programmes (RMI/RMA) beginning 2004
Education and culture	Buildings and facilities of the *collèges*
	Technical, operating and service staff of the *collèges*
	Definition of sector specialisation for the *collèges*
	School health programmes
	Ownership of historical monuments (on-demand)
	Management of works and restoration subsidies for historic monuments
	Departmental master plan for art education

actions of sub-national institutional levels by an *ex post* or *a posteriori* legal control.

Second, each region has an audit office, which keeps control of sub-national authority expenditures and financial records; regional courts of audit were created in 1982. In the area of finances, national backing for sub-national authorities is expressed via the financial resource system of the sub-national authorities. These may receive reimbursement of state taxes, state subsidies in the form of grants for administration and equipment, and even loans. Elected representatives are free to plan expenditure and application of public resources.

3. Regional policy and the use of contracts: the case of the state-region planning contracts

Contractual practices in France are a long-standing tradition. Contracts were already used in the 1970s in the domain of urban public policies (city contracts, *contrats de ville*, CVs), well before decentralisation began. The process of decentralisation has seemingly reinforced and accentuated the use of contracts to govern the relationships between the central and sub-national governments. In fact, the state-region planning contracts (*Contrats de Plans Etat-Région*, CPERs), the most significant type of contracts existing in France, were created almost as a result of decentralisation in 1982.

One purpose of the decentralisation process was not only to delegate certain tasks to the lower institutional levels but also to reform the system of central planning. Thus, in 1982 a system of "regional planning" was created (Act 82-653, 29 July). The creation of regional plans essentially made the notion of a national plan obsolete. Instead, a set of consistent regional plans essentially constituted the national plan, with the central government guaranteeing consistency between the regional plans.

Guaranteeing consistency between the regional plans was initially framed by the use of contracts. Article 11 of the same act stated that the central government could settle contracts with regions, public or private enterprises, and any other moral entity based on mutual commitment between the parties with the purpose to reach the objectives of the regional plan. These contracts were to be the CPERs, eventually launched in 1984. While instituted to connect regional and national planning, the link between contracts and central planning tended to disappear. Thus, typically, CPERs will be renamed in 2007 as "State-Region Projects Contracts". This change and the related reference to regional projects reveals a wish to replace the (rather) top-down planning procedure by a (more) bottom-up one.

The remainder of the section describes context of co-ordination between the regions and the central government, details the contractual mechanisms

upon which CPERs are based, and presents an assessment of contractual practices.

3.1. Co-ordination context

Four dimensions characterise the context in which the regions and the central government co-ordinate their actions and sign contracts: evolving levels of knowledge by both parties, broad scope of responsibilities, strong vertical inter-dependencies, and administrative procedures for enforcement.

3.1.1. Levels of knowledge by both parties

The first dimension of the context within which contracts take place relates to relative degree of knowledge of the two parties. Historically, both parties had equally low-levels of information about two issues: first, what were the sub-national (regional and infra-regional) and national competences; second, how and how far these competences could be best used to implement public policies. Therefore, the use of contracts to complement decentralisation initially functioned as a learning mechanism.

The need for a mechanism or a procedure that allows the acquisition of information dates back to the first stages of the decentralisation process (in 1982). Twenty-five years ago decentralisation represented a dramatic change in an institutional framework in which all policy choices were historically made by the central government. For the first time, non-central institutions were granted the responsibility to plan for their own development. As a consequence, both the regions and the central government were obliged to acquire information about the regional competencies and also about how these competencies could be used to reach more general, national, objectives.

Today, things have changed. Nowadays the central government and the regions have accumulated experience. They are better informed about their skills, the policy objectives, and the best ways to translate competences into means to reach these goals. However, the parties continue to insist that a learning device is necessary to update the stock of knowledge available to the region and to the central government. As such, both the central and the regional government envisage and utilise the contract as a method to increase their respective level of information.

3.1.2. Scope of responsibilities

The second aspect of the context of co-ordination within which decentralisation of regional policies and the use of contracts occur is that the tasks that have been progressively transferred by the central to the regional

government relate to the whole economic and social development of the country and its regional components.

This feature is a consequence of the nature of decentralisation (the blocks of competencies being delegated to each level cover every aspect of regional activities) and also of the context within which decentralisation took place (a means to replace central by regional planning; and even, to replace planning by the establishment of contracts). Furthermore, the scope of responsibilities has widened and the complexity of delegation has increased over the years. In effect, as decentralisation proceeds, more tasks and responsibilities are delegated to the regions and to sub-national levels of government. For instance, the competences about certain infrastructure – namely roads – now fall into the domain of competences of the departments (and will no longer be included in the next generation of contracts).

Thus, decentralisation is about many aspects of regional policy. It is not restricted to precise matters alone. It does not occur only when certain problems have to be solved. In other words, "delegation" is as complex as the whole economic activities of regions.

3.1.3. *Strong vertical inter-dependencies*

A third crucial aspect of the context within which the regions and the central government co-ordinate their behaviours corresponds to the existence of strong vertical inter-dependencies between the central and the sub-national governments. In effect, the process of decentralisation has resulted in assigning to the regions tasks that cannot be reached independently from what is done by the central level and in the other regions. Thus, the tasks delegated and the objectives assigned to the regions have to be compatible with the policies designed at the central level. Beside the inter-dependencies between regional and national objectives, inter-dependencies (at least indirectly) also exist between the regions themselves. Because each region must choose objectives that are compatible with and contribute to national objectives, there is *de facto* co-ordination among regions.

3.1.4. *Enforcement procedure*

CPERs are contracts that take place within the context of a unitary state. From this perspective, three elements are important to emphasise the nature of the situation of France. First, administrative judges are in charge of controlling of the behaviours of the State in the French dualist regime – a legal regime in which private and public matters remain relatively distinct. Therefore, the control of contracts signed by the State involves administrative judges. However, the judges do not evaluate the content of the contract but only its legal dimensions. A second and important element is that the regions

can be considered as politically responsible for the realisation and execution of the contract if – and only if – the objectives signed upon are indeed chosen by the region. Finally, CPERs may be enforced as long as regions are able to react when the central government performs an engagement. This is far from obvious in a unitary state, a political structure in which the lower levels of government are not granted the right to retaliate against the behaviours of the central government.

3.2. Contractual mechanisms

3.2.1. General features

There are four general features of the CPER worth mentioning.

First, CPERs are signed between the central government (the regional prefect) and the head of the regional council (an elected official). Other regional actors, such as associations and firms, also play a notable role in the process of preparing the regional strategic plan.

Second, CPERs include a territorial component that consists of specific sub-contracts: *contrats de pays* (CPs), *contrats d'agglomération* (agglomeration contracts, CAs) and *contrats de parcs naturels régionaux* (regional nature parks contracts, CPNRs). These sub-contracts are contained within and form a part of CPERs. Thus, although they address different issues, these contracts nonetheless belong to a single framework – that of the state-region planning contracts.

A third element related to all aspects of CPER, and not just to the "territorial" dimension, is that these CPERs are co-funding and, strictly speaking, not delegation contracts. Thus, parties agree upon the realisation of a certain number of tasks and the way these tasks will be funded. They do not assign the realisation of tasks to the regions, departments or any other sub-national authority.

Finally, the duration of the CPER contract is seven years. The standard duration of the first two generations was five years. For the last of the four generations of contract, it has been extended to seven years from 2000 to 2006.

3.2.2. Learning, bargaining and the pre-contractual stage

The different contracts that are used in France are built as means to allow the regions and the central government to improve their respective level of information about the regional competences and the objectives of the central government.

One contractual device that allows actors to improve knowledge and information is the establishment of a pre-contractual stage during which the

negotiation between the region and the prefect is prepared. The parties conduct various studies at this stage. On one side, the regions hire experts that analyse the local situation, its strengths and weaknesses, and try to decipher what will be the situation in the future. On the other side, the prefect (on behalf of the central government) produces the regional strategy of the State, a document which explains how the central government will adapt its national strategy to the context of each region. This document is based on inter-ministerial agreements at the central level.

A second contractual provision that is important from the perspective of the acquisition of information consists of clauses that allow for the possible revision of the contract. Thus, each CPER includes an article that mentions that it will be possible to modify the terms of the contract, the objectives of the contract, and the means to be used. From the perspective of knowledge acquisition, revision clauses are important because new information acquired from studies may require contract revision. For example, the CPERs signed in 2000 allowed revisions to occur at mid-term, namely in 2003.

To improve information and knowledge is also a major objective of the other contracts mentioned previously, such as *contrats de pays* and *contrats d'agglomération*. These are created for the very purpose of acquiring information. These contracts define the projects that local partners will develop in order to receive funding from the central government. In the *contrat de pays*, local partners must even define the geographical perimeter of their project, the "*pays*". Communication is at the root of these contracts. Furthermore, it is important to stress that these contracts go beyond the institutional structure of the country by incorporating non-government actors. Therefore, these contracts make clear that information about sub-national competences and needs is not to be conveyed through institutional channels alone. Thus, contracts take place within but also go beyond the "hierarchical" structure that corresponds to the unitary constitutional framework. These contracts do not establish, or reinforce existing, hierarchical relationships between the central and the sub-national institutional levels. Instead, the literature on CPERs reveals that all parties, including the central government and the regions, feel as though they are placed on the same footing.

3.2.3. Complexity of policy objectives

All the different contracts discussed here are "aggregate" contracts, in the sense that the tasks that the central government and the regions contract upon are not restricted to a single and specific economic or social domain. They cover the different aspects of the development of the area to which they are linked. As a result, contracts increasingly deal with complex issues.

Some issues are "hard" and "tangible", while others are "soft" and less tangible. Over time, there has been a shift away from the former and toward the latter types of issues. Thus, in the early stages of CPERs, the projects mostly related to investments in infrastructures and the modernisation of the industrial areas. These types of projects have not disappeared. However, the share of "hard" and "tangible" projects has decreased and should continue to decrease. Instead, the contracts have progressively been devoted to general and qualitative goals, such as the welfare of the citizens, to the reinforcement of the links that exist between the inhabitants of the region, to the quality of employment and the efficiency of firms, to sustainable development and the like. From this perspective, the preambles or the texts that explain the goal of CPERs are significant. In Midi-Pyrénées, for example, "the 2000-2006 CPER has only one goal: a region based on solidarity, open and strong, to serve the inhabitants of Midi-Pyrénées". In Aquitaine, the presentation of the contract reads: "the planning contract … provides the answer to a threefold problem, the quality of environment, solidarity between individuals and among territories, and employment" (translation). The reform of CPERs that corresponds to the future fifth generation of contracts will not change but rather reinforce this orientation towards adaptation of broad objectives to regional contexts. The future contracts will also last seven years (from 2007 to 2013, like the European programmes with which they aim to be better co-ordinated) and will now be called *Contrats de Projets Etat-régions (*State-Region Projects Contracts). The "profound renovation" announced in official documents (see the report published after the CIACT of March 2006) which is inspired by the Lisbonne and Goteborg European Councils for innovation, competitiveness and sustainable development, is based on the narrowing of the content of contracts to three domains: competitiveness and attractiveness of territories; promoting sustainable development; and ensuring social and economic territorial cohesion. Several policy areas are specified under each of these three topics which can clearly reduce the scope of the previous fields of contractualised projects. However, the way these domains are presented is very general, and can include many areas, topics, and activities. While an advantage is that it can clearly lead to a great variety of regional adaptation, there is a risk that the scope of contracts will remain similar to that of the preceding generations.

Complexity is even more important in the territorial part of the CPER which will remain partly associated to the future contracts but also funded by other ministerial means. In effect, CPs, CAs and CPNRs are about the development of a given geographical areas and most of the time the projects that are designed are complex; they refer to objectives such as, the development of cultural activities or the development of tourism and tourism infrastructures.

The differing degrees of complexity associated with "hard" and "soft" issues are dealt with in the wording of contract objectives. Since CPERs address both types of tasks, the objectives actually set in the contracts and agreed upon by the parties have to be separated in two different subsets – a separation that has not changed over the years. On the one hand, there are domains in which the objectives are transformed into simple, observable and measurable tasks to be completed or targets to be achieved. These domains correspond to "hard" or "tangible" tasks, such as development of transportation infrastructure. It is worth mentioning that the last stage of decentralisation which assigns the responsibility of roads to the *départements*, will lead to the cancellation of projects attached to these competences in negotiated contracts between levels of government. On the other hand, objectives for the "soft" matters (employment, economy, social policy, culture, tourism, agriculture, etc.) are set out in vague terms and the realisation of the objectives is associated with complex tasks. For instance, the *contrat d'agglomération* or *contrat de ville* included in the CPER signed between the central government and the region Provence-Alpes Côte d'Azur (PACA) includes a particularly complex objective: "to guarantee the access of each individual to legal services". This objective is then associated with similarly complex and vague tasks: "to increase and improve the help towards the family of delinquents". In the contract, no detail is provided regarding the nature the assistance must take. Similarly, one objective of the social component of the CPER of PACA is to make "retirement houses more humane" and the task to reach this goal is "to increase the number of available beds for elderly people". Once again, the objectives, although more precise, remains complex (what does "humane" concretely mean?) and the task, even if clearer, remains somewhat vague as well (where are the beds located? which institution is supposed to finance them?).

3.2.4. *Linked national and regional objectives*

To deal with the complexity of decentralisation and the existence of inter-dependencies between regions, contracts include a mechanism that constrains the way national and regional objectives are chosen, included in the contracts, and how they relate to each other.

First, the existence of "national objectives" in the contracts guarantees that each region follows similar objectives. Frequently, the central government imposes national objectives on the regions, the departments, cities and agglomerations, and the *parc naturels régionaux* or *pays*. One typical illustration of this behaviour is the inclusion of the funding of the high speed train line in different CPERs although the purpose was only to build a national line and no specifically local infrastructure (a station, for instance) had to be built.

Second, the central government does not only impose national objectives to the regions but also controls regional objectives. In effect, the central government delineates the domain into which regional objectives have to fall. The different projects that the regions propose and that the central government accepts to co-finance will take place within the limits thus set by the inter-ministerial committee for regional planning and competitiveness (*Comité interministériel d'aménagement et de compétitivité des territoires*, CIACT [ex-CIADT]). The CIACT is a committee in which representatives of each ministry gather to propose a number of projects that are considered, from the perspective of each ministry, as crucial to regional development. These committees are placed under the authority of the prime minister and organised by an inter-ministerial body, the DIACT (*Délégation interministérielle à l'aménagement et la compétitivité des territoires*, ex-DATAR). These are quite fuzzy limits but these objectives nonetheless correspond to a national strategy, defined at the central level and that delineates the scope of the bargaining process.

Third, *contrats de pays*, *contrats d'agglomération*, or *contrats de parc naturel* regional leave more room for manoeuvre to the sub-national levels of government because, as mentioned previously, these contracts define the projects that the sub-national agents have worked out. However, these projects must still be accepted by the central government. Therefore, they can hardly be at odds with the national strategy defined by the central government.

3.3. Assessment and evaluation of the contractual practices

3.3.1. Assessment and evaluation of the contractual practices with regard to the theory

3.3.1.1. The pre-contractual stage. The pre-contractual stage can be viewed as a relevant answer to the necessity for the parties to improve their level of information. The stage corresponds to a device that increases information and also allows a selection of the best regional projects. One theoretical justification for the pre-contractual stage is what economists call "competition for the field" in which parties compete to acquire the right to produce a good. Alternatively, another theoretical justification for the pre-contractual stage is that it supports communication; in other words, communication among parties replaces competition as a means of selection of the regional projects (this is typically what takes place in *contrats de pays* and *contrats d'agglomération*). Where the precise objectives to be included in the contract are not known *ex ante*, contracts can be viewed as means to identify problems and policy objectives and to propose solutions and means to reach the objectives set out the contracts.

Learning and knowledge acquisition are not restricted to the pre-contractual stage. Even if objectives assigned and tasks delegated to the regions are identified and known before the beginning of the contract, the fact that contracts can be revised and that termination is also envisaged in each CPER means that there is room for improvements and that objectives can change. This is important because it corresponds to what theory tells us: when contracts are about complex and general matters, the contract should be open-ended.

Of course, the pre-contractual stage is not without drawbacks and flaws. First, there are important costs that can arise in the pre-contractual stage. For example, organising and conducting studies, particularly forecasting long-term studies, can be costly. Furthermore, transaction costs also impair the procedure but, not only are they difficult to measure and evaluate, they are also unavoidable.

3.3.1.2. Complexity of delegation. In the first chapter of this report, it is argued that too much complexity means that it is impossible to commit *ex ante* to verifiable and measurable objectives. As a consequence, the discretionary powers of the parties increase. In the case of CPERs, general, vague and complex objectives are transformed into simple and manageable ones for certain topics by restricting the domain of the possible strategic behaviours of the other party by delineating the domain within which the contract will take place and will thus be evaluated. The restriction of the domain of behaviour of the other party consists in establishing the respective responsibilities of the parties in order to avoid (or to limit) *ex post* opportunism. This results in a situation in which *ex ante* complex delegation is turned into *ex ante* simple delegation.

3.3.1.3. National and sub-national objectives. First, CPERs are tools to harmonise the regional objectives with those of the central government. Thus, the French central government uses CPERs to ensure that regions do not promote objectives that would be too diverse, therefore too costly, and even maybe impossible, to unite *ex post* under a single general framework. The central government clearly envisages CPERs as a tool for coherent regional policy at the national level. While the national planning system has been modified over the years, the link between contracts, planning and national objectives has been repeated by Jacques Chérèque, Former Minister for Territorial Development, in his report (written to propose a way to reform CPERs).[2] This can also be observed in practice; for instance, the CIACT always plays an important role in setting the national framework within which the regional contracts are supposed to be established.

Second, as a corollary, CPERs tend to reinforce the inter-dependencies they are meant to address. For instance, sustainable development has been indicated as a necessary, undisputable element of regional policies for the current generation of CPERs (2000-2006). Obviously, sustainable development – a general and vague goal – cannot be achieved by one region alone or in competition with others. This means that the objectives of the 26 regions must contribute to the same general purpose.

Third, the central government uses the contracts to finance the local dimensions of national projects. Specifically, the funding of certain tasks and objectives that could no longer be financed by the central government was transferred to the regions through the CPERs. This use of sub-national resources to finance national objectives has been criticised for being a strategic behaviour on the part of the central government. However, from the perspective of contract theory, the behaviour of the central government can also be interpreted as the behaviour of a principal who delegates certain tasks to the regions but retains formal authority through the definition of the objectives and tasks to be realised.

3.3.2. Assessment and evaluation of the contractual practices by the central government and the regions

3.3.2.1. Is external control possible? First, external control is rarely put into practice in the case of the non-execution of the objectives settled by the contracts. Usually, these are not the contracting parties who refer to the administrative tribunals to solve problems. The primary reason why external control is not effective is that CPERs are not genuine contracts – in a judicial meaning of the word – and therefore are not legally enforceable. CPERs only are mutual agreements made by the central government and the regions regarding actions that could be undertaken and expenses that could be made. More broadly, the absence of a genuine and effective external control is difficult to impose because CPERs are relational contracts.

3.3.2.2. Is there an internal "control"? Similarly, there is no genuine internal control – that is exerted by the parties – of the contract. The only contractual provision that allows the region to control the behaviour of the central government are the termination clauses which are "exit" clauses that allow each party, the region as well as the central government, to end the contract. This is not particularly surprising: in a unitary state, even a decentralised one, the central government acts as the agent of the citizens. Thus, only the central government has the right and means to retaliate against possible strategic behaviours of the regions. As a corollary, there is no guarantee that the central government will respect its promises. The frequent failures of the central government to satisfy its engagements are a matter of

great concern among the regions. This obviously results from the fact that the commitments are not credible because CPERs are not contracts and that commitments are "only" promises. Another view is that the lack of mechanisms of internal control indicates that reciprocal control is not a genuine problem. What is at stake is not the control of what the agents (namely, regions) have to execute on behalf of their principals (the central government) but rather the respective contributions of the parties to the common objectives of the contracts. Rather than a logic of control, CPERs follow a logic of mutual assessment that guarantees a sort of on-going learning process.

3.3.2.3. The evaluation of the CPERs. In 1993, CPERs had to be evaluated by the regional prefect. The evaluation was repeated in 1998 and in 2000. Evaluation takes place at two levels. At the national level, evaluation is led by the DIACT (ex-DATAR) (in charge of the evaluation since 1 January 2005). At the regional level, evaluation is driven by an *ad hoc* committee, made of representatives of the central government and of the regions. Furthermore, and most importantly, there is no unique framework that indicates how the contractual procedures have to be evaluated. As a result, it appears that evaluation does not result from a standardised and centralised procedure; rather, evaluation is decentralised.

Because there is no framework that indicates how the contractual procedures have to be evaluated, evaluations were particularly numerous: 150 for the second generation and 160 during 2002 and 2005. However, the domains that evaluated were rather homogenous. The 2005 DIACT report indicates that 16 domains were evaluated. Only one domain (the territorial component of CPERs) was evaluated more than 20 times (21 reports in 13 regions). Of the 15 remaining domains 70 reports focus on only six domains. Thus, 91 out of 160 reports were made in seven domains (tourism, methodology, employment, environment and sustainable development, cities, economic development and territorial policies). Interestingly, evaluations are not frequently made in domains in which it would have been easy to measure the gap between the objectives to be reached and the objectives actually reached. Tellingly, "infrastructures and transports" is the least frequently evaluated domain.

This is significant and surprising given that fact that the objectives that regions and the central government agree to finance are transformed into measurable, verifiable and quantifiable targets. In other words, although in most ways the CPERs are relational and partnership contracts, they could be (at least partially) monitored as complete and transactional contracts, and their execution controlled. This paradox can quite easily be explained: the evaluations made by the regions focus on the domains in which their room for manoeuvre is the most important, in which collaboration between the regions

and the representatives of the central government is the most important, and as it turns out the domains in which evaluation is the most difficult to realise. Thus it seems that regions tend to adopt a particularly non-opportunistic behaviour regarding the selection of performance indicators. At the regional level, evaluation is used as a tool for learning what are the good practices and what are the ones to be avoided. The problem is that this information is not diffused and thus it does not lead to improved knowledge of the state or of other regions for deciding relevant policies.

Table 2.2. **Engagements of the central government and the regions as of 2004 (% of total 2000-2006 amount)**

	Central government	Regions	Difference
Alsace	55.91	61.0	5.1
Aquitaine	56.82	67.0	10.2
Auvergne	54.73	92.8	38.1
Bourgogne	57.98	66.2	8.22
Bretagne	55.44	n.d.	–
Centre	49.05	46.6	–2.45
Champagne-Ardenne	54.65	70.8	6.15
Corse	47.51	–	–
Franche-Comté	56.17	–	–
Île-de-France	57.13	68.0	10.9
Languedoc-Roussillon	55.25	–	–
Limousin	48.65	65.2	16.5
Lorraine	61.68	–	–
Midi-Pyrénées	55.35	66.1	10.7
Nord-Pas-de-Calais	53.96	62.0	8
Basse-Normandie	53.74	56.2	2.5
Haute-Normandie	54.12	58.8	4.7
Pays-de-la-Loire	52.89	n.d.	–
Picardie	51.80	–	–
Poitou-Charentes	54.25	68.9	14.6
Provence-Alpes-Côte d'Azur	54.02	65.1	11.1
Rhône-Alpes	55.82	74.1	18.3
Guadeloupe	46.00	n.d.	–
Guyane	50.11	–	–
Martinique	45.44	61.0	15.6
La Réunion	43.75	–	–

1. Regional data are transmitted by the regions to the DIACT. 2) Per cent of the engagements with regard to the total 2000-2006 amount.

Source: DIACT (ex-DATAR).

3.3.3. *Execution of the contracts*

The percentage of resources contributed by the central government in the execution of the CPERs is not always satisfactory. In particular, differences exist across ministries and regions. In some areas contributions are high: national education (63.71%), cities (68.31%), agriculture (59.18%), and external commerce (69.65%). Others areas contributions are much lower: health (35.97%), commerce and crafts (40.51%), equipment and infrastructure (roads 50.34%; trains 33.35%; collective transportation in Ile-de-France 38.7%).[3] Moreover, four years into the contract, the central government has not always paid the two-thirds of its obligation. By contrast, it appears that regions have generally committed nearly two-thirds of their obligation (Table 2.2).

4. Conclusion

Contracts in France can be considered as long-term collective decision making mechanisms. Specifically, contracts are frameworks that delineate the domain and the conditions within which the state-regions partnership takes place. The different participants to these contracts, representatives of the regions and of the central government, frequently insist on this point. To be more precise, contracts are a bargaining procedure for the selection of objectives to be achieved and the tasks to be realised. These objectives and tasks cover a wide range of topics. This is one of the most important features of the way contracts are used in France. In fact, contracts touch on all dimensions of regional policy. Accordingly, contracts deal with both simple and complex tasks. Some of these tasks are described as relatively simple targets or objectives. Others may be defined in a vague manner. Simple targets or objectives may be problematic if only one device is used to reach diverse goals. It could be useful to reduce the number of tasks or to diminish the scope of contracts. However, the recent reform is not oriented in this way: the objectives that have to be pursued by the contracts must still fall into a set of broadly defined areas.

The fact that contract objectives must fall into a set of broadly defined areas is not without advantages. In particular more freedom is given to the regions to define their own objectives. Certainly, for a long time, CPERs were viewed as means to allow the government to gain information on how the infra-national institutional levels envisage their own development (regional or sub-national objectives and competences) and to encourage sub-national governments to do their best to finance objectives that are decided by the central government. Over time, this top-down conception has seemingly evolved into a more ascending view of contracts based on projects designed by the regions themselves, thus increasing the role and importance of regions.

Notes

1. This chapter draws on the contribution of Alain Marciano, EconomiX, Université de Reims.
2. In May 1998, Jacques Chérèque issued his report on the 2000-2006 generation of CPERs. The report is entitled: "More Regions, Better State" ("Plus de régions et mieux d'État").
3. These figures correspond to the % of resources paid by the central government at the end of 2004 (Source: DIACT).

Bibliography

André, P. (2000), *Rapport d'information fait au nom de la délégation du Sénat pour la planification sur les troisièmes contrats de plan Etat-Régions (1994-1999)*.

DATAR (Délégation à l'aménagement du territoire et à l'action régionale) (2005a), *Bilan prospectif des évaluations des contrats de plan État-Région (CPER) (2002-2005)*.

DATAR (Délégation à l'aménagement du territoire et à l'action régionale) (2005b), "Rapport d'activité, 2004", pp. 14, 15, *www.diact.gouv.fr/datar_site/datar_framedef.nsf/webmaster/bib_framedef_vf?OpenDocument*

DIACT (Délégation interministérielle à l'aménagement et la compétitivité des territoires) (2006), Dossier de presse, Comité interministériel d'aménagement et de compétitivité des territoires, 6 March 2006, *www.diact.gouv.fr/datar_site/datar_framedef.nsf/webmaster/ciadt_framedef_vf?OpenDocument*.

OECD (2006), *OECD Territorial Reviews: France*, OECD Publications, Paris.

ISBN 978-92-64-00873-1
Linking Regions and Central Governments
Contracts for Regional Development

Chapter 3

The Case of Italy[1]

This chapter examines the use of Accordo di Programma Quadro *(APQ), a multi-faceted instrument for regional policy in Italy. After providing an overview of the decentralisation context in Italy, the chapter describes the policies, institutions, and instruments associated with regional development policy. It offers a detailed summary of the APQ and the co-ordination context in which it operates, followed by an assessment of this mechanism using the analytic framework provided in Chapter 1. The chapter concludes with a series of policy recommendations for enhancing the APQ.*

1. Introduction

This paper analyses one instrument of multi-level governance employed in the context of Italian regional development using the economic theory of contracts and, in particular, the analytical framework proposed in this volume. The contractual tool that constitutes the object of this case study – the *Accordo di Programma Quadro* (Framework Programme Agreement, APQ) – can be considered one of the most relevant instruments through which the state and regions interact in the context of Italian regional development policies.[2] The distinctive element of the APQ is that it is a complex, multi-purpose instrument targeted at a single development goal. It is meant to achieve simplification and greater co-ordination in a policy context that has traditionally been highly fragmented and bureaucratically cumbersome. In order to provide a context for understanding the APQ, the paper begins by providing a general overview of Italian decentralisation and regional development policies, with a view at placing the APQ in a broader policy framework. It then proceeds, in Section 4 to introduced and analyse the APQ using the framework proposed in this volume. Finally, after providing policy recommendations regarding the APQ, the paper concludes with a summary of the analysis presented in this case study.

2. An overview of Italian decentralisation policy

2.1. Levels of government

2.1.1. Structure

The structure of the Italian sub-national government is laid out in Title V of the Italian Constitution. According to Article 114, "The Republic is composed of the Municipalities, the Provinces, the Metropolitan Cities, the Regions and the State." While modifications to the structure of sub-national government require lengthy procedures to amend the constitution, in fact, the current formulation of Article 114 is the outcome of such constitutional modifications introduced in 2001. Until 2001, the system of sub-national government was three-tiered: Regions, Provinces and Municipalities. Thus, while these three layers of territorial government have been in place for a while, the structure of metropolitan cities is still in the process of being implemented.

Italy is divided into 8 104 municipalities, 103 provinces and 20 regions. The latter, in turn, can be divided into 15 "ordinary" regions and five "special

statute" regions; *i.e.*, regions traditionally enjoying wider legislative and administrative powers. One special statute region, Trentino-Alto Adige, is further divided into the two Autonomous Provinces (AP) of Trento and Bolzano that are in many ways akin to regions.

2.1.2. Functions and powers

The legitimacy of the various sub-national levels of government rests on the provisions contained in Title V of the Italian Constitution. Article 114 states: "[M]unicipalities, Provinces, Metropolitan Cities, and Regions are autonomous entities having their own statutes, powers and functions in accordance with the principles laid down in the Constitution." Italy has long been a rather centralised state. As a result, the path to instituting the regional layer of government has been long and convoluted. The process started in 1948 with the introduction of constitutional provisions which aimed to introduce a mild form of devolution. However, important steps towards decentralisation were made during the 1990s, including:

- Reform of public administration which transferred powers from the center to the periphery and simplified procedures;
- Fiscal reform aimed at conferring financial autonomy to regions and AP through participation in national tax revenues, the possibility to impose an additional rate on top of the national rate in some cases, and the imposition of their own taxes;
- Budget reform aimed at simplifying and at making clearer the territorial distribution of funding and expenses; and
- Reforms which enhanced the powers of town mayors and province presidents with respect to local development and introduced a system of direct election for those offices.

The decentralisation process set in motion during the 1990s culminated in the 2001 constitutional reform that considerably augmented the powers attributed to the regions, rendering the structure of the Italian Republic more similar to that of a federal state. Most importantly, the powers of the central state are expressly indicated; powers not expressly reserved for the central government by the constitution are now attributed to regions – a notable departure from the past. Moreover, according to the reformed constitution, regional laws are no longer subject to *ex-ante* central state control. Nevertheless, important differences persist. The first difference concerns the matters over which regions can legislate. Indeed, the greatest part of ordinary legislation is reserved to the central state, including civil laws, criminal laws and procedural laws. The second important difference concerns the fact that the regional layer of government does not enjoy a privileged position in terms of normative powers with respect to the statutes defining the principles of

organisation and functioning of territorial authorities *vis-à-vis* the lower levels of government (provinces, municipalities and metropolitan areas).

Legislative powers are distributed between the national and regional layers of government according to a three-fold categorisation that distinguishes matters on which only the state is entitled to legislate, matters on which the state and the regions enjoy concurring legislative powers, and matters on which only regions may legislate (It. Const., Article 117; see Table 3.1).[3] The distribution of regulatory powers is coherent with the distribution of legislative powers; *i.e.*, regulatory powers are vested in the state "with respect to the subject matters of exclusive legislation, subject to any delegations of such powers to the Regions" and they are "vested in the Regions in all other subject matters". Moreover, as mentioned above, "Municipalities, Provinces and Metropolitan Cities have regulatory powers as to the organisation and implementation of the functions attributed to them." (It. Const., Article 117). As for administrative functions, these are attributed according to the principles of subsidiary, differentiation and proportionality; *i.e.*, they tend to be attributed to municipalities unless their uniform implementation requires attribution to a higher level of sub-national government.

It is important to stress that the current distribution of legislative functions between the state and the regions has posed many problems of interpretation which have been brought to the attention of the Constitutional Court and are problematic in many ways. On one hand, some uncertainties and inconsistencies exist regarding the allocation of competencies across layers of government. Some competences for which having 20 different regional laws would seem impractical have been allocated to the concurring competence at the state level (transport and navigation networks; energy, foreign trade, R&D, etc.). Other competences, arguably calling for a national framework, have been attributed to the exclusive competence of the regions (*e.g.*, local development in the industrial, commerce, handicraft and tourist sectors). Moreover, in some instances, the functional repartition of competences is somewhat odd. This is true particularly of the attribution to the exclusive competence of the state the *protection* of cultural and environmental assets, to the concurring competence the *enhancement* of cultural and environmental assets, and to the exclusive competence of the regions the management of museums and libraries. On the other hand, the central state enjoys legislative powers in matters that have a highly "transversal" nature (*e.g.*, competition policy, environment, equalisation of financial resources) and may exercise substitutive powers with respect to regions and local bodies. Most importantly, the new distribution of functions and powers makes it crucial to define the distribution of financial resources across the different layers of government, which has not yet been established

Table 3.1. **Most relevant distribution of legislative competencies between the state and the regions**

State	Regions
S.1) Exclusive legislative and executive competencies on:	R.1) Exclusive legislative and executive competencies on:
Foreign Policy Immigration Religion Defence and armed forces Competition policy Money and savings Central administration Public order and security Justice Jurisdiction and procedural law; civil and criminal law; administrative judicial system Fixation of the minimal levels of service inherent to social and civil rights to be guaranteed on the national territory Equalization of financial resources General provisions on education Social security Customs Electoral legislation, governing bodies and fundamental functions of the municipalities, provinces and metropolitan cities Protection of the environment, the ecosystem and cultural heritage	Local development (industry, commerce, handcraft, tourism) Agriculture Mining Labour policies Water resources Hunting Housing and city planning Harbours and airports Regional networks of transport Public transport Vocational training Regional administration Regional public order and safety Social services
S.2) Power to set the basic legislation on:	R.2) Competencies subject to basic State legislation:
International and EU relations of the regions Foreign trade Safeguard and work security Education, subject to the autonomy of educational institutions and with the exception of vocational education and training Research and development (R&D) Health protection Civil protection Territory government Ports and airports Transport networks Infrastructures Harmonisation of public accounts and co-ordination of public finance and the taxation system Energy Social security Enhancement of cultural and environmental assets Local credit institutions	All the subjects indicated under S2

to a satisfactory degree. Finally, the current institutional framework of decentralisation is likely to undergo additional modifications in the near future.

2.1.3. *Financial aspects*

The recent evolution of the institutional framework of decentralisation creates a need for a parallel evolution of the institutions of fiscal federalism. Indeed, the shift of functions from the central to sub-national layers of government being implemented according to the reformed constitution calls for a clarification regarding repartition of the sources of funding across layers of government that could ensure the effective performance of functions recently attributed to regions and to local authorities. While specific provisions in this regard are included in the text of the reformed Italian Constitution, operational clarity remains lacking.

The text of the constitution explicitly states that municipalities, provinces, metropolitan cities and regions enjoy revenue and expenditure autonomy (It. Const., Article 119). All layers of sub-national government might thus set and levy taxes and collect revenues of their own, as well as share in the tax revenues of their respective territories. This stands in contrast to the pre-2001 constitution that allowed financial autonomy of sub-national layers of government only within the limits set by a national law. However, there is a distinction in this regard between regions and other local authorities. Regions can levy taxes through their own legislative powers "in compliance with the Constitution and according to the principles of co-ordination of State finances and the tax system" (It. Const., Article 119). By contrast, in line with the Constitution, other local authorities can levy taxes only within the framework of a national or regional law.

In addition to local taxes and to the sharing in national tax revenues, sub-national layers of government might have access to two further sources of revenue: an equalisation fund with no allocation constraints (It. Const., Article 119, paragraph 3) and "additional resources" and "special interventions" (It. Const., Article 119, paragraph 5). The equalisation fund is designed to finance ordinary activities in areas with lower per capita taxable capacity so as to ensure homogeneous levels of service across territories. The second form of financing is aimed at promoting economic development and other social cohesion objectives so as to address structural imbalances across territories. It constitutes the only form of financial transfer with allocation constraints allowed after the 2001 constitutional reform.[4]

2.2. *Regional development policies*

2.2.1. *Overview*

Italian regional development policies have undergone a process of substantial change over time. Between 1950 and 1992, the primary objective of Italian regional development policies was the reduction of the long-standing disparities between the northern and the southern regions (*Mezzogiorno*)

Table 3.2. **Total expenditure (current and capital) distribution by sector and government level, 2003 (in EUR millions)**

	Central administrations	Regional administrations	Local administrations	Authorities of the enlarged public sector	Total
General administration	54 163.80	6 942.60	25 151.60	39.30	86 297.22
Defence	16 141.18	0.54	0.00	0.00	16 141.72
Public order and safety	14 177.12	30.61	2 524.12	0.00	16 731.85
Justice	6 643.66	0.31	445.36	0.00	7 089.33
Education	42 884.24	1 308.67	17 027.95	25.62	61 246.48
Training	422.06	1 406.64	674.76	89.21	2 592.68
Research and development	2 581.82	14.46	418.42	180.48	3 195.18
Culture	8 067.44	1 033.97	4 162.79	263.95	13 528.14
Housing	697.58	882.99	3 562.93	2 821.67	7 965.17
Health	1 131.75	85 604.40	87.10	620.87	87 444.13
Social services	22 150.67	917.91	6 427.97	304.84	29 801.39
Water cycle	209.73	445.46	259.57	2 916.51	3 831.27
Drainage and depuration	39.26	31.93	2 656.66	548.44	3 276.30
Environment	941.73	753.65	4 029.47	2 139.98	7 864.82
Waste disposal	11.96	5.72	5 598.68	1 905.81	7 522.16
Other health interventions	0.00	67.93	1 021.78	76.31	1 166.01
Employment	0.00	683.94	53.67	62.59	800.20
Social Security	251 186.89	26.46	0.00	0.00	251 213.35
Roads	2 367.19	397.43	8 122.41	1 091.73	11 978.75
Other transportation	8 810.75	2 083.93	3 637.89	27 851.49	42 384.07
Telecommunications	1 834.27	0.13	19.24	12 166.50	14 020.14
Agriculture	1 221.95	1 925.83	887.27	1 391.22	5 426.26
Fishing	0.00	13.42	2.15	0.47	16.04
Tourism	34.36	594.73	841.98	178.98	1 650.05
Commerce	81.12	202.86	997.50	417.73	1 699.21
Industry	6 783.74	1 463.30	1 336.27	32 171.41	41 754.73
Energy	19.49	101.58	0.00	72 893.20	73 014.27
Other public works	0.00	1 434.42	0.00	47.64	1 482.07
Other economic affairs	17 998.85	348.50	1 580.78	16 526.25	36 454.37
Other functions	36 133.32	4 736.32	0.00	80.09	40 949.73
TOTAL	496 735.94	113 460.60	91 528.33	176 812.24	878 537.10

Note: The data in the database Conti Pubblici Territoriali (CPT) are cash data and capture not only the Public Administration but also the firms and authorities that belong to the Enlarged Public Sector, namely Ferrovie dello Stato, ENEL, Poste Italiane, ENI, IRI, ETI, Monopoli di Stato and ENAV (since 2001).
Source: Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) (2005a), "Conti Pubblici Territoriali".

through interventions mostly aimed at industrialising the south (in popular parlance, the *Intervento Straordinario*). Many of these interventions were devised by a central entity, the *Cassa per il Mezzogiorno*. As of 1992 a process of radical change in Italian regional policies has been in progress, partly

reflecting the influence of EU economic and social cohesion policies. This process has resulted in:

- an extension of the targeted areas to less developed areas of the centre-north;
- a shift of responsibility from the *Cassa per il Mezzogiorno* (abolished in 1984) to a multiplicity of institutions, including central ministries and territorial authorities (regions, provinces and municipalities), often operating in a system of multi-level governance;
- an attempt to increase targeting, co-ordination, monitoring of territorial needs; and
- a shift from top-town policies to contractual and concerted forms of planning.

At present, the implementation of national territorial development policies rests on a two-tiered system that emphasises *regional policy* and *ordinary policy*. Regional policy is specifically aimed at addressing structural socio-economic imbalances across territories and is financed through additional resources that originate both from the EU budget (structural funds) and from the national budget (the fund of national co-financing to the structural funds and the fund for underdeveloped areas – *Fondo Aree Sottoutilizzate*, FAS). Ordinary policy draws on ordinary financial resources coming from the state budget and addresses broader development objectives that are not related to specific territories. Both policies are implemented at various levels by the central government, by the regions, and by the local authorities.

2.2.2. Institutions

The Italian framework of regional development policies encompasses, in addition to the sub-national layers of government, the following relevant institutions (since mid-2006):

- Ministry of Economic Development (which has recently assumed a previous competence of the Ministry of Economy and Finance) is responsible for:
  - ❖ Planning, co-ordinating and monitoring of EU cohesion policies and for the implementation of interventions for territorial development. Territorial development policies are based on a negotiated programming approach with regions and other competent central ministers. These functions are exercised by the *Dipartimento per le Politiche di Sviluppo* (Department for development policies, DPS) that, in turn, includes an institution devoted to the monitoring of state-financed investments called the *Nucleo tecnico di valutazione e verifica degli investimenti pubblici* (Technical Unit of evaluation and control of public investments).

- ❖ Developing the productive system and granting direct financial incentives to firms.

- *Comitato Interministeriale Programmazione Economica* (Inter-ministerial Committee on Economic Planning, CIPE) co-ordinates and directs economic planning by providing a space for the co-ordination of a number of economic and financial activities not only among relevant ministries but also among the other stakeholders involved. Within the CIPE operates the *Unità Tecnica finanza di progetto* (Technical Unit of Project Finance, Ufp), aimed at increasing the participation of private funds in the building and management of infrastructure and the system of *Monitoraggio degli investimenti pubblici* (System of Monitoring of State-financed Investments, Mip).
- The national agency *Sviluppo Italia* is responsible for a variety of functions, including supporting activities of central and local administrations, promoting innovative activities, and managing national and EU funds.

2.2.3. Instruments

The tools of Italian regional development policy have a rather marked contractual and concerted nature. The emphasis placed on participatory forms of territorial development planning and on the recourse to contractual forms of multi-level governance can be considered the outcome of at least three factors: 1) the influence of foreign experiences; 2) a country-specific need for procedural and decision-making simplification; and 3) a strong influence of EU territorial development policies. Indeed, the shift towards instruments of a predominantly contractual nature is part of a process that dates back to the mid-1980s and is partially modeled on foreign experiences (in particular, the British culture of public-private partnership and the French State-Regions Planning Contract of the early 1980s). This influence, combined with the need for simplification, were the basis of the first experiences with "contractualisation" of public policies, notably the *accordi di programma* (program agreement – likely modeled on the French *contrats de plan*) and the *conferenza dei servizi* (service conference). These contractual tools were aimed primarily at overcoming bureaucratic inertia and veto powers and thus speeding up the decision process. The use of contractual instruments as a strategy of co-ordination of development policies that involve multiple public and private actors, complex decision making, and the unified management of financial resources, dates back to the mid-1990s. It is generally referred to as "negotiated programming" (law No. 662/1996).

The choice of the tools of development policy was also influenced by EU policies, not least because they have helped to render politically acceptable deep policy changes. Indeed, the national funds devoted to economic and social cohesion are currently allocated using objectives and rules analogous to

those employed for EU structural funds. In particular, the "national additional resources" for regional development policies (see above, Section 2.1.3), attributed to the Ministry of Economy and Finance and to the Ministry of Productive Activities were unified in 2003. They are two related funds, managed by the CIPE as a joint fund used to address the needs of less developed areas, called the *Fondo per le Aree Sottoutilizzate* (Fund for Underdeveloped Areas, FAS). The resources were unified in order to ensure predictability regarding the amount of resources devoted to development and to facilitate their management according to criteria akin to those adopted for EU funds. Specifically, the rules for using FAS resources include:

- monitoring provisions to ensure respect of expenditure commitments and flexibility in the allocation of funds;
- *ex ante* evaluation of the effectiveness of public investments in achieving their stated socio-economic objectives;[5]
- a system of bonuses to speed up expenditures and to promote the co-operation of the various actors involved;
- a principle of co-operation among the various levels of government according to which the central government is responsible for elaborating the general strategy of development, regional governments decide on the territorial allocation of resources, and local governments elaborate the concrete design of projects and stipulate alliances with the relevant local actors.

The primary instruments through which the above criteria find concrete application are the *Intese Istituzionali di Programma* and the *Accordi di Programma Quadro*. Both have a rather marked contractual nature, represent a type of "negotiated programming," and constitute instruments of multi-level governance. *Intese Istituzionali di Programma* represents a preliminary and strategically-oriented act, while *Accordi di Programma Quadro* is its implementation tool. Other instruments of "negotiated programming" are the *Patti Territoriali* (Territorial Pacts), the *Contratti di Programma* (Programme Contracts) and the *Contratti d'Area* (Area Contracts). In contrast to the first two instruments, the latter may (and do) involve private parties. All of the instruments of "negotiated programming" are regulated by the CIPE, which is also responsible for approving each contract. It is worth mentioning other cases, for which policy aims at explicit targets in terms of institution building, which led to a "hard use" of indicators by conditioning financial sanctions and rewards on the attainment of quantified targets. However, from the beginning of the process, indicators were not completely known. In this circumstance, the contracts played the role of "knowledge revealing mechanisms", based on partnership and interim monitoring (from a less complete to a more complete

type). The interim monitoring was entrusted to a technical group made up of two members of the Central Evaluation Unit and two members appointed by Regions participating in the incentive scheme (Barca, *et al.*, 2004).

2.2.4. Recent developments and trends

Since February 2005, all layers of sub-national government have been involved in the definition of the Strategic National Framework 2007-2013 (*Quadro Strategico Nazionale*) that Italy is required to submit to the EU Commission in order to direct the resources that the EU cohesion policy will make available. Defining the document is meant to be highly collaborative across levels of government and to involve additional stakeholders. For the purposes of this study, at least three aspects of this process are relevant. The first is the goal set for the planning of territorial policies, namely that they unify the process of planning of development policies at the EU level (financed through EU funds and co-financing), national level (financed through the FAS), and the regional level and that this process is co-ordinated with the national planning of ordinary resources. The second important aspect of the Framework planning process is the preference accorded to planning instruments with a contractual nature. The third important aspect is the choice to enhance the role of the *Accordi di Programma Quadro*, while improving their governance.

3. The *Accordi di Programma Quadro*

3.1. *Brief description*

The *Accordi di Programma Quadro* (APQ) constitute one of the most relevant contractual instruments through which territorial development policies are practically implemented. As mentioned, the APQ operationalise the *Intesa Istituzionale di Programma* (IIP), a broad agreement reached by the central government and the regions or Autonomous Provinces on the definition of the objectives, the sectors, and the areas where the (material and immaterial) infrastructure essential to territorial development should be built. The APQ is signed by the interested region, by the Ministry of Economics and Finance, and by one or more central administrations, depending on the nature and the sector of intervention. In cases where negotiations preceding the signing of the IIP are sufficiently mature, the IIP and the APQ might be signed simultaneously.

The APQ's primary purpose is to co-ordinate the actions of the many public and private agents (vertically or functionally specialised) that are involved in the definition of territorial development policies in order to achieve greater coherence, quality and speed of intervention. Co-ordination is sought through an ex-ante process of negotiation of the objectives and the

instruments of multi-year territorial policies, as well as of the definition of reciprocal commitments and of a clear schedule. The co-ordination objective is reflected also in the duration of most APQ that stipulate commitments by their subscribers over a multi-year period. Indeed, many of the APQ signed thus far envisage commitments through 2015. Each APQ specifies:

- actions to be taken, their schedule, and the form that they should take;
- agents responsible for the implementation of each action;
- financial coverage and the sources of financing;
- monitoring and verification procedures and the agents responsible for them;
- commitments of each contractual partner and the distribution of substitutive powers in case of delay or lack of respect of contractual provisions; and
- conciliation or conflict resolution procedures.

Previous to 2006, any decision concerning the APQ needed to be taken by the *Comitato Istituzionale di Gestione* (Institutional Management Committee), composed by representatives of the Government and of the *Giunta* of the region (the executive organ) or of the Autonomous Province that collaborated with the *Comitato Paritetico di Attuazione* (Egalitarian Implementation Committee), composed of representatives of the central and local administrations involved in the implementation of the IIP. Following reform in 2005, each IIP and APQ includes a *Comitato Intesa Paritetico* (Egalitarian Committee of the Agreement), composed of political representatives or high-level administrative representatives and a *Tavolo dei Sottoscrittori* (Table of the Signatories), composed of the signatories of the APQ or their delegates. These two organs each have different responsibilities.

Since the 2005 reform, the APQ is composed of two sections: an implementation section (*sezione attuativa*) and a programming section (*sezione programmatica*). The first section includes the interventions for which financial coverage is already available and which are to be activated immediately after signing the APQ. The second section includes interventions which meet the general objectives of the APQ, but for which the required technical and/or financial conditions are not completely satisfied. This two-fold organisation of the APQ is meant to speed up the programming process and to enhance co-ordination of interventions over time. Consensus on the interventions in the programming section is achieved at the signing of the APQ so that their implementation can take place with no further negotiation. The region proposes their implementation to the "Table of the Signatories" and the Ministry of Economics and Finance then gathers the approval of the

signatories within 15 days. The APQ are utilised in all the major sectors of interventions, namely:

- natural resources: improvement and promotion of environmental and natural heritage through initiatives targeting water resources, garbage, energy, contaminated sites and natural resources;
- cultural resources: improvement and promotion of cultural and historical heritage;
- human resources: support of employment, education, training and R&D;
- local systems of development: promotion of complex initiatives such as the improvement of the industrial environment, support to districts and export systems, improvement of enterprises' product and processes, and technological innovation;
- cities: improvement of cities and social services within cities, support to communities and local institutions;
- networks and service junctions: enhancement of transport, telecommunications, innovation and security.

The greatest proportion of APQ signed as of December 2004, both in terms of numbers and of monetary value, fall in the "networks and service junctions" and "natural resources" sectors (see Table 3.3). More generally, every regional APQ involving substantial resources has been signed in the principal infrastructure sectors. In other sectors, particularly natural resources or cultural resources, APQ tend to be of smaller monetary value. This heterogeneity points to the flexibility of the APQ, an instrument whose

Table 3.3. **APQ by EU structural funds priorities and macro-areas, 2005 (in EUR millions)**

Priorities CFS	Centre-north		South		Italy	
	Values	%	Values	%	Values	%
Natural resources	4 025	17	8 306	26	12 331	22
Cultural resources	1 036	4	1 280	4	2 316	4
Human resources	194	1	549	2	743	1
Local development	1 036	4	6 381	20	7 416	13
Urban development	2 122	9	982	3	3 104	5
Material and information networks	15 756	65	15 043	46	30 799	54
Total	24 168	100	32 542	100	56 710	100

Source: Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance), Dipartimento per le Politiche di Sviluppo e Coesione (DPS) (Department for Development Policies) (2006b), *Rapporto annuale 2005* (Annual Report 2005).

precise content varies according to the object of the agreement. Moreover, the number of sectors in which APQ are utilised also suggests that these instruments are not only heterogeneous in terms of the amount of resources they mobilise, but also in other respects, such as the complexity of the object of the agreement. This results, in part, from the fact that APQ are meant to allow region-specific flexibility in the design of policies but also from an explicit choice of a complex instrument to pursue a single development goal through the co-ordination of multiple policies. With regard to flexibility, it is also worth noting that the monetary value of APQ signed in the centre-north has long exceeded the value of APQ signed in the south (see Table 3.4). The discrepancies exist because the APQ is used to direct a variety of financial resources devoted to development of both depressed areas of the south and less-developed territories of the centre-north, as well as from a greater amount of programming in the centre-north relative to the south.

Table 3.4. **Number and value of APQ signed by year by macro-areas (in EUR millions**

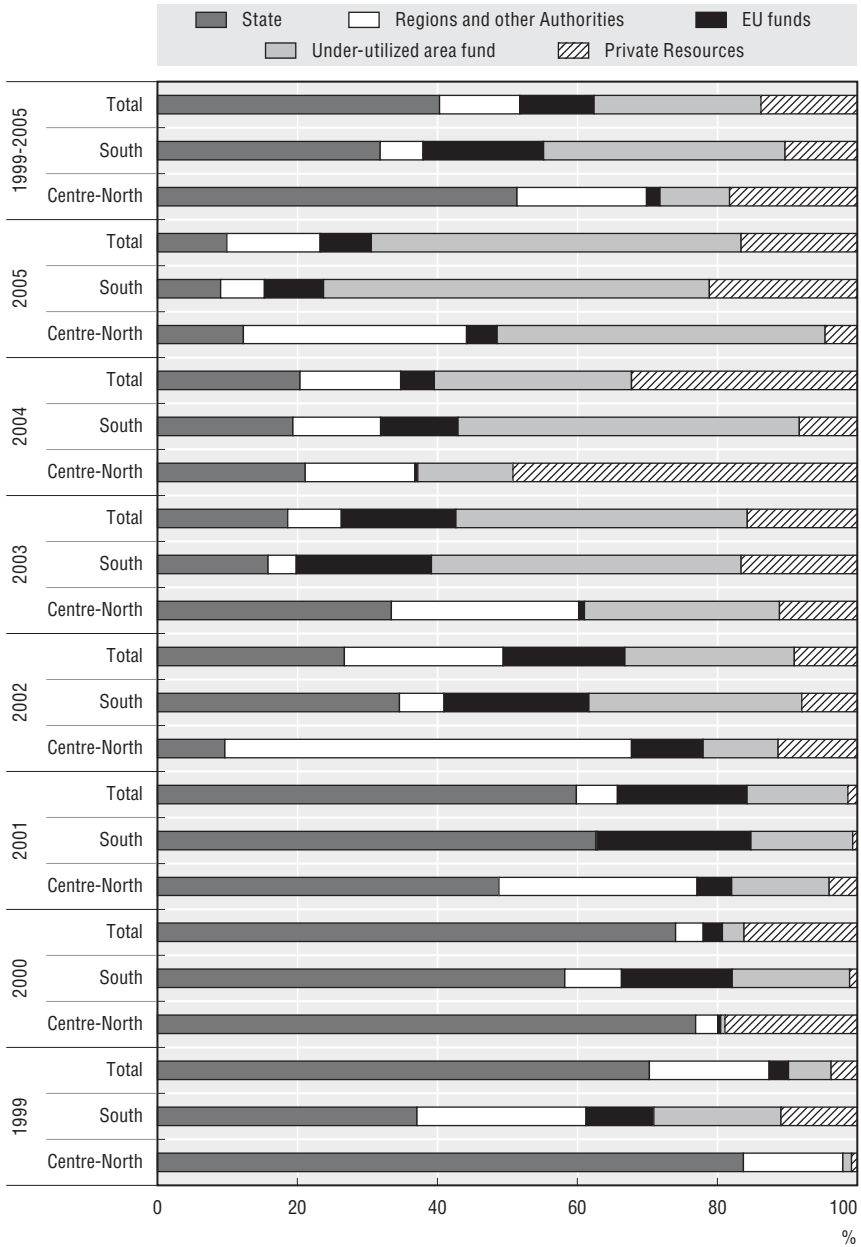
	Centre-north		South		Total	
	Value	Number	Value	Number	Value	Number
1999	4 476	10	1 680	4	6 156	14
2000	7 423	9	1 342	9	8 765	18
2001	1 704	13	6 770	11	8 474	24
2002	2 439	22	5 246	13	7 685	35
2003	1 680	36	8 846	32	10 527	68
2004	4 702	60	3 260	52	7 962	112
2005	1 743	77	5 398	69	7 141	146
Total	24 168	227	32 542	190	56 710	417

Source: Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance), Dipartimento per le Politiche di Sviluppo e Coesione (DPS) (Department for Development Policies) (2006b), *Rapporto annuale 2005* (Annual Report 2005).

APQ were originally conceived as the instrument through which the financial resources destined to territorial development policies by the annual finance law (*Legge Finanziaria*) were attributed. The scope of application of the APQ has extended with time so that the sources of financing flowing through the APQ are now multiple and include ordinary resources, national additional resources for the depressed areas, EU funding, and private resources (see Figure 3.1).

Ordinary resources may originate from the central state budget,[6] the region's budget, or the local budgets. They are relatively more important for the financing of the APQ signed in the centre-north because only 15% of the national additional resources belonging to the *Fondo Aree Sottoutilizzate* (FAS)

Figure 3.1. **APQ sources of financing over time**



Source: Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance), Dipartimento per le Politiche di Sviluppo e Coesione (DPS) (Department for Development Policies) (2006b), *Rapporto annuale 2005* (Annual Report 2005).

are directed towards interventions in this area of the country. The amount of national additional resource is defined in the annual finance law (*Legge Finanziaria*) and managed by the *Comitato Interministeriale di Programmazione Economica* (CIPE) to achieve territorial development, reduction of disparities and social cohesion as expressed in paragraph 5 of Article 119 of the Italian Constitution. APQ also draw on the EU resources administrated through the *Quadro comunitario di sostegno (*QCS), the *Programmi Operativi* in the south, and the *Documenti Unici di programmazione* in the north. Finally, private financing is particularly relevant in those sectors where the projects defined through the APQ might be expected to produce revenues, such that private actors might have an interest in participating in the financing of those interventions from which they may later obtain benefits in the form of revenue sharing.

It is important to note that the APQ ensures a substantial degree of co-ordination in the definition of the financial coverage of projects. In turn, this enhances the stability of expectations of the parties to the agreement and facilitates the planning of investments in infrastructure in each time period. However, expanded planning and coordination of the APQ over multiple periods still offers room for improvement. Each year the CIPE deliberates on the repartition among regions the fraction of the FAS destined to the APQ. As mentioned, 15% of these funds are allocated to regions of the centre-north and 85% to regions of the south. Within the geographical macro-areas, funds are allocated on the basis of three indices: 1) an index of size (size and population); 2) an index expressing the structural problems (inverse of the GDP, unemployment rate, infrastructure deficit); and 3) an index expressing the negative factors affecting the region (*e.g.*, being an island, or having a particularly small size). Each region then selects the sectors for intervention through APQ and shares the choice with the competent central administrations and with the *Dipartimento per le Politiche di Sviluppo* (Department for development policies, DPS).

3.2. Co-ordination context

In this section, the characteristics of the environment within which APQ operate will be briefly described according to the typology proposed in this volume. As a general matter, APQ signed in different sectors vary greatly along the four relevant dimensions proposed in the analytical typology. As such, it is not possible to describe this instrument as fitting squarely within a single category for each dimension. This is a consequence of the very design of the APQ which is meant to simplify procedures, promote coordination, and speed up the pace of intervention in a wide variety of sectors and through a wide variety of forms of intervention. In addition, although IIP and APQ have been in place for some time and can be considered, to some extent, a mature instrument, it should be noted that the use of this form of negotiated

programming occurs at a time of profound changes in the institutional framework of decentralisation. While the increased recourse to negotiated programming, and the APQ in particular, appears to reinforce the trend towards decentralisation, new needs and policy issues emerge as the process of decentralisation advances, which in turn requires modifications to the instrument itself. The evaluation of both the characteristics and the effectiveness of this instrument should therefore take into account the parallel evolution of Italian institutions.

3.2.1. Knowledge distribution

Knowledge distribution varies greatly according to the specific object of the APQ. As mentioned, APQ are employed in a variety of sectors and in the pursuit of diverse development objectives, ranging from the building of infrastructures to the implementation of education and training policies or local development policies. The distribution of knowledge may thus take any of the four forms of the typology proposed in this volume.

When the object of the agreement is given by a plan devoted to the development of transport or water infrastructure, as it is the case for the majority of the APQ signed up to this point, knowledge distribution tends to be symmetrical, with both the central government and the regions being similarly skilled and informed. This calls for rather complete contracting. The asymmetric distribution characterised by the presence of a scarcely skilled and scarcely informed central government and highly informed regions seems to be less prevalent. This might be considered a partial consequence of the tradition of centralisation of public policies that has long dominated the Italian landscape and has hindered the development, at the sub-national level, of the skills required both to acquire the relevant information and to manage local policies. For analogous reasons, many of the interventions agreed upon through APQ are characterised by a knowledge distribution such that the sub-national layer of government is scarcely skilled or informed, while the central government might be either highly or scarcely informed. This is the case, in particular, of the APQ aimed at implementing complex policy objectives such as the promotion of the cultural heritage, the improvement of education and training policies, and the support of employment policies. Note, however, that saying that regions possess a low degree of knowledge of local conditions does not preclude the possibility that they might be in the best position to acquire local knowledge. In other words, the typology used in this paper is meant to reflect the current state of affairs regarding knowledge distribution, and not the potential for knowledge acquisition.

Some of the co-ordination issues arising from the distribution of knowledge are connected to the specificities of the Italian institutional

framework. This is common to many APQ in so far as they are characterised by the presence of scarcely informed local authorities, independent of the amount of knowledge possessed by the central government. This refers, in particular, to the lack of informal norms able to frame the interaction between the various levels of government. Decentralisation is a relatively recent process in Italy and mutual distrust has long characterised the interactions among the various layers of government. This, in turn, makes it difficult to adopt a logic of incomplete or relational contracting because it is difficult to co-ordinate expectations on the outcomes of joint project and both parties need to learn how to interact effectively (and eventually cooperate). The culture of co-operation across levels of government is still underdeveloped.

3.2.2. *Complexity*

APQ are also very heterogeneous as regards the complexity of the projects they are meant to implement. On one side there are projects that, although technically complex, can be fairly well specified *ex ante* and whose realisation can be subject to *ex post* verification. This is the case, in particular, of infrastructure projects for the transport, water, telecommunication and energy sectors, for example. On the other side, there are projects that integrate many forms of intervention related to the same development goal. This implies that the number of instruments to be mobilised and the number of the agents involved in policy implementation are large. This is particularly the case for projects related to the quality of education, training or employment policies, those aimed at improving the innovation environment or the ability of firms to innovate, or those projects aimed at promoting the cultural or artistic heritage. In the latter case, the exact nature of the tasks necessary to realise the project cannot be univocally determined *ex ante* and critical issues exist that relate to the management of knowledge exchange among partners and the ability of parties to learn and to adjust to changing circumstances.

3.2.3. *Vertical inter-dependencies*

Although the characteristics of the APQ vary greatly according to the sector to which they relate, the degree of inter-dependence among partners tends to be high for most APQ. Inter-dependency arises as a consequence of many factors that, in some cases may, depend on the degree of complexity of the underlying policy.

First, as a general matter, the historical development of the Italian institutional framework of decentralisation policies has favored the emergence of a situation of scarce accountability of the sub-national levels of government that is hard to modify. In other words, although the Italian institutional framework is progressing toward a more decentralised model relative to the past, citizens display some inertia in attributing responsibility

for policy failure to the sub-national levels of government. As a result, the pressure for efficiency and accountability at the regional level is much reduced. This combines with the inexperience of regions in the management of most territorial policies and gives rise to long-term inter-dependencies between the central government and the regions.

A second aspect to be considered is that the nature of the policy to be implemented through some APQ (*e.g.*, employment or education policy) may generate inter-dependencies because other policies managed by the government influence the policy implemented through the APQ. This is particularly the case for complex policies.

Third, the implementation of complex policies generally involves specific bilateral investments on the part of both the central government and the regions. In this circumstance, the APQ deals with the problems of credibility of commitments and opportunism because it provides a mechanism for clarifying *ex ante* reciprocal commitments. This is particularly true for the financial commitment on the part of the central government. Indeed, the APQ aim to reinforce the new management rules of the FAS and of the other sources of funding in order to improve regions' ability to plan long-term policies through more stable expectations.

Finally, the very structure of the APQ is characterised to an important extent by an *ex ante* specification of obligations, indicators of performance, and monitoring mechanisms and thus tends towards a logic of complete contracting. This, in turn, tends to go hand in hand with a continued involvement of the central government in policy implementation and thus with a high degree of inter-dependence. In other words, the degree of inter-dependence is, to some extent, endogenous to the choice of the contractual mechanism.

3.2.4. Enforcement context

Internal control mechanisms play the most relevant role in the enforcement of the APQ. The precise nature of these mechanisms will be specified in the next section. For the time being, however, it is worth noting that this might be partly attributed to the fact that many APQ are meant to be agreements of a relational nature, whose primary objective is to stimulate the creation of a co-operative attitude. The limited reliance on external enforcement might thus be consistent with theoretical predictions. Another possible explanation for the crucial role played by internal control mechanisms may be the relative weakness of the other two possible methods of enforcement; *i.e.*, external enforcement and political accountability. The effectiveness of external enforcement of the APQ might be reduced by the lack of a specialised court experienced in the enforcement of contractual

agreements between various levels of government, due to the very recent and incomplete nature of the decentralisation process in Italy. Moreover, as of yet there is no clear provision for the regulation of the APQ through arbitration.

As for political accountability, it should be recalled that, historically, the degree of political accountability of sub-national layers of government has been rather low. In addition, despite efforts made to improve the transparency of the various APQ through monitoring and the construction of a database that is, in principle, accessible to the public, citizens still possess scarce information on the concrete functioning of the APQ. This scarcity of information on APQ might combine negatively with a culture of skepticism toward negotiation because of a prejudice instilled by the diffusion of less open negotiating practices (Bobbio, 2000). In combination, this might generate a lack of interest in the exercise of control over the APQ. Finally, direct mechanisms for improving accountability of the agents involved in the implementation of the APQ are scarcely exploited. At present the only role for private parties is the role of financing. So far, other forms of direct or indirect participation in the APQ by relevant private actors (associations, trade unions, etc.) are not expressly foreseen.

3.3. Contractual mechanisms

The APQ includes both mechanisms associated with a logic of complete contracting and mechanisms associated with a logic of relational contracting. In what follows, they will be presented distinguishing between *ex ante* and *ex post* mechanisms.

3.3.1. Ex ante mechanisms

The relational nature of the APQ is most evident in the *ex ante* phase. Indeed, the APQ is not meant to be an instrument to delegate tasks from the central government to the regions, but rather the process of contracting into the APQ is meant to allow for a co-operative fixing of policy objectives and means of implementation by the central government, the regions and the other local and central authorities. Co-operation takes place on the basis of the four-fold process described in Table 3.5.

The CIPE evaluates the APQ on the basis of two principal criteria: 1) coherence of the APQ with the criteria and objectives set in the other instruments of territorial development (regional, national, and EU); and 2) the degree of specification of the projects it includes. This is a consequence of the fact that one of the main objectives of the APQ is to ensure the co-ordination of policies that have traditionally been rather fragmented. One important aspect of the *ex ante* procedure is that it includes an *ex ante* evaluation of the proposed APQ with respect to the quality of programming which still seems to

Table 3.5. **Procedure leading to the signing of the APQ after the coming into force of the annual *Legge Finanziaria* (1 January each year)**

Phase	Action	Deadline
Phase 1	Central Administrations send to the regions and the Autonomous Provinces information concerning the programming of the ordinary and additional resources destined to their respective territories.	7 months after the coming into force of the annual *Legge Finanziaria* (31 July)
Phase 2	Regions and Autonomous Provinces communicate to the CIPE their choice of the sectoral repartition of FAS resources.	9 months after the coming into force of the annual *Legge Finanziaria* (30 September)
Phase 3	Regions, Autonomous Provinces, and central administrations sign the *Quadro Strategico dell'APQ* (Strategic Framework of the APQ) that determines, among other things, the deadline for the signing of the APQ. The strategic framework is transmitted to the CIPE and to the service for the policies of territorial development and the agreements instituted at the Department for development policies (DPS).	13 months after the coming into force of the annual *Legge Finanziaria* (31 January)
Phase 4	Central and local administrations propose the interventions to be included in both the implementation section and the programming section of the APQ 30 days before the deadline. The APQ is written down and the relevant information transferred through a computerised system to the Ministry of Economics and Finance.	Date fixed in Phase 3

Source: Based on information provided by the Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance), Dipartimento per le Politiche di Sviluppo e Coesione (DPS) (Department for Development Policies).

offer room for improvement. Indeed, in order to ease the assessment process by the CIPE of the fulfillment of the two criteria, the laws regulating the APQ envisage, since 2004, an *ex ante* evaluation performed by the *Nucleo di Valutazione* (Evaluation Unit) instituted at the competent central or regional administration, which must then submit a report on the proposed APQ to the CIPE. The monitoring report includes: 1) assessment of the internal coherence of the proposed APQ; 2) assessment of the coherence of the APQ with respect to the other development instruments employed by the concerned administration; 3) assessment of the possible socio-economic impact of the proposal; 4) evaluation of the available feasibility studies on the proposed interventions; and 5) identification of the interventions with a cost exceeding EUR 10 million that require further analysis in order to ensure their adequate implementation.

More in line with a logic of complete contracting and delegation is the *ex ante* specification: 1) by the central government of the financial resources destined to the project; and 2) by all the actors concerned, of their commitments as regards each of the projects included in the APQ and the time period within which they expect to respect their commitments.

3.3.2. Ex post mechanisms

3.3.2.1. The mechanism of information transmission. In order to ensure a smooth flow of information between the center and the periphery, the actions required as part of the implementation plan of the APQ are detailed in specific documents that are sent to the Ministry of Economics and Finance both on paper and via computerised system. The agent responsible for the APQ is required to submit every six months to the *Comitato Paritetico di Attuazione dell'Intesa* (Egalitarian Implementation Committee) a monitoring report specifying the state of implementation of the agreement, any technical or financial difficulties, changes in the quantification of the costs or in the definition of the timeframe for the interventions, and changes in the legal and regulatory framework likely to impact on the implementation of the project. In order to do so, the agent responsible for the APQ relies on the information transmitted by the agents responsible for each of the interventions, who also perform a coordination role for each of the interventions.

3.3.2.2. The mechanism through which commitments are renegotiated and modified over time. It is possible to modify both the type of projects proposed and the schedule for their implementation (CIPE decision n.36/2002). Following the reform of December 2005, the responsibility for all implementation decisions concerning the APQ rests with the Table of Signatories. The organ composed of high-level administrative and political representatives (the *Comitato Intesa Paritetico*) is responsible for higher-level decisions and evaluations, such as the control over the performance of the IIP and the evaluation of the trend of regional development. This division of responsibilities, which resulted from the reform process, is intended to increase the speed at which modifications to the APQ can be made by requiring a lower level of consensus for the implementation of lower-level decisions.

3.3.2.3. The incentive mechanism (*premialità*). An important aspect of each APQ is the system of bonuses and sanctions akin to the EU performance reserve fund. Indeed, Italy has chosen to reinforce this aspect of the EU system by implementing a similar system of bonuses and sanctions for the national financial resources destined to territorial development. As a result, incentive mechanisms relate to EU funds (4% of the funds are allocated on the basis of the ability to respect criteria such as speed of programming and spending and quality of monitoring, control and evaluation), to national funds associated to the EU structural funds (6% of the funds are allocated on the basis of the respect of administrative performance criteria), and to national additional resources for territorial development. The latter system of bonuses/sanctions is meant to stimulate the achievement of intermediate objectives regarding management procedures (CIPE decisions No. 36/2002; 17/2003 and 20/2004) such as increasing

the speed of programming activity, increasing the pace of spending, the respect of the timetables, and the improvement of the monitoring procedures (see Table 3.6). Thus, the incentive scheme is not meant to promote quality standards

Table 3.6. **The APQ incentive system concerning national additional resources introduced with CIPE decisions 36/2002 and 17/2003**

Objective	Indicator	Bonus/sanction
Increasing the speed of programming activity and of signing of the APQ.	• Programming by 31 December 2002 and by 31 December 2003, respectively, of 60% and 100% of the resources attributed up to 2000 (by CIPE decisions 142/99, 84/00 and 138/00). • Submission to the CIPE, by 31 December 2002, of the list of projects to be planned using resources assigned with the Finance Laws 2002 and 2003 (CIPE decisions 36/2002 and 17/2003) and of the spending plan. • Indication of the foreseen date of signing of the APQ by 31 December 2003.	• Complete loss of the resources attributed up to 2000 not programmed by 31 December 2003. • Loss of 5% of the resources assigned by CIPE decisions 36/2002 and 17/2003 for each month of delay in meeting any of the indicators (up to EUR 2 617 million + EUR 4 200 million).
Increasing the speed of the use of resources attributed with the Finance Laws 2002 and 2003.	• Use of the resources assigned through CIPE decisions 36/2002 and 17/2003 in the context of binding commitments towards third parties, respectively, by 31 December 2004 and 31 December 2005.	• Loss of the resources not utilised in binding commitments (up to EUR 2 744 million + EUR 5 200 million).
Increasing the speed of spending of the resources attributed with the Finance Laws 2002 and 2003.	*CIPE decision 36/02:* • Regions and Central Administrations: 1) respect of the programming schedule presented to the CIPE by 31 December 2002; 2) submission to the CIPE of a report on the state of advancement of the projects. *CIPE decision 17/2003:* • Regions: 1) respect of the spending schedule submitted to the CIPE by 31 December 2003; 2) agreement on the date of signing of the APQ with Central Administration by 31 December 2003; 3) respect of an expenditure target of 25% for each APQ signed by 31 December 2002. • Central administrations: respect of the spending schedule submitted to the CIPE by 31 December 2003.	• Bonus of 10% of the resources assigned by CIPE decisions 36/2002 and 17/2003.
Improvement of the monitoring functions of the APQ.	• Modification to the planning of the assigned resources not superior to 30% of the cost of all the interventions planned in the APQ.	• Bonus of EUR 60 million.

Source: Based on information provided by the Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance), Dipartimento per le Politiche di Sviluppo e Coesione (DPS) (Department for Development Policies).

across APQ projects, but rather to stimulate the respect of a few technical requirements. Given the relative straightforwardness of these requirements, monitoring of the incentive system related to the national additional resources is not performed by a specific technical evaluation committee (although, monitoring is still essential to the active functioning of the system).[7]

With the mentioned 2005 reform of the APQ, the system of bonuses and sanctions has been modified along the lines synthesised in Table 3.7.

Table 3.7. **The APQ incentive system concerning national additional resources following the 2005 reform**

Objective	Indicator	Bonus/sanction
Increasing the speed of programming by central administrations.	• Submission, by 31 July of each year, to the Regions and Autonomous Provinces of the information concerning the programming of the ordinary and additional resources destined to their respective territories.	• Bonus of 20% of the resources destined to the incentive system.
Increasing the speed of programming by regions and AP.	• Communication by 30 September of each year to the CIPE of the choice of the sectoral repartition of FAS resources.	• Bonus of 20% of the resources destined to the incentive system.
Increasing the speed of the design of the APQ by central administrations, regions and autonomous provinces.	• Submission of the strategic framework of the APQ to the CIPE and to the Service for the policies of territorial development and the Agreements instituted at the Department for development policies (DPS) by 31 January of the 2nd year after the coming into force of the *Legge Finanziaria* that assigns resources to the APQ.	• Central administrations: bonus of 40% of the resources destined to the incentive system. • Regions and AP: bonus of 20% of the resources destined to the incentive system.
Increasing the speed of programming by central administrations and regions.	• Ability to program the destination of the resources assigned in the preceding year by 31 July of the following year.	• Central administrations: bonus of 40% of the resources destined to the incentive system • Regions and AP: bonus of 20% of the resources destined to the incentive system
Increasing the speed of realisation of interventions by regions.	• Attribution through tender of the contract for the realisation of the interventions included in the APQ by 31 December of the 3rd year following the CIPE decision through which the relative resources have been allocated	*Bonus:* • 40% of the resources destined to the incentive system *Sanctions:* • For the interventions for which the tender is open the sanction concerns the further funds attributed to the Region or the AP • For the interventions for which the tender has not yet been opened, loss of the entire amount of FAS resources.

Source: Based on information provided by the Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance), Dipartimento per le Politiche di Sviluppo e Coesione (DPS) (Department for Development Policies).

3.3.2.4. The mechanisms meant to support learning by the concerned administrations. Multiple initiatives have been devised by the central government in the context of the APQ in order to improve the learning process of the concerned administrations. One such initiative is the "Monitoring Project" (*Progetto Monitoraggio*, CIPE decision No. 17/2003), which is intended to improve the ability of public administrations to acquire and elaborate information concerning the progress of their projects. A second initiative addresses the opportunity for local administrations to receive support from *Sviluppo Italia* for the improvement of public procurement, especially in the field of local development and urban areas and from SOGESID (*società per azioni a capitale interamente pubblico*) for the improvement of the implementation of policies in the water sector.

3.3.2.5. The enforcement mechanism. With respect to enforcement, two aspects are worth emphasising. The first, the mechanism of bonuses/sanctions described above constitutes an essential component of the enforcement mechanism. This is not only because regions' access to available resources is conditional on achieving performance standards, but also because the bonus/sanctions system envisages a certain degree of competition for funds among the regions that limits the scope for collusive behaviors and races-to-the-bottom.[8] An aspect worth stressing is the threefold role played by the Ministry of Economics and Finance (and particularly by the Department for development policies) that is party to the APQ, is responsible for supporting regions' ability to program activities through the APQ, and is responsible for monitoring performance standards. Such threefold role may be considered consistent with the incomplete and relational nature of the APQ, especially in light of the fact that the indicators of performance adopted as part of the incentive system tend to be objective and easily verifiable. Thus, the scope for moral hazard on the part of the Ministry of Economics and Finance is greatly reduced.

The second aspect of enforcement concerns the conciliation or conflict resolution procedures that apply to the agreement. The details of the procedures are established by each APQ but it is the agent responsible for the APQ, expressly indicated in the contract, which performs the role of arbitrator and attempts a co-operative conciliation procedure. In the event this procedure does not work, controversies are solved in the competent legal fora. In this regard, a relevant and controversial question concerns the juridical nature of the APQ. While a few experts consider the APQ a contract in the strict sense of the term (so that the APQ would be disciplined by private law), most deem the APQ a peculiar form, namely a conventional act with a public nature that is different from both the private law contract and from an administrative act. According to this view, controversies over the formation,

the conclusion, and the execution of the contract are solved by the administrative judge (the Council of State).

3.4. Performance assessment

3.4.1. Evaluation by the Ministry of Economics and Finance

In its most recent report, the Department for Development and Cohesion Policies of the Ministry of Economics and Finance evaluates the APQ along five principal dimensions:

1. **Programming:** 95% of the resources allocated by the CIPE to the IIP were programmed by December 2005 in APQ (EUR 12.5 billion programmed out of EUR 15.9 billion allocated).
2. **Number of signed APQ:** the number of APQ signed increased steadily over time, with a particularly marked increase in 2004 and in 2005.
3. **Use of resources in binding commitments:**[9] sensible increase over time of the amount of resources allocated to the APQ that have been used in binding commitments, which amount to the 42% of the total value of the APQ.
4. **Expenditure:** the last monitoring of the IIP of June 2005 reveals that the average ratio between realised expenditure and total value of the APQ amounts to 24.5%. In evaluating this data, however, it should be considered that various factors contribute to lower it, including the fact that the total value of the APQ increases each year and that many APQ involve interventions whose completion is foreseen by 2015. Thus, it would be odd that most of the expenditures were realised in their first years of existence.
5. **Private financial resources programmed in APQ:** the amount of private resources in APQ increased from 13.4% to 14.0% between 2004 and 2005.

In summary, the information provided by the Ministry of Economy and Finance suggests positive conclusions as regards the ability of the APQ to achieve a few important indicators of performance, which further suggests the effectiveness of the incentive system in disciplining the APQ so as to achieve its proposed objectives. Another positive aspect of the APQ, considered by the Department for development policies in the 2004 report, is its long-term nature. Many IIP stipulate that they will last until objectives have been achieved. This constituted an important departure from the past. It contributes to stabilising expectations regarding the availability of financial resources destined to territorial policies and to creating a framework conducive to co-operation. Indeed, IIP and APQ have created the expectation of repeat-play and may make it more convenient to invest co-operation.

3.4.2. *Insights from contract theory*

The framework adopted in this volume may suggest that the fact that APQ are conceived of as an all-purpose instrument that is meant to deal with situations diverging along the four key dimensions might be problematic at least for two reasons. First, the fact that the same instrument is used in very different contexts along the four dimensions considered raises the question of whether the instrument is flexible enough to accommodate such heterogeneity. The second is that each of the four dimensions might suggest the optimality of the recourse to contractual mechanisms that might be at odds one with the other. These two aspects will be considered in turn.

Let us reconsider the implications of the analysis of each of the four dimensions considered above. In considering the dimension "knowledge distribution" a first element of tension arises. Indeed, it has been highlighted that APQ are predominantly used in situations in which the local authorities possess limited knowledge/skills that might, however, diverge from the amount of knowledge possessed by the central government; *i.e.*, the central government might be highly or scarcely informed as regards particular aspects of the implementation of given APQ. These two situations may call for the implementation of different contractual mechanisms. In particular, contract theory suggests that in the first case more complete contracting with structured monitoring mechanisms might help to solve the crucial issue of learning by the sub-national administration, while in the second case relational contracting might better suit the objective of promoting a co-operative attitude between equally uninformed parties and monitoring procedures might be counter-productive.

A similar tension emerges when considering the degree of complexity. The economic theory of contracts predicts that, in cases in which a high degree of complexity renders central the question of facilitating parties' learning and flexible adaptation, the adoption of contractual mechanisms of a predominantly relational nature should be observed. In other words, rather than fixing obligations *ex ante* in a complete contract and implementing a strict monitoring mechanism, parties will tend to predispose through a relational contract a governance mechanism that allows them to ameliorate their co-operation. This is to some extent the case for APQ, in that the two-step process that leads from the signing of the IIP to the signing of the APQ is characterised by negotiation and co-operation across levels of government both as regards the definition of the general objectives and framework of the policy to be implemented (through the IIP) and as regards the implementation of the policy (through the APQ). The choice of a two-step process supports the relational nature of the agreement in so far as it ensures that agreement reached on the broad framework of policy co-operation across levels of

government is not subject to renegotiation at the stage of implementation, so that the latter may occur at a more rapid pace.

However, in contrast with the predictions of contract theory, the APQ signed for the implementation of complex projects use, as any other APQ, a system of monitoring and reporting and a system of incentives that confer to the APQ some aspects of a complete transactional contract. Observation of the degree of complexity of the objects of the APQ thus suggests that there is a potential misalignment between the observed degree of complexity and the shape of the APQ. There exists a risk, in particular, that problems of multi-tasking may arise. Regions might be induced by the contractual structure of the APQ to focus on the fulfillment of those tasks that can more easily be monitored by the central government, at the expenses of some "core" task that is harder to measure.

Another issue that is raised by the heterogeneity of the APQ along the dimension of complexity relates to the nature of the distribution of decision rights within the agreement and to the degree of delegation of authority. Again, it might be possible that the heterogeneous nature of the projects implemented through APQ might pose some problem to the smooth functioning of this instrument. Different degrees of complexity call, indeed, for different distributions of decision rights and of authority (more complex projects calling for increased delegation of authority and vice-versa) and it is relevant to ask whether the APQ is a flexible enough instrument in this regard.

The high degree of inter-dependency involved in most APQ suggests the possibility that the current structure of the APQ might be partly unsuitable to implement some of the policies to which it is relevant, especially in light of the other characteristics of the coordination environment (notably in circumstances characterised by a low level of knowledge on the part of both the central government and the regions and a high degree of complexity). The question is whether the logic of complete contracting that permeates the APQ to some extent, might conflict with the long term objective of the reduction of inter-dependencies that seems implicit in the fact that APQ are also meant to promote learning and the gradual shift of responsibilities from the center to the periphery that is associated to processes of decentralisation.

Finally, in regard to enforcement, the mechanisms currently envisaged by the APQ seem to suffer from substantial weaknesses. This is due to the traditionally low level of accountability of local administrations *vis-à-vis* citizens and to the lack of uniform provisions concerning the involvement of external arbitrators.

Consider now the second problem raised above, namely that each of the four dimensions might suggest the optimality of the recourse to contractual mechanisms that might be at odds one with the other. This is the case, for

instance, of the tension between the high degree of complexity of many APQ – which calls for a high degree of delegation of authority and decision rights – and the persistent inter-dependence across the actions of the different layers of government that calls for reducing the degree of delegation. Similarly, there exists a tension around the fact that many APQ involving complex projects are implemented in situations where the central government is skilled and the sub-national authority is not skilled, so that a high degree of delegation conflicts with the lack of skills of sub-national layers of government.

In summary, the economic theory of contracts suggests that a number of tensions might be detected in connection with two crucial characteristics of the APQ, namely the all-purpose nature of the instrument (that is not differentiated according to the characteristics of the co-ordination environment) and the fact that the APQ combines elements of a transactional and elements of a relational contract. Therefore, it becomes important to ask at least two questions: what is, in actual fact, the extent of the tension between the transactional and the relational elements of the APQ? And what should be the optimal degree of differentiation of the APQ?

As for the first question, a number of aspects of the practical implementation of the APQ might suggest that, to some extent, this tension is more apparent than real. This holds, in particular, for the monitoring and the incentive mechanisms. The monitoring and incentive schemes implemented in the APQ might not actually contradict the rationale of a relational contract insofar as they serve the purpose of clarifying to the concerned administrations expectations regarding their behavior and in so far as they help to build mutual trust. Similarly, the adoption of a monitoring system and of a system of bonuses/sanctions based on simple indicators might have helped to overcome the risk of collusion among the concerned administrations aimed at weakening the established rules.

From both of these perspectives, what is relevant is that the adoption of contractual mechanisms associated with a logic of complete contracting might be an intermediate step necessary to create the conditions for the sustainability of relational contracts. Indeed, this might be an indispensable step in light of the fact that both the process of decentralisation and the institutions of fiscal federalism are still relatively immature, and as a result that there is a real lack of informal norms and established practice on which relational contracting may rely. However, as the decentralisation process matures, it is possible that the characteristics of all of the dimensions that have been considered (and especially the degree of inter-dependence) will change with time. Therefore, a first conclusion that may be drawn from this analysis is that it is important for the APQ to evolve in response to changes along the four dimensions so as to allow an efficient response to the changing interaction among them.

The only clear tension that may be detected in connection with the operation of the monitoring and the incentive systems embodied in the APQ concerns the distortions that a system of bonuses/penalties based on simple and easily verifiable indicators may induce when agents are required to perform multiple tasks – *i.e.*, the multi-tasking problem. Indeed, this is frequently indicated as a real concern and it is widely reported that many administrations still display a rather passive attitude towards negotiation, *i.e.*, they tend to "fulfill obligations" rather than to co-operate, although the quality of multi-level co-operation varies greatly from region to region.

Turning now to the second question – what should be the optimal degree of differentiation of the APQ – it is proposed that the peculiar characteristics of the Italian institutional environment may render preferable a strategy of adoption of an undifferentiated instrument such as the APQ to a strategy of differentiation of the contractual mechanisms in relation to the characteristics of the co-ordination context. Indeed, while this differentiation may turn out to be very useful to tune instruments to specific situations, a "second level of ignorance" may be rather pervasive in the economy: that concerning the "meta-knowledge" of the very distribution of knowledge across the various relevant actors. In other words, the characteristics of the distributions of knowledge across actors might not be clear enough *ex ante* to allow the tailoring of contractual forms to the specific characteristics of knowledge distribution. If this is the case, differentiation may turn out to be rather problematic and it may be better to have instruments that are flexible enough to cope with a variety of distributions of knowledge among various levels of government and private agents. Moreover, the distributions of knowledge do not only depend on the (often "*a priori*" unknown) characteristics of the problem to be studied but are partially endogenous.[10] They are path-dependent characteristics that are often inherited from the past history and decision-making traditions of a particular country or region.[11] This adds another element of unpredictability to the specific characteristics of the relevant distribution of knowledge and makes the future distribution of knowledge an endogenous result of the process. Within the limits of present knowledge, the future distribution of knowledge may itself become an additional objective of economic policy.

3.5. *Policy recommendations*

- **Simplify procedures:** although the APQ have helped to speed up the planning process, they remain very complex to manage. This may have negative consequences not only on the effectiveness of the interaction between the different levels of government, but it may also have the undesirable consequence of favoring "capture" of this instrument by bureaucratically skilled private agents. In other words, complex

bureaucratic procedures might deter efficient private parties from participating in APQ, leaving the floor to less efficient but more bureaucratically skilled agents.

- **Enhance flexibility:** given that most APQ are meant to deal with complex matters it is important for the internal governance structure of the agreement to adjust in response to learning and experience accumulated. Co-operation does not exist in a vacuum and it is thus important to build up the pre-requisites for it, which includes informal norms of interaction and a common knowledge base. In its first years of existence, the APQ has shown an ability to evolve over time. Indeed, the monitoring and incentive schemes that might seem rather rigid contractual instruments, useful in a preliminary phase of co-ordination in order to overcome the consequences of a longstanding attitude of mutual distrust and of the scarce alignment of expectations, have been progressively associated to more mature forms of governance. It is thus important for this evolutionary process to continue smoothly and consciously. Moreover, it is important to improve the internal mechanisms for *in itinere* modification of commitments, although important steps have been made also in this regard with the recent reform of 2005.
- **Increase accountability of local administrations:** in Section 3.2.3 it was mentioned that even though the Italian institutional framework is progressing towards a more decentralised model relative to the past, citizens' expectations display some inertia in attributing responsibility for policy failure to the sub-national levels of government. As a result, the pressure towards efficiency imposed on regions by accountability is much reduced. Increased accountability of sub-national levels of government might have a host of beneficial effects, including an increase in their intrinsic motivation that may help sustaining relational contracting.
- **Increase transparency and participation of civil society:** this might not only contribute to increasing accountability, but it may also help the administrations involved in the signing of the APQ to make more informed choices concerning the selection and the implementation of the projects included in the APQ.

4. Conclusion

The primary contractual instrument of multi-level governance adopted in the context of Italian regional development policies – the *Accordo di Programma Quadro* (APQ) – has been presented in this chapter. The APQ frames the interaction between the regions, the Ministry of Economic Development (before June 2006 it was the Ministry of Economy and Finance), and one or more competent central administrations and may involve the participation of

private parties. The distinctive characteristic of the APQ is that it is conceived of as a complex, multi-purpose instrument meant to achieve simplification and greater co-ordination in a policy context that has traditionally been highly fragmented and bureaucratically cumbersome. The analysis proposed in this chapter has shown, on one side, that this very characteristic of the APQ might be problematic in light of the economic theory of contracts. That theory, and the framework proposed in this volume in particular, suggests the need for a differentiation of the contractual instruments adopted according to the characteristics of the co-ordination context in terms of knowledge distribution, complexity, vertical inter-dependencies, and enforcement context. On the other side, it has been proposed that, on closer inspection, the limited differentiation of the APQ turns out to be less problematic than it may first appear. This is for a number of reasons, and in particular because the nature of the Italian institutional environment suggests that a "second level of ignorance" may be rather pervasive in the economy: that concerning the "true" distribution of knowledge itself. Under such circumstances, foregoing the benefits from fine-tuning of policies through differentiation might be more than compensated by the flexibility that the APQ offers in coping with a variety of distributions of knowledge among various levels of government and private agents.

As a final note, consider that the analysis proposed in this chapter underscores the need for the APQ to be able to evolve over time in response to changing circumstances and to the progressive gathering of second-order knowledge on the distribution of knowledge and competences among parties. Due precisely to its nature as a complex and scarcely differentiated contractual instrument, the effectiveness of the APQ depends on its flexibility.[12] In this regard, the recent reform of the APQ, with the associated modification to the governance structure and to the incentive system, should be valued positively as an attempt to ensure the prompt adaptation of the APQ to the new second-order knowledge accumulated through experience and to the new competencies that are endogenously created by the co-operation of different levels of government.

Notes

1. This chapter draws on the contributions of Maria Alessandra Rossi, Siena University and EconomiX, University of Paris X and Ugo Pagano, Siena University and Central European University, Budapest. They thank Fabrizio Barca and Federica Busillo for their useful comments.
2. Its central role is confirmed by the documents prepared for the Strategic National Framework 2007-2013 that Italy must submit to the EU Commission in order to direct the resources that the EU cohesion policy will attribute to the country.

3. The state is responsible for establishing basic principles and regions are responsible for the definition of the practical implementation.
4. The 2001 constitutional reform has forbidden the use of earmarked grants, with the exception of those indicated in the paragraph 5 of Article 119 of the constitution. Note also that the same section of the constitution constitutes the legislative basis upon which interventions complementary to those funded through the EU cohesion fund can be financed.
5. There is not yet *in itinere* and *ex post* evaluation, as is the case for EU funds. Note that forms of *in itinere* and *ex post* evaluation are in place for the procedural objectives set by the incentive system (*premialità*), but no *in itinere* and *ex post* evaluation is envisaged for substantial socio-economic objectives.
6. Including funds managed by the agencies responsible for transport networks such as Agenzia Nazionale Autonoma Strade Statali (ANAS) and Rete Ferroviaria Italiana (RFI)
7. By contrast, the 4% EU performance reserve envisages monitoring by a committee including experts nominated by the EU Commission and the 6% national reserve envisages monitoring by an independent technical group composed by members of the Evaluation Unit of the DPS and members of the Regional Evaluation Units.
8. The system of bonuses (*premialità*) includes provisions implying a shift of a fraction of the available resources from non-performing to performing Regions.
9. Taking into consideration the project's life cycle, the expression "binding commitment" refers to that stage in which financial resources, already programmed by the Administration, are utilised by means of commitments having juridical obligations for each part involved in a formal contract, for example by means of tenders or direct form of contracting out.
10. In much economic theory, the information asymmetries arising from alternative distributions of knowledge are the basis to redistribute ownership of assets, power to take decisions and all sorts of incentives. However, the asymmetric distribution of information is itself endogenous and depends on these very factors that it can influence (Pagano, 1998).
11. This uncertainty is particularly pervasive because it does not only concern the instrument by which a goal may be achieved but also the goal itself. In this respect, market failure in the provision of local public goods may be twofold. Not only, as standard economic theory predicts, because of the free-rider problem, but also because individuals fail to provide them. Often, they fail also to be aware that they (collectively) need these goods and the role of public policy must also be favour political and negotiation processes by which the individuals can become aware of their collective needs. On this point, see Barca, 2006, p. 66.
12. In turn, the flexibility of the instrument allows also the application of a criterion of "institutional parsimony" according to which the instrument is commensurate to the institutional complexity involved by the policy objective. On this point see DPS (2006), *Quadro Strategico Nazionale per la Politica Regionale di Sviluppo 2007-2013*, p. 17.

Bibliography

d'Arcangelo, Lucia (2003), "La programmazione Negoziata", in Giuseppe Ferraro (ed.), *Sviluppo e occupazione nell'Europa federale : itinerari giuridici e socioeconomici su regioni e autonomie locali*, Giuffrè, Torino.

Barca, Fabrizio (2001), "Rethinking Partnerships for Development Policies: Lessons from a European Policy Experiment", paper presented at the Conference "Exploring Policy Options for a Rural America", 30 April-1 May 2001, Kansas City.

Barca, Fabrizio (2006), *Italia Frenata: Paradossi e lezioni della politica dello sviluppo*, Donzelli, Roma.

Barca, F., M. Brezzi, F. Terribile and F. Utili (2004), "Measuring for Decision Making: Soft and Hard Use of Indicators in Regional Development Policies", *Materiali Uval, analisi e studi*, No. 2, November-December.

Bobbio, Luigi (2000), "Produzione di Politiche a Mezzo di Contratti nella Pubblica Amministrazione Italiana", *Stato e Mercato*, No. 58, pp. 111-141.

Bruzzo, Aurelio and Mariella Volpe (2001), "Politiche di Sviluppo Territoriale in Italia: l'Evoluzione degli obiettivi e degli strumenti", *Quaderno del Dipartimento di Economia, Istituzione e Territorio*, No. 11/2001, Università di Ferrara.

Cassetti, Luisa (2004), "Il Regionalismo Italiano e la Multi-level Governance dopo le Recenti Riforme Costituzionali", in *Le Istituzioni Economiche del Federalismo*, No. 1/ 2004, pp. 111-122.

Comitato di Amministrazioni Centrali per la Politica di Coesione 2007-2013 (2006), Documento Strategico Preliminare Nazionale 2007-2013, available at *www.dps.mef.gov.it/documentazione/QSN/docs/Bozza_QSN_2007-2013_aprile_2006.pdf*.

Consiglio Nazionale dell'Economia e del Lavoro (2001), *Approfondimento dei Problemi Relativi alle Procedure Nazionali e Territoriali di Concertazione*.

Consiglio Nazionale dell'Economia e del Lavoro (2001), *Osservazioni e Proposte: la Concertazione Istituzionale e Sociale negli Strumenti di Programmazione Negoziata*.

Flora, Achille (2003), "La Pubblica Amministrazione nelle Politiche di Sviluppo: la Programmazione Negoziata", in Lucio Giannotta (ed.), *Economia, Diritto e Politica nell'Amministrazione di Risultato*, Giappichelli, Torino.

Genovese, Stefano (1997), "Gli Strumenti della Programmazione Negoziata: Intese, Accordi, Patti Territoriali e Contratti d'Area", in Giuseppe Santoro Passarelli (ed.), *Flessibilità e Diritto del Lavoro*, Giappichelli, Torino.

de Grazia, Davide (2002), "L'Autonomia Finanziaria degli Enti Territoriali nel Nuovo Titolo V della Costituzione", *Le Istituzioni del Federalismo*, No. 2/2002, pp. 268-304.

Istituto di Studi e Analisi Economica (2005), *Rapporto sull'Attuazione del Federalismo*.

Pagano, U. (1998), "Redistributions of Assets and Distributions of Asymmetric Information", in Erik Olin Wright (ed.), *Recasting Egalitarism: New Rules for Communities, States and Markets*, Verso, London and New York.

Ministero delle Attività Produttive (2005), *Relazione sugli Interventi di Sostegno alle Attività Economiche e Produttive*.

Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) – Dipartimento per le Politiche di Sviluppo e Coesione (Department for Development Policies) (2003), *Circolare sulle Procedure di Monitoraggio degli Accordi di Programma Quadro*.

Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) – Dipartimento per le Politiche di Sviluppo e Coesione (Department for Development Policies) (2004a), *Il Fondo per le Aree Sottoutilizzate*, Elementi informativi sull'attuazione nel 2003.

Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) – Dipartimento per le Politiche di Sviluppo e Coesione (Department for Development Policies) (2004b), *Rapporto annuale 2003*.

Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) (2005a), "Conti Pubblici Territoriali".

Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) – Dipartimento per le Politiche di Sviluppo e Coesione (Department for Development Policies) (2005), *Rapporto annuale 2004*.

Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) – Dipartimento per le Politiche di Sviluppo e Coesione (Department for Development Policies) (2006a), *Quadro Strategico Nazionale per la Politica Regionale di Sviluppo 2007-2013* (bozza tecnico-amministrativa), Sintesi.

Ministero Dell'Economia e delle Finanze (Ministry of Economy and Finance) – Dipartimento per le Politiche di Sviluppo e Coesione (Department for Development Policies) (2006b), *Rapporto annuale 2005*.

Tavolo per il Rafforzamento e la Semplificazione delle Intese Istituzionali di Programma e degli APQ (2005), Information note, 21 November 2005.

Zanardi, Alberto and Gianpaolo Arachi (2004), "Designing Intergovernmental Fiscal Relations: Some Insights from the Recent Italian Reform", *Fiscal Studies*, Vol. 25, No. 3, pp. 325-365.

ISBN 978-92-64-00873-1
Linking Regions and Central Governments
Contracts for Regional Development

Chapter 4

The Case of Germany[1]

This chapter provides an overview of regional policy and the use of contracts among levels of government in Germany. While contracting is not common in Germany, attention is given to the use of "joint tasks" and competitive tenders, specifically for the InnoRegio programme. The case study incorporates an overview of German federalism and a discussion of the contracting mechanisms (as applied prior to the 2006 constitutional reform). The chapter concludes with policy advice derived from the analysis.

1. Introduction

Germany is often described as a prototype of co-operative federalism. It is characterised by a strong inter-dependence between the federal, the state, and the communal level. There are 16 states, 439 districts, and approximately 14 000 municipalities. While explicit contracting among levels of government is not a common tool in Germany, some governance mechanisms could be interpreted within the framework of contract theory. This case study will examine two such mechanisms: joint tasks and competitive tenders. The study refers specifically to aspects of the German Constitution. However, as reforms of federalism were put into place on 1 September 2006, the analysis of "joint tasks" refers to the period prior to the reform.

2. Institutional and political context

2.1. Legislative authority at different levels of government

The starting point of legislative competence is that all competence lies with the states (Article 70 of the German Constitution, the *Grundgesetz*, [GG]). The areas in which the federal level has exclusive competence are enumerated in Article 73 of the constitution. Although both articles seem to assign a strong role to the states (the *Länder*), their importance has continually diminished since the constitution was passed until the reform of the German Constitution in 1994. Ultimately, Article 72 proved to be the main instrument for centralising ever more competence at the federal level. This article establishes the "concurrent legislation" that allocates competence to the states *as long as the federal level remains inactive*. However, the federal legislature has the right to become active, if its involvement is needed in order to establish "equal living conditions" or to preserve "legal and economic unity". Another kind of legislation, also based on the requirements just named, is called "framework legislation". Here, the federal level defines the common framework within which the states can pass their own legislation (Art. 75 GG). A summary of the legislative authorities that differ from the general principal that assigns competence to the states is provided in Table 4.1. Importantly, recent reform (September 2006) has changed the relationship between *Länder* and the federal level with respect to legislative authority.

Table 4.1. **Legislative authority in Germany apart from the general principle of giving competence to the states (until 31 August 2006)**

Type	Conditions for application	Areas of application (examples)
Exclusive to the Federation (Art. 71 GG).	List enumerated in Article 73	• Foreign affairs, defence • Citizenship • Freedom of movement, passport matters, immigration, emigration • Currency, money, weights, measures • Unity of customs and trading area • Air transport • Traffic of railroads • Postal affairs
Concurrent Legislation (Art. 72 GG).	"Federation has legislative authority if and insofar as the establishment of equal living conditions … or the preservation of legal and economic unity necessitates …"; List enumerated in Article 74.	• Civil law, criminal law and execution of sentences, judicial organisation • Registration of births, deaths, marriages • Association and assembly • Residence, settlement of aliens • Weapons, explosives • Public welfare • Economic matters Nuclear energy for peaceful purposes • Labour law • Educational and training grants
Framework Legislation (until 31 August 2006) (Art. 75 GG).	The federal level defines the common framework within which the states can pass their own legislation.	• Legal status of persons in public service • Principles governing higher education • Legal status of the press • Hunting, nature conservation, landscape management • Land distribution; regional planning, management of water resources • Registration of residence/domicile and identity cards • Protection of transfer of items of German culture to foreign countries

Source: German constitution.

2.2. Legislative competence at different levels of government

Despite the fact that the starting point of legislative competence is the states, in the German version of federalism, legislative competence is overwhelmingly allocated to the federal level, whereas the states are responsible for the implementation of legislation; *i.e.*, carrying the administrative burden. This system is called "executive" or "administrative federalism". The term "executive federalism" refers to the role of the states in the implementation of existing legislation. Here, the states function as executors of federal legislation (see Table 4.2 below). In order to be passed, however, many laws need the consent of the chamber representing the states (the *Bundesrat*). In fact, it is rather a common political practice that the Federation and the *Länder* support each other in the fulfilment of their

Table 4.2. **Implementation of federal legislation in Germany apart from the general principle that states execute federal statutes as matters of their own concern (until 31 August 2006)**

Type	Description	Examples
State Execution With Federal Supervision (Art. 84).	• States provide for establishment of requisite authorities and the regulation of administrative procedures unless otherwise provided by federal legislator (but the Bundesrat needs to consent). • The federal government may issue general administrative rules (but the Bundesrat needs to consent). • Federal supervision covers lawfulness of execution.	• Social and youth welfare • Protection of the environment (as far as in federal legislation) • Urban redevelopment
State Execution as Federal Agency (Art. 85).	• Establishment of requisite authorities remains concern of the states unless otherwise provided. • The federal government may issue general administrative rules (but the Bundesrat needs to consent). • States are subject to instructions of federal authorities. • Federal supervision covers both lawfulness and appropriateness of execution	• Federal highways • Federal motorways • Air traffic administration
Direct Federal Administration (Art. 86).	• The federal government may issue general administrative rules in cases where it executes laws through its own administrative authorities or through federal corporations or institutions established under public law.	• Foreign service • Federal finance administration • Administration of federal waterways • Federal border guard • Central offices for police information • Armed forces • Aviation • Railroads

Source: German Constitution

respective tasks, to agree on terms and to find a consensus before taking decisions. With respect to taxes, according to the constitution, states do not have at their disposition the competence to levy substantial taxes. Their competences are confined to the levying of rather marginal local consumption and expense taxes like the beverage tax, the dog tax, the hunting tax, and the entertainment tax (Art. 105, sec. 2a GG). All federal tax laws concerning taxes whose revenue goes partly or entirely to the *Länder* or cities are decreed with the consensus of the Federal Assembly (*Bundesrat*).

2.3. Taxing authority and financial resource allocation at different levels of government

Although the power to tax is overwhelmingly allocated to the federal level, all three levels of the federal structure have a right to their own sources of income in order to ensure a certain financial autonomy (see Table 4.3). In Germany, a distinction is made between a "separation system" (*Trennsystem*) and a "connex system" (*Verbundsystem*). The proceeds of taxes that belong to the former are allocated to one single level of the federal system, whereas various levels share in the proceeds of the latter (these are also called joint taxes). Materially, the connex system is more important than the separation system as some 70% of total tax receipts of the state fall into this category.[2]

The most important instrument for allocating the financial resources to states is the "state financial equalisation scheme" (*Länderfinanzausgleich*). In the past, the rules of this scheme have changed frequently. The equalisation scheme is organised as a four-step procedure: In the first step ("primary equalisation"), the proceeds of all taxes to which states have an exclusive right as well as their share of the individual and corporate income taxes is distributed according to the principle of local tax revenue (Art. 107, sec. 1,

Table 4.3. **Overview of revenues and tasks by level of government**

Federal level	16 states	439 districts and approximately 14 000 municipalities
Revenues 2001 (In EUR billion)		
• 79.3 from federal taxes (gasoline tax, tobacco tax, etc.) • 146.5 from common taxes (income tax, value added tax)	• 1.6 from state taxes (car tax, tax on acquisition of real estate, etc.) • 138.1 from common taxes (income tax, value added tax)	• 34.4 from municipality taxes (real estate tax, trade tax, etc.) • 25.2 from common taxes (income tax, value added tax)
Grants of federal level to states and municipalities; trade tax apportioned from municipalities		Grants and subsidies of the states to the municipalities; trade tax apportioned from municipalities
Tasks financed		
• Social Security (primarily federal subsidies for pensions and unemployment insurance) • Defence • Foreign policy • Traffic • Regional economic development • Large research organisations	• Schools • Universities • Police • Administration of justice • Health • Culture • Apartment construction support • Tax administration	• Water and energy supply • Removal of refuse, sewerage • Social aid • Construction permits • Registration • Kindergarten • Construction of schools • Public parks, public transportation
Tasks assigned by the federal level, joint tasks according to Articles 91 and 104 GG		Obligatory tasks executed upon instruction and administration by commission

Source: Bundesministerium der Finanzen (2001).

sentence 1 GG).[3] The primary equalisation is refined by way of a secondary equalisation, which consists of three further steps:

- At least 75% of the state share of value added tax receipts is distributed on the basis of state population size. Up to 25% is distributed to financially weak states (called "supplementary shares") in order to lift their share to be closer to the average of all states.
- The next step is often called "equalisation scheme proper" and its purpose is to lead to an "approximation of living conditions" among states (Art. 107, sec. 2, sentence 1 GG), which means that financially strong states subsidise financially weak ones. The financial position of states is measured on the basis of both their revenue capacity and their financial needs.
- The last step consists of additional payments by the central government to weak states called "federal complementary assignments" (Art. 107, sec. 2, sentence 3 GG).

Although constitutionally the local authorities are not an autonomous third level of the federal structure but belong to the states, the constitution assigns to them a relatively important role in the administrative structure of the states. On top of the taxes that they receive from the separation system, the states are obliged to let municipalities participate in the joint taxes (obligatory tax compound). In addition, the states can let the municipalities participate in the proceeds of the state taxes (facultative tax compound). In fact, the states have a broad range of discretion in their decision regarding the extent to which they let the municipalities participate in the proceeds. Here, the main instrument is the municipal financial equalisation scheme.

In summary, there are important inter-dependencies between both the federal level and the states and between the states and the municipalities. These inter-dependencies cover the financial equalisation scheme and the joint tasks, as well as a rather elaborate system of vertical assignments.

2.4. Federalism reform

Before discussing how these central tenets of German federalism can be described using the concepts of contract theory, it is important to point that changes have taken place in search of a new balance between federalist and co-operative elements under the heading of "federalism reform". The most important critique concerning the allocation of tasks in the German version of federalism was that there was no institutional congruence.[4] In other words, those paying for the provision of goods, those consuming them, and those deciding upon their provision were not necessarily similar. Another prominent critique was that German-style federalism does not allow a substantial degree of competition between states. These, and other, critiques have had implications for the relations between the federal and state

governments, and thus for contract-type relationships. The federalism reform process resulted in an extensive reform of the Constitution (in force since 1 September 2006). As this reform is not considered in this analysis, it will be important to monitor the evolution of the further federalism reform process in order to know if and how contract-type relationships in Germany change over time.

3. Regional policy and the use of contracts among levels of government

As already mentioned in the introduction, there is no explicit contracting among levels of government in Germany.[5] Similar to the basic principle of legislative competence, where the starting point is that the competence is with the states, the constitution posits that it is basically the states that are to carry out federal statutes as matters of their own concern (Art. 83 GG). Yet, also similar to legislative competence, there are many exceptions to this basic principle that could be interpreted within the framework of contract theory. The following institutional arrangements deserve to be mentioned explicitly: joint tasks (*Gemeinschaftsaufgaben*; Art. 91 and 104 GG), competitive tenders, and various arrangements not based on financial contributions.

Some aspects of regional development policy in the narrow sense (*i.e.*, regional policy besides the fiscal equalisation schemes) are organised as a joint task in Germany. While the primary responsibility for regional development lies with the Lander, their districts, and their municipalities (Articles 30 and 28 GG, respectively), specific areas of "regional development policy" described in the constitution are jointly administered by the federal government and the *Länder*. Joint tasks are the basic instrument for safeguarding a co-ordinated regional policy and avoiding excessive competition among *Länder* in Germany. In fact, the central government has co-operated with the *Länder* in the field of regional policy within the "Joint Task for the Improvement of Regional Economic Structures" (*Gemeinschaftsaufgabe Verbesserung der regionalen Wirtschaftsstruktur*, GA) since 1969. In this case, each *Länder* and the central government co-operatively define a framework agreement for regional programmes, which is implemented by the sub-national level but jointly financed (50/50).

While the GA provides a specific framework for regional policy, the case studies here examine the concept of joint tasks more broadly and interpret them using the contracts framework put forward in this report. According to the constitution, the traditional rationale provided for joint tasks is that some tasks are associated with substantial spillover effects (*e.g.*, improving regional economic infrastructure), thus implying that states will have incentives to supply them in suboptimal quantities. For such a co-ordination context,

institutionalised bargaining structures (co-decision) would be adequate (Art. 91 GG). A second rationale for joint tasks according to Article 104 is the vertical inter-dependencies between levels of government that make it necessary to provide earmarked grants or special support programmes (*e.g.*, the urban development programme). State execution of federal laws as agents of the central government ("execution as a federal agency") can also be subsumed under these joint tasks in a non-juridical sense. One example is the issuing of passports by the municipalities.

In addition to joint tasks, in recent years the federal and state governments have made use of a competitive tender process to promote regional innovation and growth. Examples include the BioRegio and InnoRegio programmes as well as the programme City 2030. Single regions had the right to compete for national funding and the most promising proposals were then selected and supported financially. A more complete description of the competitive tenders process follows in the next section.

Finally, the federal and state governments co-operate in ways that extend beyond fiscal relationships. One example of non-fiscal inter-dependencies is regional planning (*Raumordnung*) that functions according to the "counter flow principle". This basically means that a combination of top-down and bottom-up elements is used: the top level announces some requirements and the bottom level publishes its necessities, makes proposals, and provides information. In terms of contract theory, this would be characterised as a specific form of co-decision. Regional planning is assumed to be highly complex with a high degree of vertical inter-dependence. Over the last few years, some attempts have been made by the states to induce subordinate infra-regional units to co-operate more closely. These attempts have been based on a variety of incentives; the law on congested urban areas in the state of Hessen (*Ballungsraumgesetz*) is one of them.[6] The municipalities are asked to create special purpose associations by a certain deadline. If they let the deadline pass without having created such an association, they are subject to enforced co-operation from above.

As no discussion of contracts is complete without mention of enforcement, it is important to point out that in Germany it is the Supreme Audit Courts (both the federal one as well as the state ones) that supervise tasks completed in an economic fashion. But over the last few years, extensive evaluation procedures have been used ever more frequently. There are few policy areas that have not been evaluated (examples include the promotion of urban as well as regional planning, technology and innovation centres, the promotion of labour markets). This is particularly true for fixed-term support programmes, which are regularly evaluated by external experts.

In the next section, three case studies regarding the use of contracts are presented. These are chosen from policy areas that are dominantly structured in one typical mode on the one hand (the first two cases), or are especially innovative on the other (the last case). They are:

- "Joint tasks" proper (Art. 91a and b GG);
- "Joint tasks" more widely conceived (Art. 104a GG); and
- The InnoRegio programme, as an innovative example for the allocation of regional policy resources by way of a tender.

4. Case studies

4.1. Joint tasks proper

While the fiscal equalisation schemes can be considered as the most important single instrument of German co-operative federalism, there are a number of areas in which the linkage between the various government levels is strong. These are the joint tasks. According to Articles 91a and 91b of the constitution, the joint tasks are:

- improvement of regional economic infrastructure;
- improvement of agrarian structure and the protection of the coasts; and
- assessment through international comparison and reporting of the performance of the education system.[7]

In policy areas that are commonly assigned, the federal government not only participates in their financing, but also in the common framework planning (which is co-ordinated by a planning committee made up of representatives of both the federal and the state level) and hence influences the results. Based on the constitution, every common assignment is codified by way of a law that is passed with the consent of the second chamber of Parliament, the *Bundesrat*.

The anchoring of the joint tasks in law is one of the core components of the basic finance reform of the year 1969. It was the aim of this reform to reflect in the constitution the ways in which the two levels of government had been co-operating for a long time. The reform aimed to clarify financial competences and to make the system of mixed financing more transparent. Until 1969, the financial relationships between the federal and the state levels were based on the "National Budget Order" dating back to 1922 which was founded on a system of separate taxes. Together with the law in support of stability and growth enacted in 1967, the reform of 1969 produced a number of changes. Among them were: 1) the creation of a financial planning committee headed by the federal minister of finance which issues recommendations for a better co-ordination regarding the financial planning of the federal, the state, and the communal levels; 2) the fixing of the "general economic

equilibrium" as a basic principle for the budgetary behaviour of both the federal and the state governments; 3) the codifying of the joint tasks in the constitution; and 4) the transition from a pure system of separate taxes to a mixed system consisting of both connected and separate taxes.

According to the constitution, there are certain conditions under which the federal government co-operates with the states in executing tasks that basically fall into the area of competence of the states "if these tasks are relevant for the entire society and the participation of the federal level is necessary to improve living conditions" (Art. 91a, sec. 1 GG). This is the most intensive form of co-operation under the German Constitution. It obliges both the federal and the state governments to jointly plan, determine, and finance these tasks. The federal level secures exactly half of the costs in the areas of agrarian structure and at least half of the costs for the protection of coasts (Art. 91a, sec. 4 GG until 31 August 2006). The same distribution criteria are applied to all *Länder*.

The laws regarding the implementation of joint tasks also provide for the preparation of framework plans to be prepared by planning committees. These committees are composed of the federal minister of finance, the respective ministers of the states, and headed by the respective federal minister. Every state has one vote at its disposal and the federal government 16 votes. Traditionally, the members have attempted to decide consensually or at least with a low number of opposing votes. The decision rule is at least three-fourths majority. The planning committee is noteworthy because the federal and the state level meet on an equal footing. It is an arena where states can pursue their specific interests by interacting directly with the federal government.

As a consequence of the way in which joint tasks are developed and approved, there is a loss of authority by Parliament. The planning committee first informs the federal and the state executives of the framework plan that it has passed. The executives are required to transfer the indicators directly into their projected annual budgets. In principle, the parliaments have the right to refute the various positions in the budget but this is done rarely.

On the other hand, the influence of the federal government with regard to joint tasks is not as important as could be expected if one looks at the financial share secured by the federal government or at the leverage the federal government has in the planning process. With regard to the latter, during the planning process the federal government is the only actor that can claim to represent "the common interest" but the federal level is usually not able to dominate the states. This is because the federal government does not have at its disposal a monitoring and supervising right (*Aufsichtsrecht*) or a policy-making competence (*Richtlinienkompetenz*). In their deliberations, the

planning committees depend on information from the states such that the actual competence of the federal level is severely restricted.

4.1.1. Voluntary co-operation

Whereas Article 91a of the constitution describes obligatory joint tasks, Article 91b describes voluntary co-operation: "The federation and the states can, on the basis of agreements, co-operate in the fields of education planning and the advancement of organisations and projects of scientific research that is relevant beyond the regions. The sharing of the costs is regulated via a respective agreement." This passage was introduced into the German Constitution in 1969. Similar to the other provisions just discussed, its implementation served to codify practices already underway. This allowed the federal level to participate in the cost-intensive area of education planning. The "Federal-State-Commission for Education Planning" (*Bund-Länder-Kommission für Bildungsplanung,* BLK) is a permanent discussion forum for all questions regarding the education system and the advancement of the sciences that touch equally upon federal and state interests. The commission's aim is to secure a certain degree of homogeneity in the development of the education system, but also to initiate model reforms. The reports and suggestions of the commission should be taken into account by the governments in their education policies. They are, however, legally binding only for those state governments that have previously agreed to them. An obligation to conform does not exist.

The framework co-operation between the federal level and the states concerning the joint advancement of research regulates the co-operation between the two levels, in particular with regard to the financing of scientific research (Art. 91b GG). Due to the nationwide relevance of academic research, the federal level participates in the execution of tasks assigned to the states. The co-operation extends *inter alia* to organisations such as the German Research Society (*Deutsche Forschungsgemeinschaft,* DFG), the Max-Planck-Society for the Advancement of Sciences, the Fraunhofer-Society, and other science organisations whose importance extends beyond the regions and whose financial needs exceed the financial strength of the states in which they are located.

4.2. Joint tasks more widely conceived

In addition to the joint tasks just described, there are joint tasks more widely conceived according to Article 104a of the constitution. In both types of joint tasks, the financial obligations and the possibilities to influence policies are divided between the federal level and the states in such a way that the federal government transfers earmarked grants and influences the decisions concerning how the respective good is provided. Most of the transfers,

approximately EUR 60 billion yearly fit this description. The federal level participates in the financing of the following tasks, which states are responsible for administering:

- With regard to the state execution as federal agency (*Bundesauftragsverwaltung*), such as administration of the federal highways and other federal roads, the federal government bears those costs that accrue as a direct consequence of the fulfilment of the task. However, it does not bear the indirect costs that accrue to the states as a result of administering these tasks.
- The federal government may bear all or some of the direct costs of laws that provide for monetary payments to private or public recipients such as apartment subsidies or the support of education (Art. 104a, sec. 3 GG). With regard to apartment subsidies, for example, the federal level bears half of the costs and with regard to education support it bears 65% of the direct costs. If a law proposes that states bear more than 25% of the costs, the law will need the consent of the *Bundesrat* in order to be passed (until 31 August 2006).
- In addition, the federal level has the option to participate in particularly important investments of the states or the municipalities ("investment help competence", Art. 104a, sec. 4 GG until 31 August 2006). This financial assistance can only be granted for specific purposes: to prevent disturbance of the "overall economic equilibrium", to compensate for different economic capacities, and to promote economic growth. The specific conditions and the procedure used to determine the size of the support are to be regulated in a federal law (passed with the consent of the *Bundesrat*) or on the basis of the annual federal budget law in an administrative agreement. (It is important to note that in the course of federalism reform, the financial aid/support was partly abolished (aid for promotion of house building and financing of city transportation routes) and tightened through the conditions of the new Article 104b of the constitution. In the future, financial aid/support will only be accorded temporarily and their use will be controlled regularly. Moreover, in the future, the Bund can not promote any area/field where the *Länder* have the exclusive legislative competence.)

The planning autonomy for investments in cases of Art. 104a, sec. 4 GG (until 31 August 2006) rests entirely with the states. They decide whether or not there will be an investment programme supported by the federal government in their territory. This means that the execution of investment programmes depends on the registration of suitable projects by states with the federal government, but without the federal government having the possibility to select individual projects by discretion. The federal government may only exclude entire projects from being supported if they do not meet standards or are not suitable to reach the respective task. This competence is

relevant with regard to social apartment construction, urban development programmes, the improvement of traffic conditions in the municipalities (public transportation and communal road construction), and in particular to the investment support programmes for states that joined the federation in 1990.

German federalism has been described as "executive federalism" meaning that the federal level passes new legislation, which will then be implemented by both the states and the municipalities. This means that new tasks can be defined by the federal level which will lead to additional expenditures on the state and the municipal levels. There are two "pure" ways to deal with this issue. On the one hand, one could oblige the federal level to pay for all subsequent expenditures (*Veranlassungskonnexität*), on the other, one could make states and municipalities pay (*Ausführungskonnexität*). This is a classical principal agent situation. The efficient solution would in principle be to let the states and the municipalities pay because that will create incentives to provide the respective goods in a cost-efficient way (see Huber/ Lichtblau, 1999). However, Article 104a, Section 2 of the constitution deviates from the general rule of *Ausführungskonnexität* and thus from contract theory. Rather, the ever higher number of tasks that the federal level assigns to the lower levels within executive federalism ought to be dealt with by increasing the tax share allocated to these levels.

While this increase of the tax share regularly takes place in the relationship between the 16 states and the federal level (with regard to the value added tax), it generates bigger problems in the relationship between the states and the local level (see for example Art. 83 sec. 3 of the Constitution of Bavaria). The budget of the municipalities has to be confirmed by their states. If a state does not accept the budget plan submitted by the municipalities, the latter have to change it until the state authorities accept it. This is frequently the case. In the extreme case that a municipality refuses to obey to the state obligations, the state has the legal right to change the local mayor by a "state prefect". A stronger legal position of the local level could lead to the usage of explicit contracts, as the following case of Hessen shows.

In 1991, the principle of "fiscal equivalence" was introduced into the Constitution of Hessen by way of a referendum (for more information about fiscal equivalence see Nivola, 2003). This changed made it problematic for the state level to delegate tasks without fiscal compensation. As a result of this constitutional change and the new bargaining power acquired by the local authorities, the state of Hessen now relies on suggestions rather than on binding obligations when assigning new tasks to the municipalities. In turn, the state hopes to prevent the municipalities from bringing a legal suit against the state in the Constitutional Court of Hessen for not complying with the principle of fiscal equivalence. With regard to social policies (*e.g.*, social aid for

the prevention of violence, the prevention of drug abuse, ambulant medical care of the handicapped, etc.), Hessen has gone even further. In a framework agreement entitled "Principles for a new structure and the communalisation of the support of social help programs in Hessen", concluded between the state of Hessen and local authorities, the budgetary autonomy of the communal level has been significantly strengthened. Instead of assigning binding obligations and asking for detailed accounting, the state now prefers to enter into agreements of objectives. This seems to be a direct consequence of the state's realisation that the tasks are quite complex and that knowledge, which is only locally available, can be better mobilised with this new institutional arrangement. The state and the non-state actors at the communal level have an incentive to increase efficiency as they are the residual claimants in these incomplete contracts.

4.3. Competitive tenders

In addition to the more traditional support instruments, a number of innovative programmes were created over the last few years. At the federal level, a number of competitive tenders, such as the BioRegio, InnoRegio, City 2030, and the Learning Region were created. The core idea of these programmes is the linking of regional actors, which is expected to unleash regional competences and capabilities, to bundle, and to consolidate them. The InnoRegio programme is offered as an example of the allocation of regional policy resources by way of a competitive tender.

The InnoRegio Competition was started in 1999, with a projected end date of 2006. The main goal of the programme was to improve the innovative potential of regions. Regionally, the programme is geared towards the eastern part of the country. Whereas the BioRegio competition aims to promote growth in a specific industry which is seen as key for the future, the InnoRegio Competition aims at disseminating regional innovation potential which can vary from region to region. The concept is based on the assumption that innovative potential will be applied to a greater extent if regional actors such as entrepreneurs, politicians, associations, chambers of commerce, research institutes and others interact within a network. The hope is that this more intense communication will also produce greater research and development which should, in turn, lead to an improvement of the innovative potential and to a faster dissemination of innovation.

The implementation of the programme is divided into a qualification phase, a development phase, and an execution phase. Since the inception of the programme in 1999, 444 highly heterogeneous projects have applied for support within the qualification phase. The applicants had to identify and to demonstrate the innovative potential of their regions, the potential gains that membership in the programme would have for their region, and to develop a

concept of how further measures could be implemented in their region. An independent jury selected 25 areas that participated in the development phase. The most important criteria for being selected were the level of innovation, the quality of co-operation networks that are believed to enhance innovation, and the potential gain for the region. Each of these 25 selected areas was awarded a prize of EUR 150 000 which was to be used to produce a detailed plan of how the various instruments could be implemented in the third phase. Before entering into the third phase, the jury gave recommendations to applicants concerning the entry into the third phase based on additional criteria. The following aspects played some role:

- innovativeness of the approach;
- relevance for the competitiveness and the employment situation in the region;
- dynamic potential of the project for the region (lifting of innovation barriers);
- specific value added of the project for the region;
- sustainability of the development induced by the project in the region;
- plausibility and implementability of the project;
- quality of the cooperation;
- level and intensity of network;
- participation of relevant actors;
- own effort of the region; and
- transferability of the approach to other regions.

A total of EUR 255.6 million was made available for selected projects. In the end, 23 areas were selected for monetary support, most of them from the eastern part of the country. Many of the projects that were not selected for financial support were carried on nevertheless. Preliminary evaluation reports already stress the success of the programme (Bauer, 2002; Hornschild, *et al*., 2005). According to these reports, the InnoRegio Competition has led to an improvement in "soft factors". The majority of the firms and research institutes that participate in the programme say that the programme has enabled them to establish important contacts with actors in the region to which they did not have contact prior to the competition. These contacts can be important for suppliers or buyers of products, but also for co-operation partners in innovation projects. Additionally, the financial support paid in the execution phase has enabled some small and medium size enterprises to begin their own R&D activities for the first time. However, the participating actors criticise the administrative burden and the high technical threshold that has to be mastered before programmes are accepted as worthy of financial support.

The InnoRegio programme is clearly used as a tool for learning. While the programme itself has all the characteristics of a relational contract there is no explicit contract in the narrow sense. A large part of the learning effect is caused by the bidding process and it seems that the German government plans to extend this tool for regional development programmes in the future. Until now, extending the schemes beyond the pioneer regions in which the competitive tender process has been tried successfully has not been discussed.

5. Conclusions

Regional development policy in the narrow sense (excluding the fiscal equalisation scheme) is organised as a joint task according to Article 91a of the German Constitution. It is assumed that these are complex tasks with important vertical inter-dependencies, which implies that institutionalised bargaining structures (co-decision) would be adequate. The "negotiation" between the regions and the centre takes place in institutionalised planning committees consisting of the federal finance minister and the respective ministers of the states. Regional specificities are taken into account in these negotiations, but it ought to be asked whether contracts between the federal level and single states would be an additional co-ordination tool to the co-decision framework in which, traditionally, the members have always attempted to decide consensually or at least with a low number of opposing votes. Transaction costs would be lower in bilateral negotiations.

Until now, even with direct administrative assignments that would allow the actors to get close to instituting complete contracts, setting a contract for these tasks has rarely been chosen. A new way of thinking about these issues has emerged slowly. This was shown with the "Principles of re-structuring and communalisation of social help support in the state of Hessen". This framework agreement can be interpreted as an incomplete contract in which goals are agreed upon that might develop into a complete contract over time. The state of Hessen is partially forced into such agreements due to the introduction of the principle of fiscal equivalence in the state Constitution in 1991. At least with regard to the state-municipality relationship, the strengthening of the legal position of local authorities seems to be a necessary condition for allowing the usage of contracts.

For co-operation contexts in which all actors have little knowledge, competitive tenders have been established in Germany. According to the evaluations hitherto published, the experiences have been very positive. Competitive tenders seem to be a promising learning tool, although the costs of the tenders themselves are substantial. Unfortunately, a great deal of the focus of programmes like the InnoRegio programme has been the competition

for federal support (a showcase of administrative capabilities) rather than on the diffusion of "best practices" that are not region-specific (a showcase of outcomes and ideas). In this case, elements of contracting could be useful to reorient the program. Specifically, by incorporating evaluation of outcomes into a monitoring/enforcement mechanism, emphasis would shift from process (the ability to apply and receive a grant) to outcomes and thus to best practice. The central government could, in turn, use the information learned in contracts with other areas.

In summary, the following policy advice follows from this country study:

- Some of the vertical inter-dependencies are "endogenous" to the German constitution. When discussing options to optimise the delegation of competences on the basis of contract theory, a more radical question should therefore always be kept in mind, namely whether an outright decentralisation of tasks would not be a superior alternative. With regard to the German discussion, this could also be called *Politikentflechtung* (reduction of inter-dependence between the three levels).
- To address the remaining inter-dependencies, the development of contractual practices could be a useful (additional) co-ordination tool. The joint tasks, as a consensual regional development framework (of all 16 states and the federal level) could be enriched by bilateral contracts between than federal level and single states. This might be efficiency-enhancing due to lower transaction costs. When competitive bids are used in regional policy to identify best practices, contracts can be implemented to extend successful experiences from the pioneer regions to other regions. With regard to the multi-governance between states and municipalities, the improvement of the legal position of the municipalities like in Hessen might be a good way to force the states to rely more on incomplete contracts when delegating tasks.
- Finally, it is important to recall that the relationships between the central government, states, and localities evolve over time. Discussions regarding federalism reform are an important part of the current policy debate. As such, it will be important to monitor the further reform process in order to know if and how contract-type relationships in Germany change over time.

Notes

1. This chapter draws on the contributions of Stefan Voigt, Department of Management and Economics, University of Marburg and Lorenz Blume, Department of Economics, University of Kassel.
2. Many observers believe that the separation system should become more relevant again. One, rather radical option, would be to allocate the proceeds of the value added tax to the federal level and the proceeds of the income tax to the states.

3. This principle is, however, not rigorously enforced as different principles apply to the corporate income tax (the *Betriebsstättenprinzip*) and the income tax (the *Wohnsitzprinzip*).
4. Renzsch (2000) writes: "An institutional congruence, the convergence of initiating, executing and financing of a state task is, with regard to domestic policy, rather the exception than the rule" (translation).
5. One of the few exceptions is a contract between the state North Rhine-Westphalia and the federal level on financing the Metrorapid. Another example, which does not exactly refer to the relationship between two state levels, is the "university pact" in the state of Hessen. This is a contract between the state and its universities which includes a large number of agreements on land consolidation objectives. A system of indicators is used to distribute resources to the universities that are free to decide upon their concrete use.
6. The law promises to reward local authorities that have implemented a successful regional co-operation. All remarks concerning law and politics of the state Hessen could not improved by the Federal Ministry of Economics and Technology.
7. In the course of the federalism reform, the previous common task "planning of education" was replaced by a new common task to "assess through international comparison and to report the performance of the education system". The joint task for promotion of research has been modified. Bund and Länder still share the competency to promote institutions and projects of non-university research. At universities they can now collaborate in the fields of academic and research projects and institutions.

Bibliography

Bauer, B. (2002), *InnoRegio Reportage 2002*, BMBF, Berlin.

Bull, P. (1999), "Finanzausgleich im Wettbewerbsstaat, Bemerkungen zur neuen Föderalismustheorie und zu ihrer Bedeutung für den Länderfinanzausgleich", *Die Öffentliche Verwaltung*, Vol. 52/7, pp. 269-281.

Bundesministerium der Finanzen (2001), *Das System der öffentlichen Haushalte*, Berlin.

Frey, R.L. (2005), "Spatial Challenges of Federal Systems: A German or an International Problem?", in G. Färber and N. Otter (eds.), *Spatial Aspects of Federal Systems*, Speyer, pp. 1-18.

Gunlicks, A. (2003), *The Länder and German Federalism*, Manchester University Press, Manchester, New York.

Hesse, J.J. (2000), "Die bundesstaatliche Ordnung als Strukturprinzip und Gestaltungsaufgabe: Zur Parallelität der deutschen und europäischen Föderalismusdiskussion", in T. Büttner (ed.), *Finanzverfassung und Föderalismus in Deutschland und Europa*, Baden-Baden, pp. 9-38.

Hornschild, K. *et al*. (2005), *Das BMVF-Förderprogramm InnoRegio, Ergebnisse der Begleitforschung*, Deutsches Institut für Wirtschaftsforschung, Berlin, Bonn.

Huber, B. (2005), "Länderfinanzen", in Handwörterbuch der Raumordnung (ed.), Akademie für Raumforschung und Landesplanung, Hannover, pp. 543-551.

Huber, B. and K. Lichtblau (1999), "Reform der deutschen Finanzverfassung – die Rolle des Konnexitätsprinzips", *Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik*, Vol. 44, pp. 69-93.

Mückl, S. (1998), *Finanzverfassungsrechtlicher Schutz der kommunalen Selbstverwaltung*, Stuttgart.

Nivolva, P.S. (2003), "Fiscal Milestones on the Cities: Reusing the Problem of Federal Mandates", The Brookings Institution, Policy Brief No. 122, August.

Peffekoven, R. (1994), "Reform des Finanzausgleichs – eine vertane Chance", *Finanzarchiv*, Vol. 51, pp. 281-311.

Renzsch, W. (2000), "Reform der Finanzverfassung zwischen ökonomischer Effizienz, bundesstaatlicher Funktionalität und politischer Legitimität", in T. Büttner (ed.), *Finanzverfassung und Föderalismus in Deutschland und Europa*, Baden-Baden, pp. 39-60.

Rosenfeld, M.T.W. (1999), "Mehr Eigenverantwortung durch Entflechtung?", in C. Hüttig and F. Nägele (ed.), *Verflochten und verschuldet. Zum (finanz-)politischen Reformbedarf des deutschen Föderalismus in Europa*, Loccum, pp. 244-270.

Scharpf, F.W., B. Reissert and F. Schnabel (1976), *Politikverflechtung: Theorie und Empirie des kooperativen Föderalismus in der Bundesrepublik Deutschland*, Kronberg.

Scharpf, F.W. (1988), "The Joint-Decision Trap: Lessons from German Federalism and European Integration", *Public Administration*, Vol. 66, pp. 239-278.

Schwarting, G. (2001), *Der kommunale Haushalt. Haushaltswirtschaft – Haushaltssteuerung – Kassen- und Rechnungswesen*, Berlin.

Umbach, M. (ed.) (2002), *German Federalism: Past, Present, Future*, Palgrave, Houndmills, Basingstoke.

Wild, K.-P. and M. Pfeifer (1988), "Institutionen und Organisationen der regionalen Wirtschaftsförderung – Stellung und Aufgaben der Länder", in H. Karl (ed.), *Handwörterbuch der regionalen Wirtschaftsförderung*, Lfg. 27, Köln.

Wissenschaftsrat Secretariat (2006), "The Wissenschaftsrat", Cologne, May, available at *www.wissenschaftsrat.de/texte/WR-Englisch.pdf*.

ISBN 978-92-64-00873-1
Linking Regions and Central Governments
Contracts for Regional Development

Chapter 5

The Case of Spain[1]

This chapter applies the analytic framework presented in Chapter 1 to the use of the Convenio de Colaboración *in Spain. The chapter begins with an overview of the decentralisation context, followed by a description of the contracting mechanism. Three detailed case studies demonstrate how the* Convenio de Colaboración *is applied in practice: the economic development of coal mining counties, the economic development of Teruel, and the control and management of the Synchrotron light laboratory. The chapter concludes with lessons learned from the Spanish case.*

1. Introduction

Over the last few decades Spain has undergone a process of decentralisation which transferred important powers from the central government to the regions, called Autonomous Communities (AC). While the early years of decentralisation were not characterised by co-operation between the layers of government, the tide has begun to change. In fact, the emergence of particular tools has facilitated the process of co-operation. These tools can be viewed in the context of inter-governmental contracts and are the subject of this case study. Specifically, after providing a general overview of Spanish federalism, the case study introduces the reader to the *Convenio de Colaboración*, a mechanism for collaborating between layers of government. Next, three examples illustrate how this contracting system is applied to regional development. The paper concludes with a discussion of lessons to be learned from the Spanish case and offers a set of recommendations.

2. The Spanish territorial organisation

2.1. Distribution of responsibilities

Strictly speaking, Spain does not qualify as a federal state. Article 2 of the Spanish Constitution declares the sovereignty and unity of the Spanish state and "recognises and guarantees the right to self-government of the nationalities and regions of which it is composed". However, Spain can be described as a politically decentralised country with three tiers of government (central, regional and local) in which the distribution of functions and the system of governance come very close to those of a federal state (see Moreno, 1997). Regional governments, called "Autonomous Communities" (ACs), have their own legislature and executive and thus possess state-like qualities. Moreover, the right of existence of ACs is derived not only from the Spanish Constitution but is also grounded in a basic law for each AC, called the "Statute of Autonomy".

Spain is comprised of 17 Autonomous Communities, which were established from 1978 to 1983. Today, the powers devolved to each one are very similar. However, this was not always the case. The ACs with a history of self-governance received all their responsibilities in the 1980s, while the rest of ACs received additional responsibilities (basically education and health) at the end of the 1990s. The Spanish Constitution specifies two different sets of

responsibilities. Article 148 specifies the responsibilities that may be adopted by the regions, while Article 149 specifies the responsibilities that are exclusive competence of the central government. Matters not enumerated in the constitution are the residual power of the central government as long as the region does not claim the competence in the "Statute of Autonomy". The constitution also specifies the intensity of responsibility on a continuum ranging from complete legislative and executive powers, to limited legislative but complete executive powers, to only executive powers.[2]

Table 5.1 presents the different responsibilities attributed to both tiers of government by the constitution. Note that, apart from these responsibilities,

Table 5.1. **Distribution of responsibilities between the central state and the ACs**

State	Autonomous Communities (AC)
S1) Exclusive legislative and executive competencies	AC1) Exclusive legislative and executive competencies
• Immigration and emigration • International affairs • Defence • Justice • Commercial, penal, labour, industrial and intellectual property and civil law (except matters regulated by traditional regional law) • Foreign trade • Monetary system, exchange regime, and state treasury and debt • Infrastructure of a national scope (*i.e.*, inter-regional roads, railroads and water transportation, and commercial ports and airports) • Sea fishing	• General organisation of self-government • Changes in municipal boundaries and creation of supra-municipal bodies • Land use planning and housing • Infrastructures of a regional scope (*i.e.*, intra-regional roads, railroads and water transportation, and non-commercial ports and airports) • Agriculture, forestry and river fishing • Domestic trade and fairs • Tourism • Culture (*i.e.*, museums, libraries, historical heritage, cultural promotion, etc.) and sports (*i.e.*, facilities and promotion) • Social services • Environmental policy • Other listed in the "Statute of Autonomy" and not included in S1
S2) Power to set basic legislation	AC2) Competencies subject to basic state legislation
• Banking and insurance activities • Health care • Social security • Education • Local self-government	• "Economic development within the national economic policy framework" • Other listed in the "Statute of Autonomy" but included in S.2 or S.3
S3) The central state also has the power for	AC3) In addition to this the ACs have competencies
• Co-ordinating and promoting scientific and technical research • "Setting the basis for and co-ordinating the general planning of economic activity" • "Guaranteeing the equality of all Spaniards in the exercise of their constitutional rights and duties"	• Any competence delegated by the state

Source: Spanish Constitution of 1978 and contributing author's elaboration.

the constitution (Article 150.2) also envisages the possibility of central government transfer or delegation of exclusive responsibilities. This requires a qualified majority in the national legislature and has been used to transfer new competences to the ACs. Although the constitution says the central government can specify the conditions of the delegation, these new responsibilities are usually attributed to the ACs without any special conditions.

2.2. Decentralisation process

The decentralisation process in Spain was very complex and difficult to manage administratively. Note that because the ACs were created from scratch, the very process of decentralisation demanded the co-operation of both layers of government. The national government and each AC had to bargain on the interpretation of the decentralised tasks and the physical and financial means related to implementing them. This bargaining procedure was institutionalised in bilateral co-operation forums (*Comisiones Mixtas de Valoraciones*). For each specific transfer of responsibilities an agreement (*Acuerdo de Traspaso*) was signed between the central government and the AC specifying the exact nature of the responsibility and the resources transferred. This process had to be bilateral because the decentralisation process was quite asymmetric, due both to the constitutional asymmetry in the level of competences and to bargaining delays and the difficulty in implementation, which resulted in a gradual approach. Although the process was not without problems, it was successful in decentralising a large amount of expenditures, personnel and assets in a short period of time.

In summary, the Spanish ACs have responsibilities in a wide range of policy areas: health care, education, social services, environment, housing, economic promotion, agriculture, tourism, etc. They have legislative competences in most of these areas, but the decisions of their parliaments are subject to the basic laws of the nation. As a result of decentralisation, the spending power of ACs is also considerable. This tier of government, created in the early 1980s, represented 42% of Spanish public expenditure in 2003 (excluding spending on pensions), as compared to the 41% for the central government and 17% for local governments. In addition, most of the funds received by the ACs are unconditional, so this spending is managed rather freely.

The transitory role of the transfer of some competences from the central government to the regions has to be underlined. The "autonomous agreements" were mainly used to transfer extra statutory competences to two regions (Canary islands and Comunidad Valenciana in 1982 and a larger set of regions in 1992) in order to reach the same assignment of competences as in Catalunya, Basque Country, Galicia and Andalusia, while waiting for a definitive transfer of competences due to statutory reform.

However, decentralisation in Spain is not without problems. For example, there is a general feeling by some ACs that, in some cases, the central government basic laws are too detailed, which limits the ability of ACs to develop substantial aspects of policy areas. Some ACs (especially Catalunya and the Basque Country) consider this behaviour to be an encroachment of the central government on regional competences. Moreover, the central government is starting to make use of its responsibility to guarantee social rights in order to pass new laws that impose spending mandates on the ACs in areas such as education, elder care, housing, etc. The ACs complaint about these "unfunded mandates" (requirements imposed on ACs by the central government with no corresponding financial assistance, which are based on Constitutional laws guaranteeing the basic equality of the citizens in the whole territory), have successfully forced the national government to partially finance the costs imposed by these laws. However, this procedure has also been criticised on the grounds that the central government is using its spending power to put strings on matters that are the exclusive competence of the ACs.

2.3. Financing arrangements

Spanish ACs are subject to two different financing regimes. On the one hand, there are the 15 ACs of the "common regime" whose services are financed by a mixture of taxes and tax-sharing arrangements and with an unconditional transfer with a strong equalisation component. The "common regime" financial system is devised by the central government but negotiated in a multilateral forum ("Council of Fiscal and Financial Policy"). On the other hand, the Basque Country and Navarra belong to the "foral regime". The constitution recognises a special status for these ACs on the basis of historical rights. Accordingly, both the Basque Country and Navarra collect all the taxes and then pay a quota to the central government to finance the services provided by the state to the citizens of these regions. The quota is negotiated bilaterally from time to time and, therefore, these two regions do not participate in the multilateral bargaining process. As a result of this separate procedure, these two ACs do not contribute to the equalisation fund and end up with a much higher level of resources per capita.

The ACs of the "common regime" have the following revenue sources: 1) own taxes, which are created by law of the AC but are restricted to tax domains not occupied by the central government and are, therefore, marginal in quantitative terms; 2) taxes ceded by the central government with full regional legal and collecting powers (*i.e.*, wealth tax, inheritance tax, wealth transmission tax); 3) a 33% share of the income tax, with substantial legal powers on the tax rates and deductions but without collecting responsibilities; 4) a 35% share of the VAT and excises, without any collecting responsibilities but with the possibility of placing a surcharge on gasoline taxes earmarked for

health financing; 5) an equalisation grant (called *Fondo de Suficiencia*) that covers the difference between estimated expenditure needs and resources obtained from items 1) to 4); 6) some specific transfers coming from national initiatives, from agreements between the central government and the ACs (*convenios*), or from regional policy funds, both at the European level (*e.g.*, FEDER, Cohesion Fund) and at the national level (*e.g.*, *Fondo de Compensación Interterritorial*); and 7) debt finance, which has been strongly restricted since 2001 (see, *e.g.*, Giorno and Joumard, 2005).

Until the beginning of the 1990s the degree of tax autonomy of "common regime" ACs was quite low. Beginning in 1994, the ACs were allowed to retain 15% of regional income tax revenues, but without the power to levy income tax. The amount increased most recently in 2001. Presently, the central government is considering a further increase in the tax share to 50% of income tax and 58% of VAT and excises. For the moment, the ACs have not used their power to modify the income tax rates, although they have introduced tax credits and deductions. The effect of these changes has been modest on average but substantial for some specific categories of taxpayers (Esteller and Durán, 2004). The central government is also considering the possibility of giving more tax powers on the excises and on the retail phase of the VAT to regions, although the latter option is subject to some problems which are both technical (no such a phase currently exists in Spain) and legal (it may be contrary to EU regulations). The equalisation grant is also currently under reform. Although expenditure needs were theoretically computed with objective data, the reality is that political considerations made the formula very redistributive during the 1980s and 1990s. The rich ACs (and specially Catalunya) claim that the equalisation grant mechanism is unfair and push to reform the system in the direction of a partial equalisation system like the German or Canadian schemes.

2.4. Conflict resolution and co-operation

The arbitrating role of the constitutional court is very important in Spain since the court has the capacity to resolve legal conflicts between the central government and the ACs, and conflicts between ACs. Most of the conflicts between the central government and the regions have been related to the delineation of the competences between one AC and the central government. The historically high degree of conflict experienced in the past is due to various factors: the vagueness of the constitution, the large proportion of concurrent and shared policy matters, and the existence of both centripetal (central government) and centrifugal forces (historical ACs) that try to influence the interpretation of the law. The constitutional court has decided in favour of the ACs as well as in favour of the central government. It has a great deal of authority and independence, due probably to the need for a compromise on the nomination of the candidates.

Clearly, during the last two decades, inter-governmental relations in Spain have been characterised by competition between layers of government. Some authors suggest that the Spanish system corresponds to the model of "dual" federalism (see, *e.g.*, Börzel, 2000), characterised by the institutional autonomy of the different layers of government. But the complex vertical distribution of powers, in combination with the permanent conflict with the historical ACs, has made the workings of the "dual" system very conflicted and dysfunctional. Since the mid-1990s things have improved a little with the promotion of new instruments for co-operation. In Spain there are both bilateral and multilateral co-operation forums. Bilateral forums (*Comisiones Mixtas*) are for bargaining between one AC and the central government on the transfers of financial resources and assets regarding concrete responsibilities. Multilateral forums (*Comisiones Sectoriales*, see MAP, 2002a) are for co-ordinating decision making on shared or concurrent policy areas. These multilateral forums were created by law in 1983 but remained largely ineffective through the mid-1990s because ACs remained sceptical regarding the motivations of the central government. Today there are 27 *Comisiones Sectoriales* and most are active. They meet various times a year, are chaired by the relevant State Minister, and all ACs Ministers usually attend.

The inception of this "co-operative federalism" in Spain is rooted in the past experience of conflict. Although it is true that the constitutional court has clarified many concerns, parties have learned that due to long delays in decision making and to the "relational capital" lost during the conflict, court imposed remedies should be a last resort. Moreover, the increasing lack of implementation capability of the central government (due to the transfers of assets and personnel) have made the central government more dependent on the executive powers of the ACs and, therefore, more prone to engage in co-operation.

3. Contracting between layers of government in Spain

This section is devoted to the analysis of contractual relations between central and regional levels. Contracts between central and local governments are also possible but scarce due to the low degree of overlapping responsibilities of these two layers of government. There is, however, widespread use of contracts between regional and local governments and between different local governments and with private partners, but this analysis focuses on the relationship between the central and regional governments.

3.1. "Convenios" as contracts

In addition to the permanent co-operation forums described previously, the central government and the ACs reach co-operative agreements to deal

with decision making regarding specific issues. The main type of agreement used is the *Convenio de Colaboración* (see MAP, 2002b). A *convenio* is a kind of contract that specifies the duties of the parties in developing a concrete activity or programme. Both parties, the central government and the AC, are free to decide if they wish to engage in this kind of contractual relationship. The regulation of *convenios* is very limited and only indicative of general rules of procedure (*Ley 30/1992 de Régimen Jurídico de las AAPP y del Procedimiento Administrativo Común*). Different legal types of *convenios* can be identified (see Table 5.2), but these categories are merely informative and help the parties to write concrete documents. However, *convenios* are legally binding contracts and the parties can rely on the courts for enforcement.

Table 5.2. **Legal types of *convenio***

Legal type	Description
Convenio	A document that specifies the duties of the parties in developing a concrete activity or programme
Protocolo general (also called *Convenio Marco*)	Similar to a *convenio* but it is very general and global; establishes the umbrella where the contractual relationship of the parties will evolve; further development is needed through the writing of additional contracts which specify the responsibilities of each party regarding the activities to be developed.
Convenio específico	Specifies and develops a *Protocolo general*
Acuerdos (also called *Addenda*)	Used to change some of the clauses specified in the contract: • Enlargement of the period of contracting (*Acuerdo de prórroga*) • Development of some aspects; *e.g.*, fixing the financial means (*Acuerdo de desarrollo*) • Change of elements of the contract (*Acuerdo de modificación*)

Source: MAP (2002b), *Los Convenios de Colaboración entre la Administración General del Estado y las Comunidades Autónomas*, Ministerio de Administraciones Públicas, Subdirección General de Cooperación Autonómica.

The number of *convenios* signed has increased enormously over time, from only 14 in 1980, to 116 in 1985, 209 in 1990, 285 in 1995, 461 in 2000 and approximately 800 in 2004 (as indicated by the "Registro Nacional de Convenios", Ministerio de Administraciones Públicas). The increased use of inter-governmental contracts during the 1990s is related to the reduction in inter-governmental conflict and to the impetus given to co-operation through multi-lateral forums, since many of the agreements reached in these forums are then operationalised through the signature of *convenios* with each of the participating ACs. These contracts can be new (60% in 2004) or the development, modification or enlargement of an existing one (*i.e.*, the *Acuerdos*, 40% in 2004). These *convenios* are used in most of the policy domains, with most signed in the areas of social assistance (26% of all *convenios* signed during 1980-2002), culture (13.5%), agriculture (8.5%) and public works (7.1%).

Most of *convenios* have a financial component (75% in 2004). This number is lower among new contracts (66%) and higher among *Acuerdos* (87%), reflecting the practice of not committing resources in the initial contract. The financial commitment of the national government is made, most of the time, in the form of inter-governmental transfers. However, in some cases it is also made by spending directly on some items or by providing personnel or assets. In 2002, the national government contributed an average of the 65% of the financial means to *convenios* while the ACs provided the 28%. The remaining funds were provided by local governments, the private sector, and the European Union (EU). While statistics indicate that the EU's share of financing to *convenios* via structural funds is low, the numbers can be misleading as the central government or the AC occasionally uses previously distributed EU structural funds to finance its share of the *convenio*.

Despite the high number of contracts signed each year, the amount of funds obtained by the ACs from *convenios* is rather small. In 2001, these resources represented just 2% of AC's overall revenue (both conditional and unconditional) and a 7% of conditional revenues (Ministerio de Economía y Hacienda, "Informe sobre la financiación de las CCAA", 2001). This is to be expected, however, since co-funding is only one of the purposes of these contracts. In fact, since cooperation is a broad concept, to judge the relevance of *convenios* only by their budgetary weight is not entirely fair.

Table 5.3 presents a typology of *convenios* elaborated by the Spanish central government (*Ministerio de Administraciones Públicas*). It demonstrates the types of matters dealt with by these contracts. As it will be shown, not all the relevant commitments are related to the funding of services. There are nine different types of *convenios* (see MAP, 2005). A brief description of the purposes and one example of each type are presented in the table.

3.2. Contract nature

The first characteristic of *convenios* that will be highlighted is its flexibility. Although *convenios* are not permanent agreements (the period of the contract is clearly specified in the text) many are renewed periodically, either by automatically extending the period or by signing a new contract. In any case, note that the legal typology of Table 5.2 allows for a very flexible and sustained contractual relationship, since contracts can be developed, enlarged and modified without the need of starting the process from scratch. In addition, when co-operation involves a very uncertain, complex and long-term project with one AC, the central government and the AC can create a permanent decision-making structure which may take the legal form of a *consorcio*, or a public corporation. Historically, *consorcios* have been reserved to organise the relationship with local governments (see, Font *et al*., 1999), but there are recent

Table 5.3. **Types of *convenio* with examples**

	Type of *convenio*	Example of *convenio*	Responsibility of national government (NG)	Responsibility of the Autonomous Community (AC)
(1)	Supply or exchange of information	Database on drug surveillance	Fund the service with EUR 117 618.	Distribute cards to doctors to be used to notify drug effects. Collect the data and introduce it into the database
(2)	National funding of services specific to one AC	Special education for gifted students	Fund the programme with EUR 36 010.	Develop a special programme for gifted students. Fund it with EUR 56 456.
(3)	National funding of services of all the ACs	Shelter, integration and education support to immigrants	Fund the programme with EUR 130 000 000. Distribute the quantity among ACs. Approve specific projects jointly with each AC.	Present specific projects to be co-funded and implement them
(4)	Supply of technical advice	Advice offices for firm creation	Supplies the technical design of the offices and the software that allows for the web management of all the permits required to create a firm. No financial commitment for the NG.	Create the offices and use them to inform and advise on firm creation. No concrete financial commitment in the agreement.
(5)	Management assignment	Technical works to identify vegetable varieties	Pay EUR 95 000 in exchange of the work. The NG is the owner of the information and can use it for its own purposes (*e.g.*, managing subsidies).	A specialised entity of the AC will perform the works needed to identify the species, varieties and geographical location.
(6)	Pooling of resources to fulfil common objectives	Health services for the military	The NG supplies some specialised treatments in the military hospitals to the general population.	The AC supplies general treatments to the military in AC's hospitals. The cost of these mutual services will be evaluated and neted out from time to time.
(7)	Transfer of assets	Cession of the use of part of buildings of the Monastery of San Jerónimo de Yuste	Cede the use of part of the buildings that belong to state during a period of ten years. No financial commitment.	No financial commitment. The buildings are ceded without rent.
(8)	Creation of an inter-governmental administrative forum	Creation of a joint customs office	Co-operate on the tasks necessary to create a unique procedure to declare imports and exports and pay the specific indirect tax of the Canary Islands. Participate in a bilateral commission and working groups. No financial commitments.	Co-operate on the tasks necessary to create this joint customs office. No financial commitments.
(9)	Creation of a common management entity	Consorcio Casa Árabe	Representation in the *Consorcio Casa Árabe* created to improve the relationship with the arabic and muslim world. Fund the *Consorcio* yearly; the contribution for 2005 is EUR 833 753.	Representation in the *Consorcio Casa Árabe* according to the rules of its Statute, included in an annex to the *convenio*.

Note: The *convenios* selected aim to be representative of those signed during 2005 in each of these categories in that they represent quite well the traits of the *convenios* included in each category. However, this does not mean that they are the most relevant qualitatively or quantitatively.

Source: MAP (2005), *Convenios de Colaboración autorizados durante 2005, Análisis de contenidos*, Ministerio de Administraciones Públicas, Subdirección General de Cooperación Autonómica, and own elaboration.

proposals of co-operation via *consorcios* with some ACs in areas of large scientific infrastructure, airport management and tax administration.

Therefore, it is not possible to say if *convenios* are in general complete or incomplete contracts, transactional or relational. The flexibility of its design, the possibility to tie successive contracts, and the possibility to use this instrument to create decision-making bodies, allows both for very simple transactional *convenios* which specify very concrete tasks to be performed and for a complex and evolving relationship that is defined in a series of contracts, or that is institutionalised with the creation of a *consorcio*. As will be illustrated below with examples, this flexibility allows for the adjustment of the type of contract according to different coordination contexts.

The second trait that is worth mentioning in the case of *convenios* is the follow-up regarding the implementation of the contract. Law 30/92 specifies that each *convenio* should have a monitoring commission (*Comisión de Seguimiento*). This is a common institution of surveillance and control charged with solving the problems of interpretation and compliance with the clauses of the contract. In *consorcios*, conflicts are dealt first inside the institution, and if the conflict is not resolved, then secondarily within the monitoring commission of the *convenio* that created the institution. These are arbitration mechanisms typical of incomplete contracts.

Conflicts between the two layers of government not solved by the monitoring commission will be dealt by the administrative courts (*Jurisdicción Contencioso-Administrativa*), which is the branch of the judiciary charged with solving conflicts between different layers of government. The constitutional court will intervene only when the conflict is related to the competences of each layer of government. Although it is hard to obtain quantitative information, it seems that conflicts regarding the management of *convenios* have been kept to a minimum in the past. Two different reasons may help to explain why. First, the arbitration mechanisms described above may be enough to deal with potential conflicts, especially when the partners are engaged in a sustained co-operation process and try to avoid conflicts. Second, although the judiciary is not politically decentralised in Spain, it is independent from the national legislative and the executive branches and typically gives a fair treatment to the different layers of government.

The third trait of *convenios* is a high degree of transparency, since the text of the contract is available to third parties through its publication in the official bulletin of the central government. So, in a sense, the citizens are also able to monitor the implementation of the contract. In fact, the few known cases of legal action related to *convenios* were initiated by private actors or by opposition parties.

The final trait of Spanish inter-governmental contracting that is worth mentioning is the low use of performance indicators to assess the success of the *convenio*. The only information in this area relates to the field of education, but the delay in the evaluation reports cast some doubts about their real utility in improving the co-ordination process. This fact does not pose a problem for *convenios* that deal with very specific tasks, since the work completed by the monitoring commission and by the financial controller (which guarantees that financial payments have been made in exchange of the promised tasks) should suffice. However, in more complex matters, when the delegation refers also to policy design, it would be better to evaluate the performance of the contract instead of simply checking that financial resources have been employed as intended.

There are various reasons that explain this low use of performance evaluations. The first one is the fact that Spain is a politically decentralised country, implying that the assignment of responsibilities is made by the constitution and that the tasks of evaluating the performance are in the hands of the citizens. Any attempt by the central government to evaluate the performance of the ACs would be seen as a downgrading of the ACs' powers. As a result of this, in some cases, inter-governmental contracting in Spain is more an instrument of *ex ante* bargaining on the objectives of a policy than a method of *ex post* monitoring of its implementation. Recall that co-operation in Spain is voluntary, meaning that the only thing that forces the parties to contract is the realisation of potential mutual gains. The second explanation for the limited use of performance evaluations is that the lack of confidence in inter-governmental co-operation experienced in the past may have impeded the use of evaluations. If this is the case, contract assessment will improve in the future, following the increased co-operation impetus. The third reason for the low use of evaluation is the low development of performance auditing in the Spanish public sector (see Zapico, 2002).

3.3. Regional development contracts

A non-deniable portion of the *convenios* between the national government and the ACs deals with co-operation in economic development policies. Using a broad definition of economic development policies (see MAP, 2002), this category includes the following policy areas: 1) human capital (including, *e.g.*, education, vocational learning, active employment policies, etc.); 2) R&D and entrepreneurship; 3) road and railroad transportation networks; 4) water transportation networks; 5) renewable energy; 6) environmental protection; and 7) regional and local development. To gauge the relevance of the agreements in these areas, note that in 2002 they represented 62% of the total funding (see, *e.g.*, MAP, 2002). Most of these funds are used to finance investment and the financial size of each of these *convenios* is substantial. On average, the central

government finances 72% of spending and the ACs 24%. In some cases the monies contributed by the central government (and sometimes contributions from the AC) come from EU funds.

The justification for these agreements is the concurrence of responsibilities of both layers of government in all these areas. As has been already discussed, the central government has the ability to pass basic legislation in all of these policy areas. Moreover, it also has competences for "setting the basis for and co-ordinating the general planning of economic activity" and for "co-ordinating and promoting scientific and technical research" (see Table 5.1). However, the statutes of autonomy also indicate that the competences in promoting economic development in their jurisdictions and implementation in all the aforementioned policy areas are in the hands of the ACs. Thus co-operation is especially needed in the area of economic development in order to avoid duplication of planning efforts, to design coherent development strategies, and to exploit the possible synergies derived from the pooling of resources and capabilities.

A high share of the resources is devoted to the road and railroad transportation and water networks area (54%, see MAP, 2002), and to human capital, R&D and entrepreneurship (29%). The funds devoted specifically to regional and local development agreements in 2002 were also sizeable (14%), but only included two *convenios* – one dealing with economic development in coal mining counties and the other with a lagging Spanish department (Teruel). The central government has important role in regional policy such as setting the basis for and co-ordinating the general planning of economic activity, and building of general interest in ports and airports, roads and highways traversing more than one AC. Regional policy in Spain is also largely related to the management of EU Structural Funds and the smaller national investment fund, called *Fondo de Compensación Interterritorial*. The role of the central government in this case consists of allocating funds among regions (respecting EU criteria) and then among layers of government. This distribution among layers is the result of the decision of the central government, but is conditioned by EU criteria and by the distribution of responsibilities among layers of government. This is a tight constraint in Spain, since responsibilities for regional development policies and for the implementation in many economic development areas are on the hands of the ACs. Once the resources are allocated, each layer determines the concrete projects to be funded, respecting EU priorities. Of course, there is co-ordination among layers in order to present coherent planning documents to the EU. This co-ordination takes place in occasional workings groups organised by the Ministry of Finance. The national government is charged with the responsibility of elaborating these plans, but uses the lines of activity proposed by the ACs. As mentioned previously, sometimes the central government or the ACs use the EU funds to fulfil co-funding obligations derived from a specific voluntary

agreement. In these cases, however, co-operation does not arise from the implementation of a national planning framework, but from the realisation that this specific project will be best undertaken jointly.

4. Case studies

The following three case studies introduce the use of *convenios* as a manner of inter-governmental contracting for regional development. Each case is described and then analysed according to the framework suggested in this report. The three case studies are: 1) inter-governmental agreements reached each year to develop the "1998-2005 Plan for Coal Mining Restructuring and the Alternative Development of Coal Mining Counties"; 2) the economic development of Teruel; and 3) the construction and management of the Synchrotron light laboratory.

4.1. Economic development of coal mining counties

Coal mining counties are a real challenge for regional development policies. The level of specialisation in coal mining in these counties is very high, with no real alternative industrial activities. Unfortunately, the coal mining industry in Spain is highly inefficient, with very few profitable mines. This is a long-standing problem sustained by enormous subsidies for coal production paid by Spaniards through their electricity bills. Subsidisation has not solved the problems of the industry and, therefore, coal mining employment is continuously decreasing. As a result, coal mining regions face high levels of emigration, unemployment, and inactivity (early retirement and a high proportion of people receiving handicapped subsidies).

The Spanish central government and the ACs have devoted substantial efforts to develop these zones. This case study deals with the different inter-governmental agreements reached each year to develop the "1998-2005 Plan for Coal Mining Restructuring and the Alternative Development of Coal Mining Counties", created after a 1997 pact between the central government, the unions, and business associations. The plan channels financial resources from the European Regional Development Fund (ERDF) to these areas, with the purpose of contributing to restructuring and diversifying their economies. The plan has two main components: building infrastructures and subsidising employment creation. More than 50% of the infrastructure funds are spent on transportation projects and the remainder of the funds go to develop environmental infrastructure, industrial complexes, and education projects. An agency of the central government was created in 1997 to manage the plan, the "Institute for Coal Mining Restructuring and the Alternative Development of Coal Mining Counties". The purpose of the Institute is to deal comprehensively with the problems of coal mining counties, since, in addition to managing the

development plan, it deals with the strategy for restructuring coal mining by setting the levels of coal mining activity and subsidising coal production.

The interesting point is that the Institute has limited implementation capabilities and, therefore, must rely on other layers of government. Both the infrastructure projects and the aid for employment creation are implemented through *convenios* signed between each of the lagging coal mining counties (up to 115) and the ACs in which they reside (Andalucía, Aragón, Asturias, Castilla-León, Castilla-La Mancha, Catalunya and Galicia). In the case of infrastructure projects, a general agreement is usually signed with each AC. This agreement includes a list of eligible projects for a specific period of time. These projects are selected by the AC but they must be agreed upon by the central government. A more concrete agreement is then needed to develop each project. Each *convenio* includes a monitoring commission, with representation from both the central government and the AC, which is responsible for tracking implementation. In the case of aid for employment creation, agreements can also be signed with the AC's development agencies. These *convenios* are used to assign to the AC the responsibility of identifying the projects that merit the subsidy, based on criteria set by the Institute (*e.g.*, employment created) and the control over use of the subsidies by the firms. Regarding follow-up, the *convenio* includes clauses that require the AC to demonstrate how the subsidies have been used and its performance in terms of employment creation.

This co-ordination context is highly complex because many different instruments and variables interact in the design of the appropriate policy to deal with the problems of coal mining counties. Moreover, although the problems of mining industries are similar across Spain, the development policy must be different for each county. The co-ordination context is characterised also by a high level of vertical inter-dependencies. In particular, the success of the development policy will have an impact on various national policies. For example, it can reduce the need for unemployment and handicapped subsidies and for early retirement pensions, all paid for by the central government. Moreover, successful restructuring of the economy of coal mining counties will ease the process of mine closures, helping to reduce the enormous national subsidies for coal production. Regarding the distribution of knowledge, both layers of government face difficulties in ascertaining the best development strategy for the coal mining counties. As such, the situation is characterised by a low level of knowledge at both layers of government. At the same time, however, the AC may have superior knowledge on the needs of each coal mining county and greater ability to sustain co-operation with local actors. In this sense, the central government has low knowledge and the AC has greater knowledge along specific dimensions.

Based on the framework suggested in this report, the types of contracts needed in this co-ordination context range from incomplete contracts with audit to co-decision with arbitrage. The first type will be appropriate for the situation in which the AC has a high level of knowledge and the second type for the situation in which neither layer of government has a great deal of knowledge. The situation depicted above has elements of both types of contracts. On the one hand, the main goals and priorities of the plan are set by the central government and the implementation is delegated to the AC by signing separate agreements for the infrastructure projects and for the assistance for new business activity. The performance of the AC is then supervised by the central government, which demands certification of the activities carried out. All of this resembles an incomplete contract. On the other hand, it is true that the AC participates in decision making in the monitoring commission of the *convenios*, suggesting a situation of co-decision with arbitration. Note, however, that in the case of business subsidies, the workings of the commission are limited to bureaucratic tasks related to the follow-up for specific projects, while the general design of the subsidies are decided by the central government uniformly for all the coal mining zones.

It seems, therefore, that the type of contract used for coal mining counties is partially aligned with the suggestions of the theory. For a more comprehensive assessment, however, one must identify the goal of the policy, and this is a matter of judgement. If the goal is to implement a set of previously identified priority projects, then an incomplete contract used to delegate implementation to the AC would suffice. But if the goal is the development of the coal mining area, then this is a situation of low knowledge for both layers of government and co-decision should be increased. In the latter case, the central government could reduce its role in setting the priorities of the plan and the design of assistance to business, but continue to jointly decide the amount of funds allocated to each zone on the basis of objective criteria, in co-operation with the unions and the ACs. After all, transparency and objectivity in the allocation of funds is valuable. However, both the infrastructure projects and the design and management of business subsidies could be decided in partnership between both layers of government. The creation of a *consorcio* or a public corporation (*Sociedad Mixta*) for each coal mining county could be used in this case. The specific design of the policy for each zone is of paramount importance; actually it is not possible to fully adapt the policy mix to local needs because, although infrastructure projects are selected jointly by the central government and the AC, the design and amount allocated to infrastructure and to assistance for business, respectively, are decided by different institutions.

In fact, the solution suggested here already exists in some coal mining counties. For example, in the main coal mining AC, Asturias, there is a public

corporation called SODECO ("Society for the Development of Mining Counties") owned with equal shares by the central government and by the AC, and whose purpose is to aid in employment creation by giving advice and financial support to new business. Note, however, that this corporation is limited to dealing with business assistance and the design of the subsidy scheme is subject to the central government guidelines. In other coal mining zones there are examples of *consorcios* in which local governments take control of a wider list of development instruments.[3]

4.2. Economic development of Teruel

The second case study is the plan for the economic development of Teruel, a department in the autonomous region of Aragon. Aragon was not included among EU Objective 1 regions and, therefore, is not entitled to receive either EU Structural Funds or to participate in the *Fondo de Compensación Interterritorial*. Although Aragon is a relatively rich region, Teruel is a lagging province with an economy specialised in agriculture and mining and with a marked process of emigration. Therefore, an instrument was needed to promote the economic development of this department.

The plan for the economic development of Teruel was created in 1992 and has been renewed three times, most recently in 2005. The goals of the plan are to promote business activity, to improve infrastructure, and to foster quality of life in order to avoid emigration. To fulfil these objectives investment funds of EUR 30 million for 2006-2008 (*Fondo de inversiones para Teruel*) will be devoted to projects that aid new business initiatives, build industrial zones, and develop transportation, energy and environmental infrastructures. Importantly, agreements with the AC of Aragon are needed to develop the plan. The usual way to proceed is to sign a general *convenio* which specifies a list of eligible projects for a specific period of time and also creates a monitoring commission, where both the central government and the AC are represented, that is responsible for selecting the projects that will be funded each year. This commission is also responsible for following up on the implementation of projects that are the responsibility of the AC.

A second fund will be created to provide assistance to new business using preferential rate loans and capital shares. This fund will be managed by SEPIDES, a public corporation specialised in business promotion in lagging zones, which is part of the Spanish public industrial holding SEPI. This fund will amount to EUR 12 million for 2006-2008, with contributions equally divided among the central government, the AC of Aragon, and saving banks located in the region. Although the fund will be managed by SEPIDES, an agreement will be signed by all the partners involved, and an additional monitoring commission (with representation of the central government, the AC, and the savings banks) will be responsible for fixing the basic criteria for

distributing the funds and for following up on projects funded using periodic information supplied by SEPIDES. In fact, these partners are the owners of SODIAR, a public corporation whose purpose is business promotion in the AC of Aragon. The control of this corporation is in the hands of the central government, which owns the 51% of the capital through SEPIDES. The AC owns 6% of capital and the remaining portion is held by the saving banks.

The co-ordination context in Teruel is characterised by complexity, vertical inter-dependence, and low levels of knowledge for both layers of government. First, because of the very general policy goal in this case, many different instruments must be combined to find the appropriate development policy for Teruel. As a result the co-ordination context is extremely complex. Moreover, these different instruments are the responsibility of different layers of government and the success of the development policy will have an impact on various national policies, producing vertical inter-dependencies. If, for example, the ACs regional policy towards this province is successful, there will be less pressure for the central government to allocate development funds to Teruel, unemployment subsidies will decline, and tax receipts to the national budget will increase. Finally, both layers of government face difficulties in ascertaining which is the best development strategy for Teruel, as such the situation is characterised by low levels of knowledge for both the central government and the AC. However, when it comes to specific projects, the AC will have better knowledge of the specific needs within of its jurisdiction and, as the projects are not technically complex (*i.e.*, Spanish ACs know how to build a road), they have at least a similar level of expertise as the central government. In this sense, the central government has a low level of knowledge and that the AC has a higher degree of knowledge.

Like the case of the coal mining counties, the framework outlined in the first part of this report suggests that the type of contract needed in this context can vary, ranging from an incomplete contract with audit to co-decision with arbitrage. The case of Teruel has elements of both types of contracts. On the one hand, the main goals and priorities of the plan are set by the central government and then the implementation is delegated either to the AC or to the SEPIDES Corporation, whose performance can be audited by the central government (an incomplete contract). On the other hand, the AC participates in decision-making through the monitoring commission of the *convenios* with the central government and with SEPIDES. This resembles a co-decision mechanism with the arbitration role played by the monitoring commission. Thus, the type of contract used is more or less aligned with the suggestions of the theory.

Looking at the policy goals for Teruel, if the goal is to implement a set of priority projects, then an incomplete contract used to delegate its implementation to the AC would suffice. But if the goal is the development of

the department, and both layers of government possess low levels of knowledge, co-decision should be increased. In this case, the central government could reduce its role in setting alone the priorities and in implementing business assistance though a national agency (SEPIDES), and all the policy steps could be decided in partnership between both layers of government. The creation of a *consorcio* or a public corporation (*Sociedad Mixta*) with equal shares for each layer of government could be used in this case. The AC participation in SODIAR can be seen as one step in this direction, but as has been explained above, the control of this corporation is in the hands of the central government.

4.3. Construction and management of the Synchrotron light laboratory

The ALBA Synchrotron is a particle accelerator, a very large and expensive research facility, which is planned to be located in Cerdanyola, a site near Barcelona that also hosts a university and many technological firms (see *www.cells.es* for more details of the project). Obviously, this project provides benefits not only to the local and regional communities (by affecting both local technological firms and the local research community), but also to all Spanish researchers and firms. As a result of these spillover effects, the involvement of the central government is justified.

The agreement analysed is the 2002 *convenio* between the Ministry of Science and Technology and the AC that will host the facility, Catalunya. This agreement includes the financial promises to fund the construction of the facility. Each layer of government will fund the 50% of the investment, which amounts to EUR 164 million to be spent during the period 2003-2008. The agreement specifies the quantities to be spent each year. The agreement does not specify the obligation to contribute to operating expenses, since these costs are expected to be fully covered by user charges paid by the research teams that use the particle accelerator. However, the agreement says that if an operating deficit appears, the monitoring commission (*Comisión de Seguimiento*) could solve the problem by writing a new agreement (*Addenda*) which specifies the distribution of the burden.

The agreement also creates the partnership (*consorcio*) that will be responsible for managing the facility once built. The statutes of the *consorcio* are included in an annex to the *convenio*. The governance structure of the *consorcio* can be defined as follows. The *consorcio* will have a political decision-making body (*Consejo Rector*) and a management body (*Comisión Ejecutiva*). The *Consejo Rector* is formed by a president, which will rotate yearly from one layer of government to the other and have a qualified vote, and by eight representatives (four for each layer of government). Its responsibilities include providing general guidelines of activity, approving the annual budget and the plans of activity and projects, and specifying the rules of the relationship with

the users of the facility. The *Comision Ejecutiva* is formed by a manager and four members (two from each layer of government). Among its responsibilities are organising the services offered by the facility and setting the user charges.

The co-ordination context for the ALBA Synchrotron could be classified as being either low or high complexity. On the one hand, the building of this facility is technically complex, but this complexity should be dealt with easily by delegation of these tasks to the engineers and scientists. So, there is no complexity in the sense that there are not many different policy instruments interacting in the building and management of the Synchrotron. On the other hand, although the building of the facility is not complex, the design of the scientific policy is, in the sense that there are many instruments that will determine the success of scientific investments (*e.g.*, in terms of scientific outputs or economic impact on the industry).

The co-ordination context is also characterised by a high level of inter-dependencies. There are horizontal inter-dependencies derived from the fact that the facility would benefit all the Spanish scientific community, and vertical inter-dependencies derived from the fact that both layers of government have responsibilities on this matter. Moreover, the project's success could have an impact on future R&D programs that could be carried out by the central government and by the other regions since future programs will depend on access to the equipment and since all the partners will have to pay for maintenance in the future. Also, the clustering of researchers around the Synchrotron will help the national scientific community in general by fostering the development of scientific programmes in related fields of knowledge.

Regarding the level of knowledge, both layers of government have a low level of knowledge. Neither has previously built or managed such a facility and it is unlikely that another will be built in the future, so there are no chances to learn. Moreover, the project entails significant risks: the construction risk (*i.e.*, exact localisation, detailed design of the building, budgetary deviations), the scientific risk (*i.e.*, failures in identifying the most appropriate research policy for the facility, related to the number of light lines defined and to its assignment to research groups and firms), and the management risk (*i.e.*, optimisation of the financial returns and possible appearance of operating deficits in the future). Although a great part of these risks can (and should) be dealt with in advance, it is clear that a number of very complex decisions will have to be taken.

Following the framework suggested in this report, the type of contract needed for this co-ordination context is co-decision with arbitrage. In this case contracting should be completely relational, based on a permanent partnership between layers of government. This is, in fact, the case of the

Synchrotron since, as explained above, both the construction and the management of the facility depend on a *consorcio* where both layers of government and the scientific community are represented. The decision-making bodies of the *consorcio* play the needed arbitrating role. Thus, it seems that there is perfect alignment between the contractual solution and the prescription of the theory.

5. Conclusions

This section summarises the main conclusions of the chapter and makes some policy recommendations for Spain. It also highlights some of the lessons that can be learned from the Spanish case.

First, in Spain, inter-governmental contracts (called *convenios*) have played an important role in implementing co-operation efforts arising mainly from multi-lateral forums. Moreover, the very use of contracts has fostered the co-operation initiated at the beginning of the 1990s. Therefore, it appears that both the Spanish state and the ACs are learning to co-operate though the use of contracts. The main recommendation here is to continue to make efforts to foster the co-operative spirit of Spanish federalism by increasing the frequency of multi-lateral meetings and the scope of the issues to be dealt with. However, it is equally important to give incentives to the ACs to participate actively in these forums by increasing the relevance of the decisions taken and by avoiding the encroachment of these forums on matters of their exclusive competence. The purpose of these recommendations is the increase in the number of inter-governmental agreements.

Inter-governmental contracts in Spain are based on a set of legally enforceable instruments which is a flexible and appropriate way to deal with very different co-ordination contexts. For example, *convenios* are quite capable of dealing with contexts requiring incomplete contracts with arbitrage, either through the workings of the monitoring commission or through the creation of a permanent institution (a *consorcio* or a public society). However, the case studies presented here show that the contract solution chosen is not always clearly aligned with the coordination context. Although the solution to the "Synchrotron light laboratory" case was clearly appropriate, the same cannot be said in the other two cases. The coal mining counties and Teruel cases might be best dealt with the creation of a permanent institution (*i.e.*, a *consorcio*) for each local area. Moreover, while some aspects of the implementation of these programmes are dealt co-operatively, the most relevant aspects of their design are not delegated (*e.g.*, the design of assistance to business programs). This reveals a presumption that the level of knowledge of the regional government is low. However, this presumption is not always warranted given the high level of complexity and site-specificity of local

development programs. A recommendation is to involve the ACs and local actors (*e.g.*, local governments, private partners) in the design of the appropriate local development policy. This means that the central government has to accept that the co-ordination context is characterised by a low level of knowledge at all levels and that the contract solution should be relational and context specific.

Inter-governmental contracts in Spain are also quite transparent, since they are subject to publicity requirements. However, eligibility criteria are not always clear when *convenios* arise from a bilateral agreement. Moreover, the case studies reveal that in some cases the use of many different agreements and *convenios* and the involvement of different national agencies creates a complicated network of inter-governmental relations that is quite difficult for the interested public to follow. Recall, for example, the case of Teruel where the agreements are implemented either by the AC or by a central government business development agency which, in turn, may delegate to the AC's business development agency, and that a public society owned both by the central government and the AC also intervenes. The first recommendation in this regard is to use multi-lateral agreements when possible, distributing the resources with objective data, and introducing performance criteria and competitive tendering procedures when applicable. For this to be done, performance indicators and evaluation procedures should be improved. A notable development in this regard is the recent creation of a national agency for the evaluation of public policies and the quality of services (*La Agencia de Evaluación de las Políticas Públicas y la Calidad de los Servicios*). The agency will initially focus on some specific service areas. The second recommendation is to simplify the network of actors and contracts used at the implementation stage in order to make more clear who is responsible for the policy.

The main lesson that can be learned from the Spanish case is that inter-governmental contracts are useful even in a situation where co-operation is entirely voluntary and different tiers of government are fearful of losing their prerogatives. In this case, contracts are not a planning tool for the development of the central government's policies but a tool to solve the conflicts of interest between the central government and the AC. Thus, it is not surprising that contracts in Spain do not deal with the creation of macro-development policies, but rather address the implementation of concrete projects. Another lesson that can be derived from the Spanish case relates to the performance of different contract arrangements in different co-ordination contexts. Here, the case studies show that arbitrage mechanisms (*i.e.*, monitoring commissions) and permanent institutions (*i.e.*, *consorcios*) work quite well in some cases.

Notes

1. This chapter draws on the contribution of Albert Solé-Ollé, Departmento d'Hisenda Pública and Institut d'Economia de Barcelona (IEB), Universitat de Barcelona.
2. Some responsibilities are attributed by law to the municipalities. In Spain there are more than 8 000 municipalities, most of which are rather small (90% of them have less than 5 000 inhabitants). The responsibilities of Spanish municipalities are similar to the ones attribute elsewhere to local governments (*e.g.*, garbage collection, water supply, street paving and cleaning, parks and recreation) with the exception of education, which is a regional responsibility in Spain. In addition to municipalities, there is an upper-tier of local government called Diputación provincial, with the basic responsibility of giving technical and financial support to municipalities. There are also voluntary associations of municipalities (called *mancomunidades*) and a plenty of partnerships (between municipalities, with regional governments and with private actors) which are not analysed in this chapter (see Font *et al.*, 1999, for a survey).
3. A good example is the *consorcio* Cercs-Bergadà created in 1989 by the central government (through the state employment agency INEM, the AC of Catalunya, the municipality of Cercs and the county association of coal producers (see *www.cfi.es* for more details). The first goal of the *consorcio* was to aid in the restructuring process of mining and in finding new jobs for the people that lost the jobs in the mines, but when mines where definitively closed it moved to the fields of formation of the unemployed and aids to new business.

Bibliography

Börzel, T. (2000), "From Competitive Regionalism to Cooperative Federalism: the Europeanization of the Spanish State of the Autonomies", *Publius: The Journal of Federalism*, Vol. 30:2, pp. 17-42.

Esteller, A. and J.M. Durán, (2004), "El ejercicio de la capacidad normativa de las CCAA en los tributos cedidos: una primera evaluación a través de los tipos impositivos efectivos en el IRPF", *Papeles de Trabajo*, 20/2004, Instituto de Estudios Fiscales, Madrid.

Font, J., R. Gutiérrez and S. Parrado-Díez (1999), "Intergovernmental Partnerships at the Local Level in Spain: Mancomunidades and Consortia in Comparative Perspective", OECD, available at *www.oecd.org/dataoecd /11/14/1902663.pdf*.

Giorno, C. and I. Joumard (2005), "Getting the Most out of Public Sector Decentralization in Spain", OECD Economics Department Working Papers, No. 436.

MAP (Ministerio de Administraciones Públicas) (2002a), *Las conferencias sectoriales. Las comisiones bilaterales de cooperación*, Ministerio de Administraciones Públicas, Subdirección General de Cooperación Autonómica.

MAP (2002b), *Los Convenios de Colaboración entre la Administración General del Estado y las Comunidades Autónomas*, Ministerio de Administraciones Públicas, Subdirección General de Cooperación Autonómica.

MAP (2005), *Convenios de Colaboración autorizados durante 2005, Análisis de contenidos*, Ministerio de Administraciones Públicas, Subdirección General de Cooperación Autonómica.

Moreno, J.L. (1997), "Federalization and Ethnoterritorial Concurrence in Spain", *Publius: The Journal of Federalism*, Vol 27, pp. 65-84.

Presidencia del Gobierno (2005), *Plan de actuación específico para Teruel*, 28 October 2005, *www.teruelexiste.net/documentos/docs/textos/PlanActuaci%F3nTeruel.pdf*.

Zapico, E. (2002), "Budget for Results in Spain: Lessons Learned After Two Decades of Reform", OECD, *www.oecd.org/dataoecd/4/13/2497137.pdf*.

ISBN 978-92-64-00873-1
Linking Regions and Central Governments
Contracts for Regional Development

Chapter 6

The Case of Canada[1]

This chapter examines the use of inter-governmental agreements as contracting mechanisms for Canadian regional development policy. It begins with a review of the decentralisation context, followed by a brief summary of Canadian regional development policy. The chapter then turns to three case studies, each of which describes a different inter-governmental agreement: The Vancouver Urban Development Agreement, The Canada-Manitoba Economic Partnership Agreement, and The Canada-Nova Scotia Gas Tax Transfer Agreement. The analytic framework presented in Chapter 1 is used to assess the "fit" between the co-ordination contexts and contractual arrangements that characterise each of these three agreements.

1. Introduction

In the academic literature on comparative federalism, Canada is generally acknowledged to be one of the most decentralised federations in the world (Watts, 1996). This is the most important factor affecting the character of multi-level governance in Canada as well as the design and conduct of regional policy. This chapter examines how bi-partite and tri-partite intergovernmental agreements designed to enhance regional outcomes can be assessed through the lens of contractual arrangements. It begins with an overview of Canadian federalism before turning to three case studies.

2. Canadian federalism

Canada in 1867 was the first country to combine British-style parliamentary democracy with American-style federalism, though there were centralist mechanisms incorporated into the constitution designed to "resolve" any contradiction which might arise between the contrasting principles of parliamentary supremacy and divided sovereignty. However, these unitary features of the Canadian constitution, such as the powers of reservation and disallowance allowing the central government to block provincial legislation, and the general grant of power given the central government (to maintain peace, order and good government), either fell into disuse or were scaled back through judicial interpretation. Another of these – the declaratory power allowing the federal government to declare any public work to be of national interest and therefore within its jurisdiction – has been used only sparingly (for instance, with regard to nuclear power regulation and facilities). As a result, after a settling-in period Canadian governments, federal and provincial, remained largely confined to and unimpeded in their enumerated fields of jurisdiction as set out primarily in sections 91 and 92 of the 1867 Constitution Act, delimited and protected in this division of powers by court rulings. Until 1949 the external referee was the Judicial Committee of the Privy Council in Britain, and thereafter the Supreme Court of Canada (Simeon and Robinson, 1990).

In terms of the distribution of jurisdictions, foreign policy, defence, and the key economic powers – including control over currency, banks, tariffs, commerce, railways, shipping and, fisheries – were given to the central (federal) government. Agriculture and immigration are concurrent competences. The enumerated powers of the sub-national authorities (provinces) included control over various social, cultural, and education matters, and what were at the time

Table 6.1. **Division of powers between the federal and provincial governments of Canada**

Federal jurisdiction	Provincial jurisdiction
• Sec. 91 – power to ensure Peace, Order and Good Government (general grant of power) • 91.2 – trade and commerce • 91.2A – unemployment insurance • 91.3 – raising money by any mode of taxation • 91.7 – military and defence • 91.10 – navigation and shipping • 91.12 – fisheries • 91.14 – currency • 91.15 – banking • 91.19/20 – interest and legal tender • 91.21 – bankruptcy • 91.22/23 – patents and copyright • 91.24 – Indians and reserves • 91.28 – criminal law • 92.10a – inter-provincial railways, canals, telegraph • 92.10c – works declared to the general advantage of Canada (declaratory power) • 96-101 – appointment and payment of judges • 132 – treaties	• Sec. 92.2 – raising money by direct taxation • 92.5 – public lands • 92.7 – hospitals and health care institutions • 92.8 – municipal institutions • 92.10 – local works (includes roads, bridges, sewers) • 92.13 – property and civil rights (includes social services) • 92.16 – all matters of a local or private nature (general grant of power) • 92A – natural resources • 93 – education
Concurrent with federal paramountcy: • Sec. 95 – agriculture and immigration	Concurrent with provincial paramountcy: • Sec. 94A – pensions

Note: Not a complete listing of respective jurisdictions but a selection of the more significant powers of each level of government.
Source: Canada Constitution Act, 1867.

more immediately local concerns, such as hospitals and asylums, local welfare, roads, municipalities, property and civil rights, and all other matters of a purely local nature. Provinces were also accorded ownership and control over natural resources, a provision that would contribute significantly to provincial fiscal autonomy and to the role of provincial states in economic development. Both levels of government were granted important powers of taxation, though the provinces were limited to direct taxation (for example, property, income, and sales taxes) whereas the federal power to raise revenues was without restriction. Of special note is that the federal government was implicitly granted the prerogative to spend its revenues in whatever manner it chose, without restriction in terms of constitutional field of jurisdiction (Stevenson, 1989).[2]

The use of the federal "spending power", as it came to be known, is crucial to understanding the development of Canadian federalism in the modern (post-war) period. The scope of federal activities and the extent of federal intervention in the national economy and in social affairs increased dramatically during and after the Second World War, especially compared to the highly decentralised federation that describes Canada during the inter-war period. This major shift in government roles and responsibilities was not

accomplished through formal constitutional change: other than an amendment in 1940 transferring unemployment insurance to the federal government, no constitutional change was made in the division of powers. Instead it was the use made of the federal power to raise and spend monies, along with the federal government's embrace of Keynesian economic management policies and techniques (as set out in its 1945 White Paper on Employment and Incomes), that explains this radical change in the respective roles of each level of government. Keynesianism, strong economic growth, and broad public support for the extension and expansion of national social programmes (especially in English-speaking Canada) provided the philosophical and political justification for the centralisation of taxing power and for significant federal spending in the social policy field, even though most of the latter remained formally under provincial jurisdiction (Smiley, 1974).

Initially this centralisation of the Canadian federation was accomplished using tax-rental agreements, whereby the provinces surrendered their taxing power to Ottawa in return for an annual rental payment based on a formula that included an equalisation component. This fiscal arrangement was later replaced by shared-cost, conditional grant programmes, whereby provincial co-operation and participation in nationally-designed programmes was induced through the offer of matching federal funds for the establishment or extension of these programmes. With the phasing out of tax rental agreements, prompted by the refusal of the larger provinces (particularly Quebec) to continue with this practice, a national inter-provincial equalisation scheme was established to address problems of horizontal equity, thereby ensuring the full participation in shared cost programmes of the poorer provinces (Bickerton, 1990). As well, beginning in late 1950s, special bilateral "opt-out" arrangements were negotiated with Quebec, allowing that province to establish its own parallel social programmes in several areas (*e.g.*, higher education, pensions) without financial penalty. This practice of *de facto* differential treatment for Quebec has continued in a rather fitful on-again, off-again manner ever since (Gagnon, 1999).

Over a 20-year period from the mid-1970s to the mid-1990s, federal conditions on financial transfers to the provinces for social programmes were almost completely removed in return for greater certainly regarding the overall size and annual growth in these transfers.[3] This federal concern with the magnitude of inter-governmental transfers extends as well to another important federal-provincial financial arrangement: the equalisation programme. The latter became the centrepiece of Canada's regional policy in the 1960s and remains so today. The fiscal importance and sacrosanct status of these annual bloc payments to less advantaged provinces is reflected in the fact that the principle of making equalisation payments to ensure that provincial governments have sufficient revenues to provide "reasonably comparable levels of public services at reasonably comparable levels of taxation" was included as

Section 36 of the 1982 Constitution Act. The precise formula by which this constitutional obligation has been fulfilled, however, has been altered on several occasions, motivated initially by provincial pressures to make the equalisation formula more comprehensive and later by fiscal pressures on the federal government's ability to fund the transfer created by the province of Alberta's enormous windfall oil revenues (which significantly increased the national average fiscal capacity to which Ottawa was expected to raise all provinces). The equalisation formula, now a middle range five-province standard that excludes Alberta, continues to be the subject of some controversy and disagreement among Canadian governments (Bickerton, 1999; Lazar, 2005). The "special federal advisory commission" has recently delivered a synthesis report on that issue and made recommendations, thus discussions are in process about the implementation of the reforms.

The general discontent that has been registered about the manner in which Canada's horizontal fiscal imbalance has been addressed through the equalisation programme extends as well – with even greater gusto and virtual provincial unanimity – to provincial protestations about a perceived vertical fiscal imbalance between the federal government and the provinces. The nature of this provincial complaint – most vocally and persistently put forward by Quebec – is that a revenue-responsibility imbalance in the Canadian federation has arisen over the past decade that generates large annual budgetary surpluses for the central government. Meanwhile, the provinces continue to struggle to balance their budgets while fulfilling their constitutional and political obligations to provide their residents with costly social services in areas such as health and education. For more precise information on financial relationships between levels of government, see Table 6.2.[4]

Table 6.2. **Federal-provincial division of revenue, expenditures, and inter-governmental transfers**

Central government share of total revenue and expenditures	% of revenue(before transfers): 44 % of expenditure(after transfers): 37
Provincial and local shares of total revenue and expenditures	% of revenue: 56 % of expenditure: 63
CG conditional grants as % of total revenue transfers	43.6% in 1996 (4.3% if transfers for health, education and social services considered unconditional*)
CG transfers as % of provincial and local revenues	19.8% in 1996 (only 0.9% of this conditional if transfers for health, education and social services considered unconditional)
Equalisation transfers (unconditional grants based on formula assessing provincial revenue capacity in terms of 33 revenue sources against a middle-range five-province standard)	42% of all CG transfers (budgetary dependence on this transfer ranges from 30% of provincial revenues to nil; three or four provinces out of ten receive no equalisation transfer)

Note: These transfers are subject to only minimal conditions.
Source: Watts, Ronald (2005), *Autonomy or Dependence: Intergovernmental Financial Relations in Eleven Countries*, IIGR, Queen's University, Working Paper No. 5, Canada.

3. Regional development policy

Besides social transfers and the equalisation programme the federal government has pursued a range of regional development policies since the 1960s. Initially focused primarily on Atlantic Canada and eastern Quebec, in the 1970s the geographic coverage of these regional development policies expanded to include virtually all regions of the country experiencing some form of regional economic disparity.[5] In any event, regional development transfers to provinces as a percentage of total federal spending declined between the 1970s and 1990s, indicating a more modest federal "fiscal effort" in the field of regional development than during the policy's early period (Savoie, 1992; 1997). Indeed, if considered strictly in terms of federal transfers to the provinces explicitly earmarked for regional and industrial development, by the late 1990s these represented only 1% of total federal transfers to the provinces, a miniscule 0.2% of total federal spending, and an even smaller 0.16% of provincial revenues (Vaillançourt, 2000, pp. 200, 210-211).

As well, federal structures and programming in the regional development field have changed quite frequently over the past 40 years. In general these changes moved away from an approach that featured centralised bureaucratic control over the distribution of grants, subsidies, and tax concessions to large manufacturing firms, toward joint federal-provincial funding of a wide and fairly indiscriminate range of projects (though infrastructure, especially transportation infrastructure, has always remained important). Finally, in more recent times, regional development programmes have been delivered by decentralised federal regional development agencies (such as the Atlantic Canada Opportunities Agency and Western Economic Diversification), which play the role of integrating federal action and co-ordination at the regional level. Diverse regions and types of problems can thus be addressed by specific contracts, devoted to specific regional concerns. For the most part these agencies provide relatively modest and indirect forms of assistance (*e.g.*, for training, technology transfer, or market research). This form of economic development assistance, often given in collaboration with other governmental and/or non-governmental partners, is most often directed to small- to-medium sized, region-based enterprises, as well as non-profit organisations or institutions, which compete for available funds based on the innovative character and general worthiness of their proposed projects, whether in the service sector, manufacturing, or research-based activities. This general shift in focus has not precluded, however, the occasional large infusion of development assistance in order to "facilitate" a major investment decision by a multi-national corporation (Bickerton, 1990; Savoie, 1992, 1997). In addition it is worth mentioning the existence of other federal programmes linked to

infrastructures for regional development that support partnerships among levels of government, such as the "Municipal Rural Infrastructure Fund" and the "Canadian Strategic Infrastructure Fund".

While direct federal spending for regional development purposes – as opposed to federal transfers to provinces for same (see above), or the traditional federal roles in economic stabilisation and maintaining an investment climate conducive to growth – has often been important, especially in less-developed regions like Atlantic Canada, it is (and has been) the provinces which have been the primary governmental initiators, planners, and regulators of their own economic development, though often in partnership or with some participation by the federal government. As already indicated, this key economic role for the provinces stems from a number of sources, including their extensive control over natural resources (an important source of economic growth and development in Canada), their constitutional responsibilities for social policy and infrastructure, their undisputed control over municipalities, and their considerable taxation, spending and regulatory powers. In short, with well-established legal claims and political prerogatives, and significant fiscal, policy making and implementation capacities, Canadian provinces have been major economic actors in their own right, while their active co-operation and/or direct participation in federal initiatives is usually considered to be necessary, if not indispensable.

4. Case studies

An assortment of contractual agreements have been used in Canada to achieve regional economic development goals in different co-ordination contexts, using grants, fiscal and/or policy decentralisation, and multi-level collaboration initiatives. Three types of agreements will be presented here. Two of these are related to the Government of Canada's recent focus on urban development. As municipal institutions are fully within provincial jurisdiction in Canada, they traditionally have been ignored in federal policy making in favour of a two-level mode of inter-governmental relations. In the new global economy, however, cities have become critical to the economic health and competitiveness of their national-states, just as Canadian cities in their infrastructure and governance are showing signs of strain. In this connection, a recent OECD study described Canada's "disjointed approach" to urban policy and a lagging national engagement with the problems of cities (OECD, 2002, p. 159).

The primary problem confronting cities in the Canadian system is a mismatch between municipal responsibilities and the policy tools and resources that are available to municipalities. Research institutes and advocacy coalitions in Canada have pressed for improvements in this situation. In 2003, the Government of Canada (GOC) responded with its "New

Deal for Cities and Communities (NDCC)", in essence a group of initiatives featuring a collaborative, multi-level governance approach to the problems of Canada's cities. The NDCC policy had three priorities: to bring an urban lens to federal and provincial policy development, to create administrative machinery for tri-level interaction, and to negotiate revenue-sharing formulas that would channel more federal and provincial tax revenues to municipalities (Bradford, 2004). Urban development agreements were one tool for achieving the priorities set forth in the NDCC (Bradford, 2006). The first case to be examined here is the implementation of a tripartite urban development agreement (UDA), customised to address the particular problems of the targeted city. While a number of these agreements have been put in place in western Canada, it is the first Vancouver Agreement (VA), covering the period 2000-2005, that will comprise the case study.

The second case study is a more conventional, bipartite (national and sub-national) economic development agreement, of the sort that has been used for more than 30 years in Canada. The federal government's decision to work in close partnership with provincial governments in this area reflects the latter's constitutional, political and economic importance in the field of regional economic development, a joint responsibility shared by the two senior levels of government based on their respective economic, social, and regulatory powers and responsibilities. While prior to the 1960s the federal government tended to limit its economic role to international trade, national infrastructure, and the broad fiscal and economic framework for economic development, as noted above it has since become more directly involved in the field of regional development policy. The primary instrument of inter-governmental co-operation used to facilitate this federal role has been the bipartite framework agreement (Savoie, 1992).[6]

Today these multi-generational agreements continue. Previously referred to as General Development Agreements, Economic and Regional Development Agreements, and Cooperation Agreements, this history of inter-governmental co-operation has not been without its problems. These have included a tendency for framework agreements to be used to fund a grab-bag of initiatives representing no particular development strategy or focus (or many simultaneously); the duplication of economic development efforts in adjacent sub-national units without any attempt to incorporate a broader regional perspective; the use of federal monies simply to replace or supplement "normal" sub-national government spending; and the funnelling of federal funds into provincial projects with little or no political credit or recognition given for this financial contribution. Each of these criticisms, along with others, has been levelled at the bipartite development agreement approach since its inception in the 1970s (Savoie, 1992).

In western Canada, the current bipartite framework agreements are referred to as Economic Partnership Agreements.[7] The second case study examined here is the CAD 50 million, five-year Canada-Manitoba Economic Partnership Agreement (MEPA), signed in 2003. The MEPA is cost-shared equally between the federal and provincial government, and administered by a two-person federal-provincial management committee, with joint representation from the federal agency Western Economic Diversification (WED) and the Manitoba Department of Intergovernmental Affairs and Trade.

Another federal initiative associated with the "New Deal for Cities" provides the basis for the third case study. In 2005, a tri-partite (national, regional, local) revenue-sharing agreement was implemented, the purpose of which is to transfer to local governments on an annual basis a portion of the federal revenue derived from the national gas tax. This revenue transfer is to be used by local governments for approved projects that enhance environmental and sustainable infrastructure, a shared policy goal that has been frustrated by the vertical revenue-responsibility imbalance affecting all Canadian municipalities. Like the Urban Development Agreements, the Gas Tax Transfer Agreements regulating the revenue transfer are premised on partnering arrangements between federal, provincial and municipal governments. From the federal government's point of view, this facilitates the utilisation of local knowledge and information and fosters better communication with local actors. The usual and expected political resistance to this type of federal "intrusion" into provincial jurisdiction has been eased in this instance by the respectful but vigorous use of the federal spending power, and the building of mutual trust between governments through open dialogue and joint decision making and action (Bradford, 2004). The particular agreement that will be referred to here is the Canada-Nova Scotia Gas Tax Agreement (NSGTA). It is important to note that although the Gas Tax Agreement initiative is a commitment still being honoured, the current government is shifting away from the NDCC and moving forward with other programmes to address city and community issues.

The contractual relationship assumed by governments when they enter into inter-governmental development agreements of the sort described above is influenced by a number of factors related to the problems governments face in co-ordinating their efforts toward achieving shared policy goals, while in the process protecting their respective interests, and that of the publics they represent. This report suggests several criteria that can be used to evaluate inter-governmental co-ordination contexts: knowledge distribution, complexity, inter-dependencies, and credible/enforceable commitments. Each co-ordination context for an inter-governmental delegation agreement (as determined by these criteria) suggests an optimal set of contractual provisions or "solution". This analytical framework will be used to assess the "fit"

between the respective co-ordination contexts and contractual arrangements that characterise the three inter-governmental agreements in question, with a view to making recommendations on possible improvements.

4.1. The Vancouver Urban Development Agreement

The trilateral Urban Development Agreement between the Government of Canada (central level), the Government of British Columbia (regional level) and the City of Vancouver (municipal level) (the Vancouver Agreement or VA), which ran from 2000-2005,[8] won national and international awards for innovative management and for improving transparency, accountability and responsiveness in the public service (VA webpage). The VA was conceived as a collaborative partnership aimed at moving away from traditional silo-based approaches toward a horizontal model of governance. Its initial focus was on the serious and varied problems of a somewhat notorious area of the city of Vancouver (the Downtown Eastside), which had experienced deteriorating economic, social and health conditions in the 1990s.[9] In response, all three levels of government agreed to the idea of an urban development agreement which would provide the framework for building a common understanding of the problems faced by government and with a view to better co-ordinating the efforts of a wide range of government departments and private sector agencies. It was decided that the VA would be guided by four key objectives:

- to revitalize the main commercial corridor in the target area;
- to dismantle the open drug scene;
- to turn problem hotels into contributory hotels; and
- to make the community safer for the most vulnerable.

Taken together, the myriad and entrenched nature of the problems addressed by the VA, the several policy domains in question, and the distribution of government responsibilities within the Canadian constitutional regime, ensured that there would be a wide variety of actors and agencies involved. This made the co-ordination context for the VA extremely complex. Initially at least the whole purpose of the VA was to better manage this complexity by increasing collaboration between governments to enhance service delivery in the Downtown Eastside; there was no new government funding made available. Eventual dedicated funding for the VA (CAD 20 million) was only provided half-way through the life of the agreement. In effect, the VA's primary purpose was to provide the framework for a new model of collaborative governance.

With severe problems of poverty, unemployment, drug addiction, mental illness, homelessness, crime, and public safety at issue, knowledge and information was both widely and unevenly dispersed amongst the various

agents and actors who initially or eventually were party to the VA. In other words, considerable asymmetries of both skill and information were at play. On some of the projects, or aspects of projects linked to the VA, the federal government can be deemed to possess a high level of expertise and information; on other aspects, the provincial or local (city) governments are better positioned in terms of knowledge and expertise; and all three governments recognised the need to engage community-based non-government agencies or actors whose specific skills and information were considered important to the design and implementation of various projects linked to the attainment of the agreement's objectives. Taken as a whole, all governments recognised that their specific expertise and jurisdictional competencies, when applied separately, were failing to solve pressing problems or attain long-term policy objectives. The multiple asymmetries involved correspond to an extremely complex co-ordination situation in that governments agreed to engage in a process of seeking together solutions to problems that individually they lacked the adequate knowledge, information and/or authority to devise or implement. This high degree of complexity (in the number and diversity of variables, as well as jurisdictional complexities) made unilateral or centrally-designed and controlled solutions impossible.

Generally, the degree of inter-dependence in this co-ordination context was high as well: whether within or between specific initiatives, in terms of horizontal inter-dependence amongst the various policy objectives of the VA; vertically in terms of the impact of various federal policies on elements of the local situation, and vice versa in terms of the potential effects of project outcomes on various matters within federal jurisdiction; as well as temporal inter-dependencies in terms of the influence that successful projects could be expected to have on the local reservoir of societal assets, skills, and capacities, which in turn would exert an ongoing influence on public policy making and local outcomes, as well as on the cost/efficiency of further delegations or decentralised initiatives in the future. Recognition of the inevitable and ongoing inter-dependencies involved in this initiative (because of the nature of the problems being addressed and the distribution of authorities) seems to have provided further impetus for launching this experiment in collaborative governance.

The final criteria in the analytical framework for determining the co-ordination context – the credibility and enforceability of commitments – suggests a varied mix of factors and mechanisms at work in the VA. The agreement envisages enforcement of the various contractual commitments and obligations through a variety of means. Negotiated annual updates to the schedule of initiatives and commitments were required. All governments were directed to work within their own jurisdictions and mandates, to use existing authorisation procedures for committing required funds, to abide by

their own internal controls and mechanisms, and accordingly to be held accountable by their own electorates for their performance. To stimulate and monitor collaboration, at least three levels of political and administrative supervision were established: a Policy Committee comprised of the relevant government ministers and mayor (the decisions of which required unanimity), a Management Committee of senior public officials drawn equally from each level of government (operating on a consensus decision-making model), aided in their efforts by a Co-ordination Unit of officials responsible for implementing the agreement, and finally Task Teams with representatives from each level of government, as well as community and business groups, on particular issues (*e.g.*, economic development, training and employment, drug addiction, crime and enforcement, housing, and food availability).[10] Until 2003, governments were required to work within their existing budgets, thus obviating the need for the creation of new reporting, supervision, or accountability structures or procedures. In the above-stated ways the VA envisaged a co-equal management and supervision process with a variety of pre-existing enforcement mechanisms: the institutional context (in terms of the division of powers and responsibilities), retention of individual governmental authorisation procedures, and external political accountability and citizen supervision (through electoral and other political processes).

The contractual solution within the VA to deal with the co-ordination context described above was the type of open, flexible partnering arrangements necessary for contracting parties with complementary assets and powers, operating on the basis of equality, each (or all) of whom cannot know *ex ante* the precise goals of their co-operation, but wish to engage in a long-term collaboration and co-ordination process. This most closely approximates a relational contract, where delegation is replaced by an equal partnership between governments wherein both policy goals and implementation are chosen co-operatively. The primary obligation of the contracting parties in this type of agreement is to respect and work within a negotiation structure, act co-operatively and in good faith to accumulate and share information, and use this information to act in concert to achieve shared policy objectives. Toward these ends, the VA was designed to provide a framework for building communication, policy and social capital networks that would enhance governmental and stakeholder collaboration and the potential for collective innovation, and ideally to externalise over time some of the co-ordination costs.

4.1.1. Assessment and recommendation

The Vancouver Agreement addressed the apparent inability of governments, and government departments acting separately within their own jurisdictions and mandates, to reverse or effectively ameliorate the

worsening economic, social and health problems of a prominent district in the City of Vancouver. As such, it represents an attempt to replace the dominant governance paradigm (the familiar silo-based delivery of public services) with a radically different model based on inter-governmental collaboration and horizontal management. The partnership constructed by the VA was one based on equality of the three participating governments, utilising unanimity and consensus as its decision-making rule. The relational contractual framework constructed was an enabling one, aimed at achieving greater consultation, co-operation, and collaboration almost as an end in itself, with the shared expectation that more effective service delivery and policy solutions would occur as a by-product of this enhanced cooperation and collaboration.

As an experiment with collaborative models of service delivery, the contractual solution represented by the VA appears to have been "well aligned" with the identified problems and the policy objectives given rise to by these problems. It was both an appropriate contractual solution to the co-ordination context with which governments were presented, and for the most part effective with regard to its main purposes. Efficiencies were gained through greater integration of services and co-operation between governments, thus reducing overlap, dysfunction, and duplication of effort. This does not mean the VA was without problems. One of its early goals – community engagement and community capacity-building – appears to offer room for improvement, with unclear guidelines governing community participation. Another problem, not surprisingly, was a lack of clarity about responsibilities and criteria for decision making. Complaints about a heavy workload for middle managers forced to "moonlight manage" the VA "off the side of their desk" perhaps reflects the lack of new or additional resources allocated to the initiative, and this may also explain managerial perceptions that a lack of dedicated funding for the VA (prior to 2003) was a major weakness in the agreement. However, once such funding was secured, it became evident that managers were encouraged to return to a more centralised, less collaborative approach, with more focus on delivering new services than co-ordinating collaborative relationships. Re-channelling dedicated VA funds through existing programme structures in one of the respective jurisdictions would be one way to reduce or avoid this problem (*A Governance Case Study: Profile of the VA*).

That the VA experience was viewed positively by the participating governments is evidenced by the signing of a second generation VA agreement in 2005. Moreover, at senior levels within the federal government there is continued interest in the efficiencies and benefits that tri-partite arrangements such as these can have in addressing complex issues requiring intervention by all three orders of government in Canada.[11] Perhaps the

greatest challenge for governments and their stakeholder partners will be to sustain and institutionalise the new governance paradigm, and to develop standards and performance indicators (which were absent in the VA). This will be needed to further develop the new generic form or "paradigm" of governance represented by the VA, to make possible a "continuous improvement" cycle in the new paradigm, and to fully take advantage and build upon (in policy making and programme implementation terms) the social capital and policy networks created under the VA (WED Canada, *The Vancouver Agreement*).

4.2. The Canada-Manitoba Economic Partnership Agreement

The second case study presents another variation in coordination context. The Canada-Manitoba Economic Partnership Agreement (MEPA) provides financial contributions to projects within two broad categories: "Building Our Economy" and "Sustainable Communities". The second generation MEPA that is the basis of this case study was signed in 2003 and runs until 2008. Due to a change in economic conditions, it differs somewhat in foci and priorities from past generations of similar bi-partite agreements. With Manitoba enjoying a low unemployment rate and satisfactory economic growth in 2003, there was reduced need for immediate or short term results or benefits from a new MEPA. Other factors became more salient in this economic context, in particular a desire to broaden the development focus to include support for institution development of the sort that would contribute to long-term economic productivity and competitiveness (particularly with regard to research and development capacity). Moreover, a political concern informing the agreement was not to run afoul of WTO rules as they relate, for instance, to business subsidies (see Table 6.3).

Accordingly, the design of the second MEPA examined here continues to shift government development efforts further along a continuum that had begun with the first generation MEPA (1998-2003): in general, moving away from an economic development program designed to provide a high degree of targeted, direct and immediate benefit to particular private sector businesses (typical of government assistance in the 1970s and 1980s), toward a programme that also if not primarily seeks to provide more long-term, indirect benefits that contribute to broader, strategic objectives related to economic restructuring and competitiveness (see Table 6.3). As a result, the MEPA is not constructed as a proposal-based programme open to the public, but instead a programme in which MEPA management targets specific categories of applicants or select projects, including both private sector businesses and non-profit, public sector organisations, universities, and research hospitals, the latter increasingly important as centres of research and innovation (see WED, *WEPA, Final Program Evaluation*, Table 5.5).

Table 6.3. **Government programme benefit continuum**

High degree of private benefit	High degree of public benefit
Direct benefit	Indirect benefit
High degree of tangible output	High degree of intangible output
Strict criteria	Non-specific criteria
Checks, balances, controls	Limited checks and controls
Clear indicators of success	Unclear indicators of success
Demonstrated feasibility	Feasibility not always required
Conditions causing shift to direct benefit programmes	Conditions causing shift to indirect benefit programmes
High unemployment and need for job creation	Low unemployment
Need to expand small business creation	Satisfactory economic growth
Slow economic growth	Short term results not essential
Short-term results needed	Institution development a priority
Concern over foreign ownership	Concern about WTO rules
	Lack of concern over foreign ownership

Source: Adapted from WED (Western Economic Diversification Canada) (n.d.), "Western Economic Partnership Agreements (WEPA): Final Program Evaluation", *www.wed-deo.gc.ca*, Figures 5.2 and 5.3.

With both the federal and provincial government having decades of experience with several generations of this type of agreement, asymmetries of policy knowledge between governments is not a major issue. Each government has developed over time a commensurate level of skill and knowledge in this field, and there is a high degree of mutual understanding with respect to roles and appropriate policy instruments. This general situation, however, does not always or equally pertain with regard to information levels at the project level, where the provincial government has an information advantage in that they are closer to the local community and can draw upon the expertise of their sector departments, for example in assessing or developing project proposals. This is countered to a degree by the consensual, co-decision arrangements within the agreement (which go some way towards equalizing decision-making information between governments), and secondly by the fact that on virtually all projects both governments benefit from the validation of individual project proposals provided by the support and financial contributions of community stakeholders. In effect, the knowledge/information situation sometimes produces between governments a relative equality of position with regard to jurisdiction, knowledge and information, and at other times a modest information advantage for the sub-national government.

The medium-term policy objectives of the MEPA – such as supporting the development of research capacities, infrastructure for knowledge industries, and nurturing the workforce skills relevant to this type of industry – are linked to the broader policy objective of enhancing the long-term productivity and competitiveness of the Manitoba economy. In general, the level of complexity involved in attaining these policy goals is high because of the wide range and

interacting character of the variables involved. On a project to project basis (a wide range of which are eligible for support), the level of due diligence exercised by governments, the credibility and track record of community stakeholders and third-party contractors, and the quality of pre-planning processes (better understood and guided as a result of long governmental experience in this policy field) are relevant factors in managing this complexity.

The degree of inter-dependence (whether vertical or horizontal) with regard to the projects supported by MEPA funding is generally low, with economic and social impacts primarily local or provincial. Again, this will vary somewhat on a project to project basis. This low inter-dependence reduces central government concerns about loss of control or authority. Regarding the credibility and enforcement of commitments, a number of factors contribute to what appears to be a generally low level of mutual concern about this: the three decades of experience with bi-partite agreements of this type, the clear limits to each government's financial commitment, the reassurance provided by community stakeholder support and financial participation, mutual confidence in existing government infrastructure for the performance of accounting, reporting, inspecting, and audit functions, and finally the detailed stipulations in the MEPA regulating joint communications with the public (a factor relevant to satisfying the demands and exigencies of each government's ongoing political accountability to citizens).

As with the Vancouver Agreement, the contractual arrangements set out in the MEPA approximate the characteristics of a relational contract. With administration of the agreement delegated to a two-person federal-provincial management committee (jointly responsible for establishing strategic priorities, administrative guidelines for review, assessment, approval, and implementation of projects, and reporting and evaluation processes), the focus is primarily on project selection and implementation, with minimal resources devoted to management, administration, and evaluation of outputs (WED, *WEPA: Final Program Evaluation*, p. 3).[12]

With one of the desired outcomes of the MEPA "institution development" that will make a contribution toward long-term economic productivity, some if not much of the impact of assistance granted under the Agreement necessarily will be intangible. This makes the efficiency of its grant allocations difficult to measure in quantitative terms; regardless, governments have made little attempt to do so. No *ex ante* performance indicators such as targets or benchmarks are included (WED, *WEPA: Final Program Evaluation*). Since the MEPA is not a legally enforceable agreement, it is implemented essentially at the discretion of the partners; moreover, its dispute resolution mechanisms do not involve third parties. However, there is a political mechanism which for both parties acts as a strong disincentive to any breakdown in co-operation:

citizen, voter and interest group preferences and expectations, and following from this pressure on governments to continue with the allocation of public funds to support job creation, economic competitiveness, and various worthy community projects.

4.2.1. Assessment and recommendation

Like the VA, the Canada-Manitoba Economic Partnership Agreement approximates a flexible and enabling relational contract premised on the equal partnership of the parties who agree to co-operate in the determination and pursuit of broad, shared policy objectives. Its design appears to be guided by three factors: recognition of the primary role assumed by the western provinces in finding ways to enhance their own economic and community development, and the responsibility of the federal government (through WED) to provide support for these efforts; the complexity of the co-ordination situation created by the problems associated with this task; and the relative parity (jurisdictionally and financially) of the two parties to the agreement. While the structure and mechanisms employed in the agreement do not accord well with the notion of delegation from central to sub-national authority, they do align well with MEPA's stated purpose of maintaining and further encouraging co-operation between the two governments to jointly define economic development priorities and to reduce overlap and duplication of their efforts to develop and diversify Manitoba's economy.

The contractual solution relies on a number of factors and devices for credibility, enforcement, and controlling exposure to risk: an environment of mutual trust based on decades of accumulated experience, a co-decision form of management, established administrative procedures and institutional mechanisms, community stakeholder participation, and a defined commitment of financial resources. This generally aligns well with the identified problems and co-ordination context. Its streamlined efficiency in terms of minimal administration costs can be criticized, however, for detracting from monitoring and evaluation capability.

Lacking *ex ante* benchmarks, measurable targets or performance indicators, the claimed economic impact and successes of the MEPA – for example, in terms of leveraged investment, job creation, or business start-ups – is rather difficult to assess (WED, *WEPA: Final Program Evaluation*). Moreover, this particular weakness in the Agreement's design could become more problematic in coming years if there continues to be a shift in focus toward support for non-traditional recipients of regional development assistance, linked to the increasingly important objective of enhancing the province's human resources and its infrastructure supporting knowledge industries. Neglecting to develop and implement an adequate feedback and evaluation mechanism

will limit the Agreement's potential to contribute to feedback learning processes, and therefore to further refinement in the effectiveness and efficiency of government programming in this area.

4.3. The Canada-Nova Scotia Gas Tax Transfer Agreement

The third case study features a very different coordination context from both the VA and the MEPA. In 2005, Gas Tax Transfer Agreements between the federal, provincial and municipal governments were implemented, utilizing a new federal transfer, the Gas Tax Fund Transfer Payment Program as its main financial mechanism. Over five years CAD 5 billion will be transferred to the provinces under this programme, which amounts to approximately one-half of the federal revenues collected from its excise tax on gasoline. The Gas Tax Agreements (GTAs) contain a number of contractual provisions with the following aims: to support Canada's environmental sustainability objectives; to provide long-term, stable, and predictable revenues to enable municipal governments to undertake projects to enhance the quantity and quality of environmentally-sustainable municipal infrastructure; to build capacity at the municipal level; to respect provincial jurisdiction over municipalities; and to ensure inter-provincial equity in revenue allocation for the above-stated purposes.

The specific GTA examined here is the five-year Canada-Nova Scotia Gas Tax Agreement (NSGTA). The conditions placed on the federal monies transferred during the period of the agreement – that they be put towards the creation of new municipal infrastructure that meets the guidelines for the programme – has clear implications for the co-ordination context. This new federal transfer has been inserted into an existing fiscal and institutional framework of clear and uncontested provincial control – including tight financial and regulatory oversight – over municipalities, and this is recognised in the Agreement. Moreover, the building of municipal infrastructure is a task which is well rehearsed and understood by provincial and municipal governments, which have a long history of collaboration on such matters. This means that provinces already have well-established guidelines, procedures, norms and expectations for these types of expenditures, with well-developed technical and project management capabilities. However, the federal government is providing 100% of the financing and the amount of funds being made available to sub-national authorities is significant. Moreover, a political commitment has been made to extend this new federal transfer beyond the initial five-year period, even possibly to make it permanent.

In this co-ordination context, the federal government is subject to asymmetries of both knowledge and information that benefit the other levels of government. This creates the possibility that both adverse selection (hidden information) and moral hazard (hidden action) may occur. Under these

circumstances, in the absence of compensating contractual mechanisms, the probability of central government loss of control over its decentralised fiscal resources is high. On the other hand, the level of complexity involved in the projects funded under the agreement – primarily the building of infrastructure – is relatively low, creating the conditions for observable, measurable, and comparable outcomes. As well, similar GTAs have been signed with all provinces (thereby producing a repeated strategic game situation), so should it choose to do so, the federal government is in a position to accumulate information and to further refine an incentive scheme to ensure optimal provincial and local behaviour in subsequent agreements.

In terms of the criteria of inter-dependence and irreversibility, there would appear to be little long-term risk involved for the central government in the GTAs. The tasks being delegated are almost wholly within provincial jurisdiction, with few spillover effects likely. Nor does efficient completion of the tasks appear to be dependent upon complementary action on the part of the federal government, short of providing the promised funds. Moreover, at this point at least, the transfer of the new funds to provinces (then on to municipalities) is neither permanent nor irreversible; the GTAs have a five-year time horizon, with the possibility of renewal.

The final criteria describing the co-ordination context is the credibility and enforceability of commitments under the Agreement. This is primarily addressed by a new governance mechanism in the form of an Oversight Partnership Committee (OPC), comprised of representatives of the two senior levels of government (Atlantic Canada Opportunities Agency, section Nova Scotia and the Nova Scotia province), as well as the Nova Scotia Union of Municipalities. The OPC provides senior management of the agreement, with more direct and detailed supervision provided by the existing institutional framework (*i.e.*, the administrative laws and financial controls of the province). As well, external enforcement through political accountability to citizens is particularly relevant in this case for the provincial and municipal levels of government, since municipal infrastructure is (and always has been) within their jurisdiction and purview. This ensures clear public and partisan perceptions and expectations regarding the distribution of functional responsibilities in this area of government activity.

This co-ordination context has allowed for the design of an incomplete transactional contract, and the NSGTA approximates this "solution". Included in the Agreement is an incentives/revelation scheme, as well as supervision, monitor, audit, and sanction mechanisms to avoid *ex post* deviation from contractual obligations. With a knowledge distribution that favours the province and municipalities, and the relatively low level of complexity involved in new increments of municipal infrastructure spending, the contracting governments were able to define *ex ante* the policy objectives to be

reached, the strategies for doing so, and the methods of implementation. The NSGTA includes criteria that will be used to assess, and mechanisms to verify, provincial and municipal performance. This corresponds to the logic of delegation in the principal-agent theory of contracts: decentralisation becomes an instrument that allows the central government to take advantage of the knowledge, information and capacities of regional and local authorities to more efficiently and effectively pursue national policy goals (in this case, the building of new environmentally-sustainable, municipal infrastructure "of the centre").

The list of federal and provincial obligations under the NSGTA addresses the possibility that each of the three levels of government may attempt to divert funds, thus frustrating the policy objective and reducing the efficiency of the decentralisation initiative. Several provisions seek to ensure that no existing transfers or funds being spent on municipal infrastructure are clawed back, cancelled, displaced, or allowed to expire as the result of the new gas tax transfer. Commitments to this effect are made by both senior levels of government, and the province agrees to "enforce all terms and conditions of Funding Agreements in a diligent and timely manner and seek remedies from non-compliant Eligible Recipients [municipalities]", including the enforcement of penalties through Municipal Funding Agreements (NSGTA, Sections 3.1, 3.2). Indeed, the annual allocation of the new monies to municipalities will only be triggered by full compliance with all obligations under the agreement (Section 3). The Agreement also includes a commitment (one of the mandates given the OPC) to develop a methodology for the measurement of incremental spending on municipal infrastructure (Section 1).

Further provisions regarding the credibility and enforceability of commitments are evident in clauses on reporting, auditing, evaluation, default, and remedies, all of which appear to be consistent with the logic of transactional contracts (NSGTA, Sections 7, 8). The province is to submit an annual report to the Government of Canada, and an Outcomes Report to its own public at the end of the five-year agreement. The latter will detail the investments made and include information on the contribution of each investment towards the policy objective of cleaner air, water, and reduced greenhouse gas emissions. The province also agrees to submit to an audit by the Government of Canada (if the latter so requests), share any additional information it accumulates, and participate in a joint federal-provincial evaluation of the Agreement. Should the federal government declare the province of Nova Scotia to be in default of any of its obligations under the agreement, it may suspend or terminate its own obligation to pay funds. The OPC will act as arbiter in the event of a dispute or contentious issue (sections 8.1-8.3).

4.3.1. Assessment and recommendation

The Canada-Nova Scotia Gas Tax Agreement is the most recent of the inter-governmental agreements under consideration, and therefore the most difficult to assess in terms of its actual performance. However, compared to the first two cases examined above, it is much more precise in its objectives, hierarchical in its relationships, and endowed with mechanisms for inciting proper behaviour and the fulfilment of contractual obligations. There are some key differences between the NSGTA and the other agreements which explain this. Perhaps most important of these is the funding mechanism around which the agreement is constructed. The Gas Tax Fund Transfer Payment Program is a significant new federal transfer, slated to grow over time, funded out of the revenues generated by the federal excise tax on gasoline. As the contributor of a significant pool of new funds to the budgetary coffers of sub-national authorities, the central government in this instance is placed in a strong bargaining position *vis-à-vis* those authorities regarding the purposes to which the new monies will be put and the methods by which they will be expended. Secondly, the federal policy objective is that the funds be allocated to local governments (cities and municipalities) for the planning and building of local infrastructure, yet these authorities and functions are clearly and indisputably within provincial jurisdiction, requiring the federal government to secure the agreement and active engagement of the provinces in order to achieve the policy objective. Thirdly, the knowledge, expertise, information and capacity to undertake the tasks set out in the agreement lay primarily with the sub-national authorities, forcing the central government to rely on these authorities to use the delegated fiscal resources efficiently, but in the absence of revelation and incentive mechanisms, creating the possibility that this may not be done.

For these reasons the contractual solutions in the NSGTA align well with the co-ordination problems and policy objective. The NSGTA is a legally binding agreement with financial penalties and ultimately the courts as instruments for ensuring the full observation of commitments. Agreement provisions to check any possible diversion, displacement or misuse of funds, by any of the three levels of government – along with other provisions requiring transparency, submission upon request to a federal audit, and annual progress reports to the public – satisfies the mutual concerns of the parties about the credibility and enforcement of commitments. At present an incomplete contract, the commitment on the part of all parties to develop performance indicators suggests the possibility or even probability of evolution toward a more complete contract with incentives and supervision mechanisms, in line with the suggested solution in the framework proposed in the first chapter of this report (see also Table 6.4). Moreover, the requirement that communities develop integrated community sustainability plans, and the provision of

Table 6.4. **From co-ordination contexts to contractual solutions**

Dimension	Values	Contractual Solution	VA	MEPA	NSGTA
Knowledge/ information distribution	HH	Complete *self-enforced incentives*		X	
	HL	Complete *Arbitrage*			
	LH	Incomplete *Audit*	X	X	X
	LL	Co-decision *Arbitrage*	X		
Complexity	High	Incomplete or Co-decision *Audit/Arbitrage*	X	X	
	Low	Complete *Incentives*			X
Inter-dependencies	High	Co-decision *Arbitrage*	X		
	Low	Incomplete		X	X
Enforcement context	Unitary	*Arbitrage*			
	Unitary – Admin. Court	*Supervision*			
	Federal state	Incomplete *Supervision*	X	X	X

resources through the new transfer to help them carry this out, ensures progress towards greater policy, management and implementation capacity at the local level, one of the federal government's policy objectives in both its environmental and cities agendas. In short, the NSGTA constitutes an excellent example of an inter-governmental agreement that utilises contractual design to optimise the effectiveness of the relationship between all levels of government.

5. Conclusion

The principle of contracting between governments is a useful way for governments to organise their relationships in the most efficient manner given the widely varying circumstances and conditions under which they must co-ordinate their actions and interventions, the jurisdictional divisions that often need to be transcended given the complexity and inter-dependence of policy problems, and the uneven distribution of information, knowledge and capacities between levels of government in each policy sector. These realities of governance in all OECD countries require the development of a range of instruments of inter-governmental co-ordination and collaboration that are negotiated, mutually-acceptable, reliable, and flexible. They also must be consistent with constitutional obligations, democratic norms, and the principles of good governance. When conceived as contracts, these arrangements can be regularised and institutionalised, but also revised, adjusted, and fine-tuned to optimize efficiency and effectiveness.

The key to the usefulness of contracts, and therefore to their widespread use, is the existence of trust between the contracting governments and the mutual benefits derived from contracting. This can be facilitated by various fiscal, legal, organisational, and political mechanisms incorporated into the contracts for these purposes, but also by accumulated experience with the contracting process itself.

In the case of Canada, a decentralised federal system means the central government needs to contract in order to take advantage of the knowledge, information, and capacities (legal, administrative, and fiscal) of the regional and local authorities. Central authorities do this in order to more effectively pursue national policy goals, an objective that requires government actions to be co-ordinated, both in areas of shared jurisdiction (environmental policy, regional development) and in areas of exclusive jurisdiction where complexity requires complementarity of government action. A variety of contractual practices have been shown to be relevant in these circumstances, including bipartite, tri-partite, and revenue transfer agreements. Based on the case studies examined herein, a particularly important consideration regarding these contractual arrangements is the need for flexibility, co-decision, and horizontal collaboration to encourage and manage the process of learning in the increasingly complex policy and co-ordination situations facing governments today.

Notes

1. This chapter draws on the contribution of James Bickerton, Department of Political Science, St. Francis Xavier University.
2. This open-ended federal "spending power" was often disputed by Quebec and periodically by other provinces, and was finally confirmed and clarified by a Supreme Court ruling in the early 1990s.
3. The one significant exception to this trend is the Canada Health Act (1984), which re–imposed conditions on the provinces by which they must abide to continue to receive, without financial penalty, the Canada Health Transfer (the annual federal contribution to provincial health care expenditures).
4. The Conservative federal government elected on 23 January 2006, has promised to enter negotiations with the provinces to address this question.
5. While on a per capita basis, the least economically developed region of the country – the Atlantic provinces – continues to be the biggest recipient of federal regional development aid, this is somewhat misleading in that other programmes, such as industry and technology programmes managed by the federal Department of Industry, have provided extensive support and assistance to businesses and communities in Canada's industrial heartland. Arguably it is the latter (much larger) federal expenditures that are more important in shaping and sustaining Canada's regional economies (Beale, 2000; APEC, 2004).

6. Although all provinces have signed agreements of this sort with the federal government, they have been particularly important for those provinces experiencing lagging growth, high unemployment, and other economic disparities (Savoie, 1992).
7. An evaluation of the first generation of these agreements noted that they have been successful in leveraging additional investment from the private sector, increasing the number of business start-ups, contributing to job creation, and fostering intergovernmental partnership toward the shared policy goal of diversifying the western Canadian economy (WED webpage).
8. A second generation Vancouver Agreement was signed in 2005.
9. In 1997, a public health crisis was declared because of rising HIV infection rates among intravenous drug users in the Downtown Eastside. This stimulated the political response that eventually produced the VA.
10. It is the task teams that identified funding priorities and looked for funding through existing government programmes, private agencies, or foundations, or if necessary (beginning in 2003) dedicated VA funds. Consultation with and the direct participation of community representatives throughout this process is noteworthy in that community engagement was one of the original stated purposes of the VA.
11. Trilateral UDAs have been signed with a number of western Canadian cities. A new UDA has been negotiated for the City of Toronto, and is currently awaiting final approvals prior to signing and implementation.
12. Standard internal administrative controls on the disbursement of public funds continue to be applied to discrete projects which are recipients of assistance under the Economic Partnership Agreement.

Bibliography

APEC (Atlantic Provinces Economic Council) (2004), "Business Subsidies and Their Role in Atlantic Canada", Atlantic Report, Vol. 39:2 (summer).

Beale, Elizabeth (2000), "The View from Atlantic Canada", Canadian Business Economics, Vol. 8:1.

Bickerton, James (1990), Nova Scotia, Ottawa and the Politics of Regional Development, University of Toronto Press, Toronto.

Bickerton, James (1999), "Regionalism in Canada", in James Bickerton and Alain-G. Gagnon (eds), Canadian Politics, 3rd Edition, Broadview Press, Peterborough, Ontario.

Bradford, Neil (2004), "Canada's Urban Agenda: A New Deal for the Cities?", in James Bickerton and Alain-G. Gagnon (eds.), Canadian Politics, 4th Edition. Broadview Press, Peterborough, Ontario.

Bradford, Neil (2006), "Placing Social Policy? Reflections on Canada's New Deal for Cities and Communities", draft paper, prepared for Annual Meeting of the Canadian Political Science Association, 3 June 2006, York University, Toronto, accessed December 2006 at *www.cpsa-acsp.ca/papers-2006/Bradford.pdf*.

Gagnon, Alain-G. (1999), "Quebec's Constitutional Odyssey", in James Bickerton and Alain-G. Gagnon (eds.), Canadian Politics, 3rd Edition, Broadview Press, Peterborough, Ontario.

Government of Canada (2000), "Vancouver Agreement: An Urban Development Agreement Between Canada-British Columbia-Vancouver", initiated 2000, updated 2005, *www.vancouveragreement.ca*.

Government of Canada (2005), "Canada-Nova Scotia Agreement on the Transfer of Federal Gas Tax Revenues Under the New Deal for Cities and Communities".

Government of Canada, "Canada-Manitoba Economic Partnership Agreement", *www.epa.gov.mb.ca*.

Government of Canada, "Canada-Manitoba Economic Partnership Agreement, Annual Progress Report, 2004-2005", *www.epa.gov.mb.ca*.

Lazar, Harvey (ed.) (2005), Canadian Fiscal Arrangements: What Works, What Might Work Better, Institute of Intergovernmental Relations, Kingston, Ontario.

OECD (2002), OECD Territorial Reviews: Canada, OECD Publications, Paris.

OECD (2005a), "Intergovernmental Transfers and Decentralised Public Spending", GOV/TDPC/RD(2005)15.

OECD (2005b), "A Contractual Approach to Multi-level Governance: How to Design Effective Relationships Between Central and Sub-National Governments?", GOV/TDPC/RD(2005)16.

Savoie, Donald (1992), Regional Economic Development: Canada's Search for Solutions, 2nd Edition, University of Toronto Press, Toronto.

Savoie, Donald (1997), Rethinking Canada's Regional Development Policy: An Atlantic Perspective, Canadian Institute for Research on Regional Development, Moncton, New Brunswick.

Simeon, Richard and Ian Robinson (1990), State, Society and the Development of Canadian Federalism, 71, Research Studies for the Royal Commission on the Economic Union and Development Prospects for Canada, University of Toronto Press, Toronto.

Smiley, Donald (1974), Constitutional Adaptation and Canadian Federalism Since 1945, Royal Commission on Bilingualism and Biculturalism, Information Canada, Ottawa, Ontario.

Stevenson, Garth (1989), Unfulfilled Union, Gage Publishing, Toronto.

Vaillancourt, François (2000), "Federal-Provincial Small Transfer Programs in Canada, 1957-1998: Importance, Composition and Evaluation", in Harvey Lazar (ed.), Canada: The State of the Federation 1999/2000: Toward a New Mission Statement for Canadian Fiscal Federalism, McGill-Queen's University Press, Montreal, pp. 189-212.

Watts, Ronald (1996), Comparing Federal Systems in the 1990s, Institute of Intergovernmental Relations, Kingston, Ontario.

Watts, Ronald (2005), "Autonomy or Dependence: Intergovernmental Financial Relations in Eleven Countries IIGR", Working Paper No. 5, Queen's University, Canada.

Western Economic Diversification Canada (n.d.), "The Vancouver Agreement: A Governance Case Study", WED Canada, Reports and Publications, *www.wed-deo.gc.ca*.

Western Economic Diversification Canada (n.d.), "Western Economic Partnership Agreements: Final Program Evaluation", *www.wed-deo.gc.ca*.

Interviews

Mr. Adam Ostry, Director, Policy and Communications, Cities Secretariat, Transportation and Infrastructure Canada.

Mr. Derryl Millar, Director of Operations for Manitoba, Western Economic Diversification Canada.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(42 2007 10 1 P) ISBN 978-92-64-00873-1 – No. 55497 2007

Linking Regions and Central Governments

CONTRACTS FOR REGIONAL DEVELOPMENT

The last 15 years have brought a dramatic change in public decision making and public policy building. A trend toward decentralisation has meant that sub-national governments increasingly find themselves responsible for providing a host of public goods and services. Rarely, however, can they "go it alone". Co-ordination among levels of government is imperative. Given this environment, how can arrangements among levels of government be made effective?

Contract theory provides important insights into the various types of agreements between different levels of government. These contractual arrangements between levels of government are unavoidable, particularly in a regional development context, which is characterised by complex interactions and incentives between national and sub-national actors. However, there is no "optimal" contractual arrangement that fits all co-ordination contexts. How then should governments decide which arrangements to pursue? This book offers a unique analytic framework for assessing multi-level governance arrangements, which is subsequently applied to five case studies of regional development policy: Canada, France, Germany, Italy, and Spain. The book reveals the importance of contractual arrangements for customised management of interdependencies, for clarifying responsibilities among actors, for dialogue, and for learning.

This book should be of interest to policy makers and practitioners seeking to identify and design new and better mechanisms for effective multi-level governance, to NGOs and firms engaged in regional development, and to academics interested in multi-level governance and regional policy.

www.oecd.org

ISBN 978-92-64-00873-1
42 2007 10 1 P

OECD
OECDPUBLISHING