OECD MULTILINGUAL SUMMARIES

Linking Regions and Central Governments: Contracts for Regional Development

Summary in English

I/ Aim of the study

Relations among levels of government are unavoidable because each must deal with another to achieve policy goals. As a result, governments must design mechanisms for the efficient and effective co-ordination of these relations. In short, they must develop and implement effective contracts which are tailored to the specific context to be addressed.

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 decision mechanism that has been mutually agreed upon. In the latter case, the contract is 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. 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 their relationships, in particular with respect to regional development policies.

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

This report investigates relations among levels of government by developing an analytic framework based on the economic theory of contracts, and subsequently applies this framework to five case studies. 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 their interactions, and the dynamic of relationships.

The analytic framework proposed in this report reveals a continuum of arrangements that ranges from “transactional” to “relational.” These two polar forms of contracts correspond to highly contrasted logics.

“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 their reciprocal duties. 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 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).

"Relational" contracting corresponds to a logic by which the parties commit to co-operate *ex post* (after the signing of the agreement) 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 implementation of 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.

To understand how the logic of contracting between levels of government performs in various institutional contexts in the area of regional policy, five case studies are presented. They cover the examples of Canada, France, Germany, Italy, and Spain. Each case presents 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

Before summarizing the main conclusions of the report, it is important to highlight the specificities of contracting among levels of government. In particular, it differs from contracting generally due to an absence of regulation by competition, an institutional lock-in effect, and no resource to vertical integration to solve co-ordination problems.

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 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.

IV/ Main results

Contracts among levels of government are unavoidable "governance" mechanisms which allow for customised management of inter-dependencies, rather than "optimal" co-ordination tools.

Contracts are unavoidable because levels of government must deal with one another to achieve policy goals. The logic of contracting between levels of government means that co-ordination mechanisms must be built to manage relationships that are unavoidable. Contracting mechanisms have to be thought of in a dynamic perspective as tools which enhance co-ordination.

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.

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.

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 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 implementation of joint policies.

The national cases about regional development policy surveyed demonstrate that contracts in unitary and federal countries correspond to a continuum of contracting aims and practices. In France, a strongly unitary state, the logic of contracting is to jointly manage policies in the framework of a decentralisation 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 to transfer responsibilities so as to train and make more accountable sub-national government, and to support mutual learning, as in 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 which are tailored to particular place-based characteristics would be needed.

In Spain, the logic is 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-dependencies and to address the antagonisms that characterised the decentralisation of Spain.

In Canada, 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 can clarify responsibilities, enhance accountability, and increase incentives for learning.

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.

In addition, clarifying responsibilities 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.

Four dimensions of the relationship between the levels of government determine the effective contractual arrangement to be implemented.

There is no "one size fits all" contractual mechanism that governments should apply. Rather 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. Four characteristics matter in the case of contracts between levels of government:

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

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 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).

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).

2. ***The degree of complexity: the wider the scope, the more relational***

When co-ordination is about complex matters complete contracting and precise control of the behaviour of the sub-national government by the centre is difficult. This leads to incomplete contracting, and more relational than transactional types of contracts. 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.

3. ***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 ensuring efficient

oversight by the judiciary or by building mechanisms aimed at informing the citizens on the performance of the co-operative process.

4. The enforcement context: institutional context matters

An important difference between countries is the enforcement context which determines how well contracts can be implemented and their credibility. Enforceability of contracts strongly depends both on the organisation of the judiciary (particularly its independence and its skill) and on the political accountability of the various governments. 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 design of the contract should anticipate these enforcement difficulties. Building mechanisms to inform citizens of the mutual duties and their completion can enhance political accountability and 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.

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

Contracts can have endogenous effects on the four characteristics summarized here, meaning that they might change after a contract is implemented. When contracts are used to promote learning and effective policy design, this can lead to an evolution and proliferation of contracts. For example, the distribution of knowledge can evolve because contracts can be used as learning tools. In the presence of knowledge asymmetries between the levels of government, the experiments made by the two parties in the course of the completion of the contract can lead them to progressively discover the best way to co-ordinate. 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.

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. 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.

Contracts aimed at addressing regional development policies tend to be relational.

In 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 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 complex ones. This complexity is 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 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. Thus, an important two-fold recommendation is to:

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

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Public Affairs and Communications Directorate.

rights@oecd.org

Fax: +33 (0)1 45 24 99 30

OECD Rights and Translation unit (PAC)
2 rue André-Pascal
75116 Paris
France

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