

We would like to thank the referee for his/her review of the paper. We are totally in agreement with his/her discourse on how to analyze the efficiency of the projects of one jurisdiction. In fact it is as the efficiency of public spending is analyzed in the literature, i.e., using public spending as input and an indicator of the goals of the spending programme as output. We point out this question in footnote 5, where we also recommend the survey of Afonso and Fernandes, 2008, for being of interest for this topic about efficiency.

But contrary to what the referee says, in this work we don't analyse if the investment decisions of Spanish regional governments are efficient or not. As we specify in the abstract, in the introductory section, and along all our paper, we quantify the fungibility effect or diversion of resources towards purposes other than investment, by regions receiving conditional capital transfers. We consider, therefore, that there can be no doubt about the purpose of our work. At no point do we seek to establish optimum or efficient levels of investment, but as we indicate, for example, at the beginning of the second paragraph of the introductory section *"To see whether donor governments have any reason to be worried about the final destinations of the grants they contribute (or regional debt), this work quantifies the diversion of resources by regions receiving conditional capital transfers...Based on frontier investment estimations, we calculate the divergence between actual and potential investment, identifying this divergence as the fungibility effect"*.

The only criticism of referee 1 is that *"the approach followed in this paper does not make a real contribution to the literature and can actually create a lot of confusion. The reason is that there is nothing such an efficient level of investment. You can not say that because you have a given level of transfers and a given level of savings or debt then you should have some level of investment"* This statement is based on a single objection: *"The problem actually comes from using an input (capital spending) as if it was an output. The authors claim that this is innovative, but it is wrong"*. There are two compelling reasons why that referee's opinion is not correct:

1.- On the one hand, probably because the referee knows partially or incompletely the institutional and legal framework of the Spanish regions. As explained in the text of the article, both the capital transfers and the indebtedness have the investment as a mandatory and exclusive purpose, so her/his assertion: *"You can not say that because you have a given level of transfers and a given level of savings or debt then you should have some level of investment"*, is not correct. There is a strong relationship between investment and these funding sources and there is literature that analyzes these issues, as we cite in our paper (Lago-Peñas, 2006, Payne, 2009). And for that reason we are interested in quantificate the deviation of resources towards purposes other than investment in the Spanish regions (fungibility effect), or the contrary effect, i.e., if the transfers received can cause a *bandwagon effect*, leading the receiving government to make a greater investment effort than its available resources permit, taking funds from other expenditures which will be abandoned, or obtaining them from other sources, such as debt or taxes. We explain in page 6 that these questions have been incipiently analysed in the literature (e.g., McGuire, 1975; Islam, 1998; Sagbas, 2001; and Sagbas and Tolga, 2008).

2.- On the other hand, at no time do we intend to determine an efficient level of investment, since as stated by the referee 1, it is practically impossible to determine an efficient or optimal level of investment. In the empirical part of our research, what we do is to determine a potential level of investment from, among other variables, the

sources of investment funding, to be able to quantify the divergence between actual and potential investment, identifying this divergence as the *fungibility effect*. Perhaps the referee's confusion is because we use for that purpose the frontier techniques that are commonly used in the analysis of efficiency, and that let us determine whether the regions are investing its potential, given certain environmental factors. However, we must say that we have put special care in the writing of the work in avoiding the expression "efficient investment" or similar so as not to confuse or lead to misunderstandings to the reader. We also specify in the text that what we analyze is not inefficiency. This is well explained in page 9.

*"We think that frontier techniques, which are usual in the analysis of efficiency of companies' production, should work well in the sphere of funding for capital expenditure, insofar as investment can be considered as the output of the donor government's policy, which will be the function of a series of inputs - the financing sources available to the regions receiving the grants for making these investments. Also, both companies and governments are worried about the potential output (production or investment) which is unrealised. In the field of the production frontier this gap represents the level of inefficiency which a company cannot overcome, while in the field of public capital expenditure which concerns us here, it represents the unused investment potential or resource diversion effect, and could be caused by at least two groups of factors. On one hand, because the regional government wants to prioritise the provision of services to its citizens (current spending), the payment of financial costs, and/or a reduction in tax pressure or debt, whether for political reasons, the pressure of the crisis, or for having demanded a high level of tax effort from the citizens. And on the other, because there may have been poor practices in the planning and management of investment projects due to corruption, managerial incompetence by the governments, or a lack of suitable human resources, all of which could be considered an "unproductive" diversion of resources, or literal inefficiency. In all cases, the gap (fungibility/bandwagon effect) detected by any of the frontier techniques we are going to use must not be identified with the inefficiency in the provision of public capital expenditure which the literature has tried to explain (Afonso and Fernandes, 2008), because this inefficiency could be precisely the cause of an excessive capital expenditure."*

This last sentence is precisely what the evaluator refers to when he states: "Actually, it might be that the regions that decide to invest less given their possibilities are the ones that are investing efficiently. We know for instance that in the last years the Spanish regions have been investing in inefficient projects ('white elephants'), so it is not clear that the more investment the better". Again, we have to say, we do not analyze inefficiency. In addition, it can be observed that the variables that we find explanatory of the divergence between the current investment and the potential respond to, among others, issues related to political decisions or socioeconomic variables, not linked to inefficiency issues.

In any case, if the referee thinks it is necessary to clarify the text in a particular aspect, we are at his/her disposal.