9. CONDITIONAL GRANTS

Conditional grants from national to subnational governments are used in virtually every country in the world where there is more than one level of government. They are especially relevant in nations where the delivery of major public services such as education and health has been decentralised to provincial or local governments. The grants can also be used to provide support and encouragement for more narrowly defined projects, such as infrastructure or administration, in order to achieve more effective decentralised decision-making.

9.1 Types of conditional grants

Conditional grants can come in many forms and have various sorts of conditions associated with them. The scope of conditional grants varies along a spectrum. At one extreme, they may be specific grants for fairly narrow and well-defined purposes such as a road or hospital. At the other end of the spectrum, they may be block grants used to support a broad area of expenditure, such as education or health.

The nature of the conditions can vary. For specific grants, the conditions can be correspondingly specific. For block grants, the conditions are typically much more general, and they may stipulate general criteria that broad spending programmes must satisfy. These can include the scope or comprehensiveness of services provided in health care, the levels of schooling to be made available to target populations in education, and so on. The criteria could be very broad indeed, covering such principles as non-discrimination, availability to residents of other jurisdictions, or fairness somehow defined, leaving considerable discretion to the provinces and municipalities to choose the design and level of services offered.

Conditional grants may be matching or non-matching. That is, the amount of the grant may or may not be tied by formula to spending by the recipient government. If matching, they may be subject to a maximum and are thus closed-ended, or they may be open-ended. Grants that are matching influence not only the programme design, but also the amount of expenditures devoted to the programme.

Finally, conditions may be imposed by the sphere of government allocating the funds, or the two spheres of government may negotiate them. In either case, an important feature of conditional grants is the method used to enforce the conditions. With specific grants, enforcement will typically not be an issue: the grant will only be paid if the recipient government undertakes the specific spending.
For block grants, enforcement is more difficult because the conditions are typically rather vague and subject to interpretation. The following methods of enforcement are possible:

- National government may enforce the conditions by penalising the subnational government whose programmes do not meet them.
- There may be some dispute settlement mechanism, possibly the courts, which might be used for adjudication.
- National government may be empowered to impose mandates on the subnational government, essentially insisting through the force of law that the recipient government enact certain measures.
- National government may simply rely on moral suasion or public opinion to induce the subnational spheres to abide by the conditions.

### 9.2 The rationale for conditional grants

The extent to which conditional grants are used and their design depend very much on the constitutional, institutional and fiscal circumstances of the nation concerned. In the most general sense, the purpose of conditional grants is to influence the fiscal decisions of the subnational government, presumably with the express intent of achieving some objective of national government, including objectives that are stipulated by the Constitution.

#### 9.2.1 Spillovers

The traditional argument for conditional grants, especially matching ones, is that the spending programmes of one jurisdiction provide benefits to residents of other jurisdictions. Examples might include transportation facilities that are used by households and firms of neighbouring municipalities, education or training provided to households who subsequently change provinces, or pollution control measures that reduce cross-border pollution. In these circumstances, there is no mechanism for registering the benefits accruing to non-residents, and conditional grants are meant to substitute for this. Though this argument is fairly non-controversial, it is unlikely to account for the bulk of inter-governmental transfers in practice.

**One argument for conditional grants is that the spending programmes of one jurisdiction provide benefits to residents of other jurisdictions.**
9.2.2 Efficiency in the national common market

A related argument is that conditional grants can help to achieve efficiency in the internal common market, that is, in the free and undistorted movement of labour, capital, goods and services across borders, especially provincial ones. Provinces may design their programmes in ways that distort these cross-border movements, either intentionally or unintentionally. For example, mobility rights may not be guaranteed in provincial programmes, educational and training qualifications may differ from one province to another, or provinces may engage in beggar-thy-neighbour policies to attract economic activity at the expense of other provinces. Conditional grants might aim to ensure that general principles of non-discrimination, equal access and mobility rights are guaranteed, or more generally they may attempt to harmonise the design of programmes that have implications for inter-provincial exchange.

9.2.3 National standards of equity

More important, and perhaps more controversial, is the use of conditional grants to achieve objectives of equity or fairness. Many of the expenditure responsibilities decentralised to provinces and municipalities are policy instruments for the pursuit of redistributive objectives. Examples include the main categories of education and health services, which together address goals of equality of opportunity, income distribution and social insurance. While there are good reasons on efficiency grounds for decentralising their provision to the provinces and municipalities, national government nonetheless maintains an interest in how these programmes are designed.

The use of conditional block grants is one effective way for national government to discharge its responsibility for national equity objectives while preserving the advantages of decentralised service provision. In the provincial sphere, the existence of significant vertical fiscal imbalances facilitates the use of conditions for this purpose. Of necessity, conditions attached to block grants for the purposes of furthering national equity objectives will be fairly general.

The effectiveness of conditions attached to grants that are used to finance health and education services will depend on the proportion of spending that is financed by grants. The more financially self-sufficient the provinces or municipalities are, the more difficult it might be to assure compliance with general conditions. This is an issue in some federations such as Canada, but not in South Africa’s provinces, which are heavily reliant on national grants.
9.2.4 Infrastructure

Conditional grants might have a particular role to play in financing infrastructure projects. These projects tend to be once-off expenditures rather than recurring ones. Moreover, they involve the creation of assets of ongoing use. Provinces and municipalities might have difficulties financing them if they have limited access to capital markets, which is especially the case with provinces. These grants might be very important for building up the capacity to provide future services of national importance (schools and hospitals), or for providing assets that build up the economic capacity of a jurisdiction so that it will be less dependent on future grants (for example, roads, communications facilities, and utilities).

9.2.5 Building administrative capacity

Related to the infrastructure argument, conditional grants may be important for developing the capacity of provinces and municipalities to provide public services. The delivery of an acceptable level of public services requires both physical and human assets. The latter includes both the acquisition of particular skills as well as the development of management and administrative expertise. Some of this comes with training, and some simply with experience. In either case, extraordinary once-off expenditures will be needed to develop the decision-making capacity of subnational governments. Once these backlogs of human and physical capital are made up, the capacity of provinces and municipalities to deliver important public services will be put on a sustainable footing.

9.2.6 Strategic arguments

Yet another related argument for conditional grants is that they are necessary to counter what is sometimes called the bailout problem or the soft budget constraint problem. If subnational governments recognise that their funding is determined partly by the extent to which their services satisfy the needs of their residents for important public services, they may take actions that exacerbate those needs and result in the granting government increasing its allocation. This exploitation by the recipient government might include overspending, spending in inefficient and unaccountable ways, or directing too much spending on items that are not in the national interest.

Part of the purpose of the costed norms approach is to remove those adverse incentives. Nonetheless, the system may be less than perfect. Even if the correct amount of equalisation grants is given to provinces and municipalities, they may simply not use them to provide services that meet the nationally mandated
standards. In these circumstances, national government might have to attach conditions to them, despite the disadvantages of doing so.

These reasons for conditional grants are distinct from, but related to, those for equalisation grants. Unconditional grants serve important national equity and efficiency objectives. They are necessary for ensuring that acceptable standards of public services can be provided at comparable tax rates to citizens no matter where they reside. Assuming that an effective system of equalising grants is in place, making them effective may involve attaching conditions to them. That may not be permissible in South Africa, where equitable shares are meant to be unconditional.

9.3 Difficulties with conditional grants

Conditional grants have some potential drawbacks. Since their intent is to influence the fiscal behaviour of the recipients, they necessarily detract from one of the objectives of decentralisation, which is to make all spheres of government responsible for their own decisions. If it were possible to set out the conditions such that they clearly reflected national objectives and no more, this interference with local or regional autonomy would be justified.

But matters are not so clear-cut. On the one hand, it is practically impossible to define general conditions to reflect national objectives in a way that is clear and unambiguous. This means that some discretion is necessary to determine the extent to which recipient governments are abiding by the conditions. Even if national government is fully benevolent, it will not be possible in practice to apply general conditions that entirely avoid interference with what may be legitimate provincial or municipal goals. In the end, a compromise must be reached between the benefits of decentralisation as achieved through provincial and local autonomy and the necessity to ensure that the exercise of this autonomy does not abrogate national objectives. The need to strike an appropriate balance is at the heart of multi-sphere government systems.

On the other hand, national governments may not be so benevolent as to resist taking the opportunity to use conditional grants to exert undue influence over the priorities of provincial and local governments. This temptation to be intrusive suggests that nations should err on the side of caution and not impose conditions on general block grants unless it is absolutely necessary to achieve national objectives.
Should the imposition of conditions become necessary, their enforcement is not trivial. Penalising provinces and municipalities whose programmes do not satisfy national norms and standards could be counter-productive. Such sanctions might make it even more difficult for the recipient governments to succeed, with the result that those most in need of services end up suffering.

Thus, the decision to impose conditions that are enforced by financial penalties is a difficult one. One would hope that moral suasion would go a long way to ensure compliance, especially if the conditions themselves reflect national objectives that are based on consensus. If the grants are well-designed and in accordance with constitutional principles, there should be little need to enforce them.

**9.4 Implications for South Africa**

Provinces in South Africa rely heavily on national grants. They are also responsible for delivering the most important public services - education, welfare, and health services. The Constitution spells out the goals that these programmes are expected to satisfy, and makes the provinces and national government jointly responsible for satisfying them. The challenges in terms of meeting these goals vary widely across provinces: both the levels of services and the capacity and experience in delivering them differ. It is natural to ask whether the use of conditional grants would facilitate the process of ensuring that all provinces deliver a minimally acceptable level of key services, while recognising that a period of transition is inevitable.

In the case of block grants to finance basic health, education and welfare services, the argument for conditions is least strong. The main financing for these services comes from the equitable shares, which can be designed to take provincial needs and costs into account. There is already constitutional provision for national government to mandate standards that provincial programmes should satisfy. Incorporating further conditions would likely be counter-productive and against the spirit of the Constitution.

The case for conditional grants is likely to be much stronger for more specific objectives. In the medium term, there is a need to build up public infrastructure to an acceptable level and thereafter to maintain it as required. The use of conditional grants for these purposes is not controversial. Conditional grants might also be useful as a means of assisting in the development of the capacity of the provinces and municipalities to deliver

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services. This may involve extraordinary expenditures on training or technological equipment. It may also be possible to identify specific areas of deficiency within the areas of education or health and in other areas of provincial or local responsibility that could use once-off funding.

There will always be a temptation to use conditional grants excessively: evidence from multi-level governments around the world bears this out. Conditional grants inevitably involve the use of discretion by national government. This tends to interfere with provincial and local autonomy, imposes uncertainty on the subnational governments, and makes them accountable for their expenditures to national government rather than to their own electorates. Thus, it is important that if conditional grants are used, their use be limited and the process by which they are determined be open to public scrutiny.