Conditionality in practice: Emerging lessons for public investment

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Lee MIZELL
The Graduate Institute of International and Development Studies, Geneva
Background information

This paper was prepared as a background document to the OECD-European Commission Seminar on “Conditionalities for More Effective Public Investment” held on 28 April 2017 at the OECD Headquarters in Paris, France. It sets a basis for reflection and discussion.

About the Project

This seminar is part of a five-part seminar series in the context of an EC-OECD project “Designing better economic development policies for regions and cities”. Other sessions in the series addressed the use of: contracts for flexibility/adaptability, performance indicators, financial instruments, and insights from behavioural science. The outcome of the seminars supports the work of the Regional Development Policy Committee and its mandate to promote the design and implementation of policies that are adapted to the relevant territorial scales or geographies, and that focus on the main factors that sustain the competitive advantages of regions and cities. The seminars also support the Directorate-General for Regional and Urban Policy (DG REGIO) of the European Commission in the preparation of the impact assessment for the post-2020 legislative proposals and to support broader discussion with stakeholders on the future direction of the delivery mechanisms of regional policy.

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Introduction

There is a tension between autonomy and constraint involved with fiscal transfers between governments, be they within or between countries. Inevitably in the design of such transfers, one must ask: should strings be attached? The nature of these “strings”, or conditions, that shape the contractual relations between grantor and recipient of funds, has been the subject of study both in the field of intergovernmental fiscal relations and in the field of international development. The former makes normative assertions regarding the circumstances in which an absence or presence of conditions makes sense (i.e. conditional vs. general purpose grants). There is some – but less – clarity in the field of international affairs where the “strings” attached to development assistance, and particularly to loan packages, have been the subject of considerable critique.

The purpose of this paper is to provide a preliminary examination of country experiences with conditionality to draw lessons about its use for shaping contractual relations between governments. It contributes to the OECD’s ongoing work to support the 2014 Recommendation of the Council on Effective Public Investment Across Levels of Government (OECD, 2014). As such, emphasis is placed on lessons for shaping public investment, an area where making the most of funds depends on how well they are managed (OECD, 2013; 2014). The paper addresses the following research questions:

- Can conditionality enhance contractual relations?
- What factors facilitate/inhibit its usefulness? Does capacity play a role?
- What are the implications for using conditionality to shape subnational public investment?

To answer these questions, the paper draws on two different streams of literature. It brings together lessons from international development assistance and the theory and experiences of intergovernmental fiscal relations. Lessons from the literature are complemented by three short case studies that highlight country experiences with conditionality in different situations (two cases of conditional grants and one of international lending). The first part of the paper syntheses these lessons and the second part presents the three case studies.

What is conditionality and why is it used?

The concept of conditionality is generally (negatively) associated with the “strings” attached to assistance provided by international financial institutions (IFIs), and with the World Bank and International Monetary Fund (IMF) in particular. But the use of conditionalties is not restricted to IFIs. They have been used by donor countries in the context of development aid, by the European Union (EU) to expand its membership (Schimmelfennig and Sedelmeier, 2004) and to deliver regional investment funds (Berkowitz et al., 2015), and by central governments in their relations with subnational levels (OECD, 2013). In all of these contexts, conditionalties shape the contractual relations between parties and set the terms under which financial assistance (or another reward, such as membership) will be delivered. This paper focuses on conditionality that involves financial transactions. In this context, the transfer of funds is made contingent on the target government taking “certain policy or institutional actions” (OECD, 2013: 57). These actions (conditions) must be met ex ante (prior to granting assistance) or ex post (once a contract is underway or based on results) (Fierro, 2003; OECD, 2013).
In general, conditionality sets out to change behaviour. This assumes a discrepancy between the preferences of the payer and the target government in the absence of any conditions. Narrowing this gap and bringing the actions of the target government into alignment with the preferences of the payer is the overarching goal of conditionality. If there were no discrepancy, then conditionality would be unnecessary. Here it is worth distinguishing between two categories of conditionality, what Killick, Gunatilaka and Marr (1998: 11) refer to as “pro forma” conditionality and “hard core” conditionality. For the authors, “pro forma” conditionality refers to conditions around which there is general consensus between the grantor and the recipient of funds, whereas “hard core” conditionality requires actions that would not take place without the insistence of the grantor, or not within the timeframe identified. While this categorisation of conditionality may obscure, in part, the heterogeneity of interests at play, it is a useful heuristic for distinguishing between conditions that are not particularly contentious and those that may prompt pushback. The challenges raised in this paper typically relate to “hard core”-type conditionality, which relies heavily on financial leverage.

**Conditionality in the international financial institution context**

With respect to international financial assistance, such as IMF or World Bank lending, conditionality is generally intended to achieve reforms that a government would not otherwise undertake. For the IMF, traditionally lending has occurred in the context of a crisis, thereby justifying requests for remedial action to address the crisis and “right the ship.” As described later, the scope and design of these conditions may be subject to critique. These are the type of conditions examined in the case of Greece in the second part of this paper. The primary justifications for IFI conditionality include protecting the lender’s resources (ensuring repayment), preventing avoidance of costly reform (moral hazard) and improving the policy environment to increase the likelihood of aid effectiveness (which applies to bilateral donors as well as IFIs) (Killick, Gunatilaka and Marr, 1998). The first two justifications for conditionality resonate with the Greek rescue package (see the case study). Although conditionality is generally viewed as coercive, more consensual justifications include helping tip the balance in favour of reform (Koeberle et al., 2005), facilitating time consistency of policies (by locking in reforms) or providing a scapegoat for unpopular reforms (Dreher, 2009; Killick, Gunatilaka and Marr, 1998; Koeberle, 2005). The legitimacy of conditionality rests on its ability to improve policies (Killick, Gunatilaka and Marr, 1998) and facilitate outcomes.

The conditions imposed on recipient governments by international financial institutions tend to take three forms: financial, macroeconomic or structural. The first is the “financial terms of the loans, such as the interest rate and repayment schedule” and is “the least intrusive form of conditionality” (Babb and Carruthers, 2008: 15). The second requires the recipient to achieve macroeconomic targets in areas such as the budget deficit or money supply, and because they therefore require governments to pursue particular economic policies, they are more intrusive than financial stipulations (Babb and Carruthers, 2008: 15). Finally, structural conditionality involves “the most intrusive lending conditions” (Babb and Carruthers, 2008: 16). It requires governments to take policy actions intended to change “the architecture of national economies and/or political systems in pursuit of goals like economic growth or democratization” (Babb and Carruthers, 2008: 16).

Structural conditionality, introduced in the 1980s, was increasingly pursued by IFIs through the 1990s. What began as a package of reforms aimed at liberalising developing country economies eventually came to include governance reforms (Babb and Carruthers, 2008; Kapur and Webb, 2000). By the outset of the 21st century, international lenders and
donors were demanding increasingly harmonised, complex, difficult to monitor reforms in exchange for aid (Babb and Carruthers, 2008). Facing increasing criticism, both the World Bank and the IMF undertook reviews of their conditionality policies in the mid-2000s to address many of the challenges summarised in the proceeding sections. For the World Bank, the result is updated policies that emphasise ownership, harmonisation, customisation, criticality, transparency and predictability (World Bank, 2005). For the IMF it means fewer conditions focused on critical domains of institutional expertise, and a stronger orientation to country circumstances and “ownership” (IMF, 2016).

**Conditionality in an intergovernmental context**

Conditionality tends to play a different (but not altogether different) role in the context of intergovernmental relations. Conditions attached to transfers are intended to align national and subnational spending priorities, to spur subnational spending in particular areas, to ensure national equity objectives and to promote minimum public service standards² (Boadway, 2007). As in the case of IFI conditionality, differences between national and subnational priorities are assumed; otherwise an unrestricted transfer would be sufficient. Where the characteristics of the good being provided would otherwise lead to under-provision (e.g. the presence of spillovers), theory prescribes conditional transfers with a matching requirement (Shah, 2007).

The majority of respondents to a 2012 OECD survey on public investment across levels of government indicated that conditions are attached to sectoral transfers for public investment (Figure 1). Most of the reported conditions tend toward the “pro forma”-type, emphasising inputs and processes for grants administration. However, some appear intended to improve the operating environment for investment: 12 respondents indicated that “implementation of certain reforms, legislation, or regulations” was among the conditions attached to funds. As part of counter-cyclical measures, the onset of the financial crisis in 2008 brought a loosening and streamlining of conditions attached to transfers for public investment in some OECD countries, and later a tightening by some countries in the face of pressure to do more with less (OECD, 2013).

**Figure 1. Types of conditions attached to transfers for public investment in OECD countries, 2012**

<table>
<thead>
<tr>
<th>Condition Type</th>
<th>No. of Respondents (n = 20)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reporting requirements</td>
<td>20</td>
</tr>
<tr>
<td>Timeframe of spending</td>
<td>18</td>
</tr>
<tr>
<td>Matching requirements</td>
<td>16</td>
</tr>
<tr>
<td>Use of environmental impact assessment</td>
<td>14</td>
</tr>
<tr>
<td>Earmarking all or parts of grants to thematic priorities</td>
<td>12</td>
</tr>
<tr>
<td>Additionality requirements</td>
<td>12</td>
</tr>
<tr>
<td>Use of ex-ante economic evaluation tools</td>
<td>11</td>
</tr>
<tr>
<td>Implementation of certain reforms/legislation/regulations</td>
<td>10</td>
</tr>
<tr>
<td>Project needs to involve several municipalities</td>
<td>9</td>
</tr>
<tr>
<td>Involvement of private sector/firms in financing PI strategy</td>
<td>7</td>
</tr>
<tr>
<td>Involvement of private sector/firms in design of PI strategy</td>
<td>5</td>
</tr>
</tbody>
</table>

*Source:* Author’s elaboration based on the 2012 OECD national Survey on Public Investment across Levels of Government.
While the conditionality examined in this paper is most often associated with sanctions (the withholding of funds for non-compliance), grantors may also offer rewards for achieving particular results. In addition to possible sanctions, both South Africa and the United States also reward grantees for performance (with an incentive component of education and health infrastructure grants in the case of South Africa, and through competitive grant programmes in the case of the United States). The current performance framework for the EU’s Structural and Investment (ESI) funds includes both potential sanctions (for non-compliance with *ex ante* conditions) and rewards (see Box A.1 in the annex). Italian regional policy incorporated rewards for performance in the previous two funding cycles of the European Structural and Cohesion Funds (see Box A.2 in the annex).

IFI conditionality and conditions attached to intergovernmental grants are not the same. Not least, the underlying agreement that binds the parties together differs. Whereas parties to an IFI loan are bound by agencies’ articles of agreement (Killick, Gunatilaka and Marr, 1998), national-subnational relations are framed by national constitutions and laws. Despite important differences, the two cases have similar characteristics that merit exploration for common themes. Importantly, in both cases, grantors use financial leverage to try to change recipient governments’ policies and practices.

**If and when does conditionality “work”?**

Conditionality can enhance contractual relations between governments to the extent that it works. The difficulty is defining “works”. In the short term, conditionality can be seen to “work” if there is an overall uptake of conditions – measured by compliance in the case of IFIs, rule transfer in the case of EU enlargement or implementation of requirements in the case of intergovernmental transfers. In this context, the circumstances under which conditions are taken up are relevant for their design. Over the longer term, “works” relates to the efficacy of the conditions in facilitating achievement of policy objectives.

**In the short term**

Certainly, conditionality can induce governments to take actions they would not otherwise take, but compliance is often far from ideal. At one end of the spectrum one can observe 100% compliance with well-defined, single conditions in the context of intergovernmental transfers (such as the case of minimum drinking age laws in the United States), although even here the US case study demonstrates resistance to full implementation where a state perceived the threatened loss of funds as a coercive overstep by the federal government. At the other end of the spectrum, the case of Greece demonstrates uneven compliance with a suite of conditionals of varying complexity. A 2007 IMF examination of 1,306 conditionalities associated with 43 programmes between 1999 and 2003 found a 54% rate of on-time compliance.

What encourages compliance? What inhibits it? Schimmelfennig and Sedelmeier (2004) employ an external incentives model to explain the effectiveness of conditionals to promote rule transfer in the context of the EU’s eastern enlargement. Although used to analyse membership conditionality, the model is broadly relevant, and as such described here and complemented by lessons learnt from reviews of IFI experience.

For Schimmelfennig and Sedelmeier (2004), conditionality is a mechanism that disrupts the target government’s equilibrium by introducing incentives to adopt particular rules (reforms). Uptake is assumed to occur where the prospective benefits exceed the costs of adoption. Four key dimensions affect this calculation:
• **High determinacy.** The clarity and the formality of the conditions (determinacy) positively affect uptake. The authors assert that determinacy helps the target government know what is expected of it and limits shirking insofar as it cannot avoid compliance by manipulating interpretation of the rules. Moreover, it binds the imposing government to deliver the “rewards” if the conditions are achieved. High determinacy resonates with the narrowly defined conditions regarding minimum drinking age laws in the US case study. But the Greek case suggests that high determinacy can also have a downside. If weakly justified, such as the requirement that Greece shed 150,000 civil service jobs in four years, the specificity of the condition can become a point for pushback if it proves politically difficult to defend.

• **Rapid and sizeable payoff.** The size and speed of the reward(s) also matter for uptake. The greater the benefit relative to the *status quo* and the shorter the time to receive it, the greater the likelihood the conditions will be implemented. The payoffs of reform are the benefits in a cost-benefit calculation the target government undertakes in evaluating the prospect of compliance. The more quickly benefits materialise the more likely the government is to undertake the reform, with the Greek case demonstrating the downside of (rapid losses and) delayed payoffs. However, speed and size of the payoff needed to offset “adoption costs” depends precisely on the costs themselves. Where the conditions demand deep reforms that produce gains but also potentially sizeable losses, the gains will need to materialise sooner. But for public investment, where the conditions attached to intergovernmental grants do not require deep reform (e.g. improvements to planning procedures) and/or gains are difficult to measure efficiency improvements, the necessary speed and size of the payoff to facilitate uptake are likely less.

• **High credibility.** Credibility occurs, according to Schimmelfennig and Sedelmeier (2004), when the imposing body has a superior bargaining position, has the capability to deliver the reward, can issue rewards (or sanctions) at no or low cost to themselves, and is consistent in their application (i.e. not subordinating delivery of rewards or sanctions to other considerations). The literature on IFI conditions clearly points to weak credibility as a key contributor to weak compliance. Authors have consistently critiqued the IMF and the World Bank for historically demonstrating an unwillingness to sanction lack of compliance on the part of borrowers, leading in turn to uneven implementation of adjustment programmes and weakening the potential growth effects. The US case also provides examples of weak compliance with grant conditions in the face of a reluctance to sanction governments. Some authors suggest that the recent United States’ Supreme Court holding in the case of *NFIB v. Sebelius* may weaken government credibility with respect to sanctioning violations of grant conditions. In this regard, the US case demonstrates how the credibility of the imposing entity can change over time.

• **Low adoption costs.** Finally, the authors assert that domestic adoption costs and their distribution among domestic actors (i.e. veto players) affect the uptake of conditions. Where adoption costs are high (perhaps due to welfare or power losses) and veto players many, uptake is less likely.
The concept of adoption costs is an area where one can locate the most important facilitator or inhibitor of compliance: ownership. The literature on IFI conditionalities is clear in asserting “ownership” as a primary contributor to uptake of conditions.4 There is a clear conclusion that conditionalities are most likely to be implemented by governments already willing to reform. Here, conditionalities offer a supportive framework for governments whose preferences for reform are in line with (even if not identical to) what is being asked by the grantor/lender. The recent uptake of ex ante conditions in the context of ESI funds (Box A.1) may be explained in this regard. This alignment will be greater where adoption costs are lower. In this conception, conditionalities do not provoke reform, but rather support it.

The literature on IFI conditionalities points to other factors that mediate the uptake of conditions. For example Killick, Gunatilaka and Marr (1998) highlight dimensions that can improve the leverage of the imposing entity. They assert conditionality is most influential when policy instruments are amenable to treatment as preconditions, easily monitored and simple (under the direct control of the target government, with a limited number of individuals or agencies required to bring about reform, and difficult to organise against). The IMF has also found higher rates of compliance when conditions fall within their core competences and are under the direct control of their counterpart agency (IMF, 2007). Uptake of conditions is also more likely where there are fewer (or no) alternatives.

In the long term

If success in the short term is about compliance, success in the long term is about impact. Does compliance lead to benefits? Killick, Gunatilaka and Marr (1998) review the experience of structural adjustment programmes implemented by the World Bank and the IMF in the 1980s though the mid-1990s and find mixed evidence of impact. According to the authors (p.49), the programmes appeared to have a positive effect on “strengthening export and [balance of payments] performance but seem to have little impact on inflation; they do not typically make much difference to the pace of economic growth, in either direction; but they are consistently associated with reduced investment levels, which threaten economic progress in the longer term.” In explaining this result, the authors point largely to weak implementation of conditions on the part of target governments. Rodrik (2015a; 2015b) has suggested that such approaches to structural reform fail to adequately target the binding constraints on growth and ignore the negative interactions among conditionalities.5 Despite this, there is some anecdotal evidence to suggest that some senior representatives of countries that emerged from structural adjustment programmes, such as Korea and Thailand, perceive that although the difficult reforms required via conditionalities inflicting short-term “pain”, they facilitated long-term growth (Roach, 2012). Koeberle (2005) points to evidence that a sizeable proportion of World Bank adjustment operations in fact achieve their development objectives, with improvements observed over time.

The benefits of the specific conditions attached to intergovernmental grants appear less systemically documented. The case studies suggest that where (willingness to) reform is already underway – as in the case of desegregation or drinking age reforms in the United States6 – narrowly defined, targeted conditionalities can have a meaningful impact on outcomes. Well designed, they have a place in ensuring basic levels of public service, encouraging subnational contributions to national goals, and counteracting local preferences that act against general welfare. The experience of the ESI funds (see Box A.1 in the annex) suggests ex ante conditions can secure changes, particularly for “pro forma”
type conditions. Anecdotally, some OECD countries report the conditions attached to grants for public investment:

... have enabled the central level to better understand the local conditions (e.g. Estonia, Italy, Slovak Republic). In Canada and Estonia, such conditionalities have helped to enhance systematic assessments of likely and actual impacts of investments, thereby reducing the incidence of “bad” investments. In Italy and Norway, conditionality has successfully encouraged the concentration of resources, thereby making it easier to promote and anticipate measures deemed crucial for regional development. (OECD, 2013: 60, 62)

**Risks of conditionality**

While effective use of conditionalities can produce benefits – be it improving balance of payments for IFI conditionalities or contributing to improved public services for conditional grants – their use comes with risks. Some of these risks are outlined here.

**Hampering accountability**

Conditionalities, by design, are upwardly accountable. They condition the release of funds on the implementation of actions identified by the lender/grantor. Even if these reforms are intended to enhance general welfare, it is the lender/grantor that determines the acceptability of their implementation. But recipients are not only upwardly accountable. Implementing agencies are downwardly accountable to citizens, to elected leaders at different levels of government, to direct beneficiaries of their services, and to professional norms and expectations. Conditions that impinge on these various forms of accountability may be problematic (causing pushback) and possibly undemocratic. Whereas “hard core” conditionality that overrides democratically expressed preferences may be justified in some cases (e.g. enforcing civil rights over the objections of local majorities, as in the US case), in most instances the influence of conditionality on accountability is likely more complex.

While some posit that IFI conditionality encroaches on national sovereignty, others argue that because the contractual arrangement between lender and borrower is a voluntary one this is not the case (Killick, Gunatilaka and Marr, 1998) – although the tension is surely recognised (Koeberle, 2005). Data suggest that perceptions regarding encroachment may be somewhat exaggerated, but are likely grounded in real tensions that emerge from a handful of reforms. IMF examination of 43 programmes between 1999 and 2003 found that out of 1,306 conditionalities, 43% had little structural depth, 53% limited depth and only 4% represented deep reforms (IMF, 2007). Even with intergovernmental transfers, tensions around autonomy and the importance of the voluntary nature of the contractual agreement to which both parties agree resonated strongly in the US case. While the US Supreme Court for the first time found a grant condition coercive and unconstitutional only recently, objections by states have been long-standing. Concerns regarding conditional grants’ intrusions on subnational autonomy have also arisen in Canada, which – like the United States – has seen legal challenges regarding their use (Choudhry and Perrin, 2007).

Aside from the tensions around autonomy that arise and potentially threaten the implementation of conditionalities, their use centralises decision making and, for some categories of subnational public investment, potentially undermines the benefits of decentralisation. This does not mean there are not appropriate justifications for conditional
transfers, but an increase in the number of conditions will constrain local decision makers’ ability to respond to local preferences and to incorporate local knowledge.

**Lack of prioritisation of binding constraints**

As noted previously, Rodrik (2015a; 2015b) has suggested that structural reform programmes fail to adequately target the binding constraints on growth and ignore the negative interactions among conditionalities. With respect to Greece, he has argued that targeting “those areas where the growth returns are the greatest would maximise early benefits” and failure to focus on tradables (his identification of a binding constraint) has led to negative interactions of reforms with respect to export competitiveness (Rodrik, 2015b). More broadly, and for the case of public investment, the “growth diagnostics” approach to reform suggests that proper identification of binding constraints is crucial for unlocking growth and avoiding unintended negative consequences of misdiagnosis (Rodrik, Hausmann and Velasco, 2005). The logic suggests that at a subnational level, a context-specific approach would consider place-based characteristics and avoid conditionalities that may not necessarily be “best fit” for a place.

**Higher levels of government may not always know best**

Following from the previous point, attaching conditions to transfers – be they loans or grants – increases demands on the issuing entity. An international body or higher level of government assumes responsibility for the design of conditions and their monitoring. This places a premium on the technical capacity and the knowledge of the grantor/lender regarding what actions to take, when and how – as well as the best way to monitor them. The reform of conditionalities by IFIs in the mid-2000s, the criticisms of the European Commission’s interventions in Greece, the discrepancy in conclusions regarding the sustainability of Greek debt, the difficulties with No Child Left Behind (NCLB) in the United States, and even the evolving nature of the conditional grant system in South Africa (found in the case studies) point to the difficulty for the higher level of government or international institution to “always know best”. A proliferation of conditionalities is likely to exacerbate this situation as the number of domains of action in which the grantor/lender must have better information increases. This suggests focusing on areas of core competence (a position taken by the IMF). Recent examination by the IMF found compliance rates higher for conditionalities that fell in the realm of the organisation’s areas of expertise and overall programmes were more successful if they had strong “analytical underpinnings” in areas subject to conditions (IMF, 2007).

**Capacity to implement may be weak**

The capacity of target governments to implement conditions emerges as a key consideration in the use of conditionality (although Killick, Gunatilaka and Marr [1998] caution against viewing it as a binding constraint). Capacity issues emerge in the US case with respect to the implementation of No Child Left Behind and in the case of South Africa particularly for smaller municipalities. A first look at the implementation of *ex ante* conditionalities for the ESI funds revealed that more developed regions had less difficulty fulfilling conditions and appeared to have existing strategies in place that they could adapt to meet conditionalities, whereas less-developed ones needed to create them (Hamza et al., 2016) (see Box A.1 in the annex). The case of Greece exemplifies the difficulties of trying to implement reform in the context of a public administration already known to face serious capacity constraints. An IMF (2007) examination of structural conditionality in 216 programmes implemented between 1995 and 2004 found on-time
compliance rates the lowest for the deepest (and likely most difficult) reforms (less than 30% compared to 54% overall).

While not necessarily the only reason for pushback, a lack of capacity for full implementation may well contribute to it – as in the case of NCLB in the United States. Even absent pushback, as in South Africa – a lack of subnational capacity can hamper the effectiveness of conditional grants to achieve outcomes – despite the conditions attached to them. Conditionality may also have the unintended effect of rewarding the most capable (those with the capacity to achieve conditions) and sanctioning the least (withholding funds from those with the least capacity to do so). Waivers might mitigate this problem, but too many waivers could weaken the technical legitimacy of the conditions (reform).

While the previous discussion outlined individual contributors to or inhibitors of compliance, they are not separate considerations. They interact and may, in many cases, be mediated by the capacity constraints. Weak capacity hampering full implementation of conditions may delay the needed “rapid and sizeable” payoffs to sustain reform commitment. It makes the administrative burden of reform more difficult to bear. It raises indirect costs of reform insofar as weakly capacitated governments may need to forego attention to other important issues in order to attend to conditionalities. It may encourage superficial compliance rather than reform where resources are unavailable to do otherwise.8

A proliferation of conditions can multiply capacity problems, and when distributed across sectors introduce co-ordination problems. Examining the World Bank adjustment programmes, Koeberle (2005: 65) finds “efforts to address performance deficiencies and capacity limitations through a larger number of conditions are generally ineffective” and “operations were less successful in countries with weak policy performance subject to more conditions, while countries with stronger performance did well regardless of the number of conditions.” The IMF (2007) finds compliance rates for structural conditionality highest when conditions are under the direct control of those implementing the programme, and compliance rates decline not with the number of conditions, but with the number of sectors involved.

**Cosmetic compliance and opting out**

Finally, there is a risk of cosmetic compliance with conditionality. This may originate with a lack of capacity for adequate implementation, a lack of willingness to implement deep reforms for political reasons, or poor monitoring technology on the part of the imposing entity that does nothing to discourage shirking or may even signal a lack of priority for deep reform on the part of the lender/donor. As in other cases, a proliferation of conditions is likely to exacerbate the problem insofar as it taxes available implementation resources and makes cosmetic compliance appealing in the short term, even if there are noble aspirations to revisit and deepen reforms over time.

There is also the risk that conditionalities prompt recipients to opt out of participation in some funding streams altogether (there is some evidence of this in the US case study). In an intergovernmental context, this may leave prospective beneficiaries short of services and raise political tensions. In an international context, “opting out” may mean looking for alternative lenders providing funds with few (or different) strings attached.9
Alternatives to “hard core” conditionality

The previous discussion paints a pessimistic picture with respect to conditionality. It is not, however, a tool without merit. The case studies, particularly those involving intergovernmental transfers, suggest that well-designed conditionality has a place in improving service delivery and encouraging reform. The preceding discussion suggests that “hard core” conditionality appears to fit those circumstances where the grantor has leverage and credibility, the target government is amenable to change (some ownership), the reward is proximate and substantial (and/or losses minimal), the changes demanded are under the direct control of the target government, there are few veto players, few alternatives, and where the target government has sufficient capacity to implement them.

Where circumstances do not lend themselves to “hard core” conditionality, more co-operative mechanisms can be considered that seek to create that ownership. Three mechanisms are discussed below. The first seeks to “soften up” the environment for reform and cultivate local demand for change through persuasion and learning. The second foregoes efforts to force or convince the target government of the need for reform, and instead rewards those already committed to it. The third option prioritises consensus on outputs and outcomes, and provides the target government with greater autonomy to choose the “best fit” strategies to get there. The mechanisms are not mutually exclusive.

Persuasion and learning

Returning to Schimmelfennig and Sedelmeier (2004), the authors acknowledge that while EU rule transfer in the context of member conditionality is best explained by the external incentives model, other models are needed to explain uptake in its absence. They point to the adoption of EU rules prior to the introduction of conditionality. They offer two explanatory models: social learning and lesson-drawing. With social learning, a government adopts reform (policies/rules) if it is persuaded of the appropriateness of reform. It is based on a view of the policies themselves as broadly applicable and having international legitimacy, and the process of adoption as fulfilling “basic standards for deliberation” (p.668). Lesson-drawing does not require external incentives. Reforms are adopted if they are perceived to solve domestic problems. Their uptake depends on domestic dissatisfaction, a search for (transferrable) solutions, “epistemic communities” promoting such reforms and few veto players. Although they maintain that the external incentives model (and conditionality) best explains rule transfer in the context of EU enlargement, they assert that reforms implemented via “social learning” and “lesson-drawing” are less likely to encounter domestic resistance and more likely to achieve sustained compliance.

Both models suggest that governments may be persuaded to adopt reforms by the legitimacy of the reforms themselves and their “fit” to address domestic problems. Ownership is a result of persuasion and learning. Clearly, this is a “softer” route to reform. It suggests mechanisms for improving alignment between national and subnational priorities, and as an alternative or even complement to conditionality. Social learning and lesson-drawing (e.g. through information sharing/benchmarking, communities of practice) represent alternatives to conditionality where the prospective “learners” recognise their knowledge gaps and are motivated to narrow them. Examples of within-country mechanisms to promote information sharing and learning about policies and practices for public investment include Infrastructure Australia (a national statutory body that provides research and advice to all levels of government), Regiosuisse in Switzerland (a national platform for information sharing regarding regional development) and the SC2 National
Selectivity

Because research suggests that conditionality works best as a facilitator rather than an instigator of reform, there have been suggestions that IFIs should engage with countries that already demonstrate an environment in which lending is likely to be effective: those with demonstrated commitment to good policies but which face high poverty (in the case of the World Bank) (Koeberle, 2005). While this approach avoids many of the problems that emerge from a lack of ownership (defined largely as the discrepancy between the priorities of the lender/donor and target government), it nonetheless makes assistance conditional on certain policies and practices – it just introduces financing once they are underway. Koeberle (2005) argues most of the world’s poor live in countries that occupy the middle ground between good and poor policies, thus limiting the appeal of selectivity for the World Bank.

The US case demonstrates the use of selectivity via the competitive discretionary education grant programme, Race to the Top. While allocating a portion of funds in this way may well reward and encourage “best practice”, it is predicated on effective ex ante “persuasion and learning” – suggesting the two approaches must co-exist. However, when considering public investment, this approach may have the unintended consequence of sidelining places (such as rural areas) where ‘best practice’ is not necessarily the “best fit.”

The IMF has also introduced a type of selectivity in its lending arrangements. In 2009, it created the Flexible Credit Line, a mechanism for disbursing funds to pre-qualified countries with sound economic fundamentals but facing a “cash crunch” (IMF, 2017; 2009). This approach rewards good policies but acknowledges that external shocks may occur. This stands in contrast to the traditional approach of crisis lending described at the outset of the paper. To date, however, only three countries have access to the Flexible Credit Line, which Panizza (2016) attributes to concerns regarding the potential stigma and signalling effect associated with tapping the facility – or worse, the rejection of an application. The author’s recommendation is a broader pre-approval mechanism that would cover nearly all IMF members based on specific and transparent criteria and would encourage countries to tap precautionary lending mechanisms as an alternative to (inefficient) reserve accumulation.

Output and outcome-based conditionality

Approaches that reward governments for achieving outputs and/or outcomes are considered less coercive than input/process-based conditionality and sanction mechanisms, with the benefit of providing the target government with greater flexibility in policy design while still maintaining accountability (Shah, 2007). These approaches, referenced earlier, feature in the US case, the South African case, and the EU and Italian performance reserves (Boxes A.1 and A.2). They do not, however, appear poised to replace conditionality tied to inputs or processes. While such approaches should be considered among the tools for promoting performance, conditioning the release of funds on the achievement of outcomes (but not necessarily outputs) poses important technical challenges, not least of which is attributing the outcomes observed to the policies and efforts of the target government (Koeberle, 2005).
Conclusion

This paper considers three practical experiences with conditionalities in the context of the literature regarding IFI conditionalities and intergovernmental transfers. It demonstrates similarities between the two categories of conditionality and reaffirms lessons from the literature, with the role of capacity emerging as a key consideration. The paper finds the following.

Conditionality has a place in the toolkit of lenders/donors, and as such for enhancing contractual relations between parties. Properly designed, conditionality can produce benefits – albeit limited. These are cases in which a “softer” route to reform is not feasible either practically (to ensure repayment capacity, to limit moral hazard – such as in the Greek case) or ethically (to protect civil rights – such as for desegregation in the US case), or because stronger incentives are needed (to improve planning capacity as in the South African case).

Ownership matters. The literature on IFI conditions is clear in this regard. Factors that mediate ownership are highlighted in the US and Greek case studies: the pre-existing alignment between priorities at different levels of government, the complexity of the reform and the capacity of the target government to address it, and the extent to which the proposed reform(s) impinge on the target government’s autonomy (or conversely, the extent to which uptake of conditions is voluntary). With respect to public investment, this suggests the importance of narrowing the gap in priorities and knowledge prior to the implementation of any conditions to improve the likelihood of their uptake. It also suggests limited use of conditionalities for encouraging complex reforms, particularly in low-capacity environments.

Given the intrusions that conditions imply for both national (in the case of IFI conditionality) and subnational (in the case of grants) governments, and the concomitant erosion of downward accountability that may be amplified by the number of conditions, they should be used strategically and sparingly. As its legitimacy ultimately rests on its ability to improve policies and outcomes, attention should be paid to interactive effects and those conditions which represent binding constraints on the outcome of interest.

Capacity constraints at all levels of government affect the uptake of conditionalities. The weaker the capacity of the target government to implement conditions, the less likely it is that benefits will materialise in a timely way. The South African case and the ESI funds experience also highlight the fact that the content of conditions may, in part, be a response precisely to capacity constraints. Sufficient capacity is also needed at the higher level of government to prioritise, design and monitor conditionality. Demands on all levels of government will increase with the number of conditions imposed and the number of sectors involved.

“Softer” mechanisms to promote performance can be considered in conjunction with and as alternatives to conditionalities. Mechanisms that promote persuasion and learning have a place both before and alongside the use of conditionality; selectivity can reward (and thereby encourage) good practice, although it runs the risk of leaving behind those that most need reform; and output (and less so outcome) conditionality can provide greater autonomy in policy choices while at the same time encourage and reward performance.

Finally, a proliferation of conditionalities is discouraged. The greater the number of conditions, the greater is the likelihood of interactive effects, constraints on autonomy and demands on capacity.
Note

1. See discussion of consensual versus coercive justifications in Collier et al. (1997) and a discussion of the nature of conditionality as consensual versus coercive in Killick, Gunatilaka and Marr (1998).

2. Boadway (2007) refers to conditional block grants to facilitate minimum service standards, but see also the example of Italy’s use of performance-oriented conditions to improve service standards in Box A.2.

3. Bergvall et al. (2006) distinguish between matching requirements (associated with mandatory earmarked grants) and co-funding (associated with discretionary earmarked grants). The former creates a “permanent incentive for increased provision” (p.7).

4. Even if the definition of ownership may be fuzzy, see Dreher (2009).

5. Discussions of the less-than-stellar mixed results of structural conditionality can also be found (for example) in Dreher (2009), Babb and Carruthers (2008), and IMF (2007).

6. In both cases, reform occurred in a broader context of change in American society. The use of conditionality to facilitate the desegregation of schools coincided with the passage of the Civil Rights Act in 1964 and the Elementary and Secondary Education Act in 1965. The introduction of state drinking age legislation took place at a time when youth drunk driving was part of the national conversation due to an awareness campaign by the civil society organisation Mothers Against Drunk Driving.

7. See, for example, discussion of accountability with respect to US federal grants in Conlan (2005).

8. See Kapur and Webb (2000) for a discussion on the time dimension of cultivating good governance capabilities.

9. The rise of BRICS, and particularly the People’s Republic of China, as an alternative source of investment for developing countries raises questions about the ability of traditional donors and lenders to apply conditions in their engagement with recipient countries.

10. See Dillon (2010) regarding the urban bias in Race to the Top and McNeil (2014) on the decision to bypass top-scoring (more urban) districts in order to support rural areas.
References


Annex A.
Examples from regional policy

Box A.1. *Ex ante* conditionalities attached to the European Structural and Investment funds

In 2013, the European Commission (EC) introduced both *ex ante* and *ex post* conditionalities for the implementation of European Structural and Investment (ESI) funds for the 2014-20 programming period. *Ex ante* conditionalities were introduced to ensure that recipients have in place the necessary conditions to make efficient and effective use of the ESI funds. Two categories of conditions were introduced:

- Seven general *ex ante* conditions that apply to all ESI funds. They address arrangements for law, policy or systems related to anti-discrimination, gender, disability, public procurement, state aid, environment and monitoring.
- Twenty-nine thematic *ex ante* conditions that relate to the 11 thematic objectives and associated investment priorities for Cohesion Policy. They focus on regulatory, strategic and administrative capacity and apply to the European Regional Development Fund, the European Social Fund and the Cohesion Fund. Seven additional conditionalities apply to the Agricultural and Rural Development Fund and another four to the European Maritime and Fisheries Fund.

Using EC-provided guidance, member states were required to determine which conditionalities were applicable for their aid package (framed by a “partnership agreement”), assess the degree of fulfilment for each applicable condition (an assessment reviewed by the Commission), and achieve or take action to achieve all conditions by the end of December 2016. Failure to do so could have led to a suspension of aid.

The Commission also linked ESI funds to two other conditions. First, it reinforced the linkages between economic governance and Cohesion Policy through macroeconomic conditionality. Reforms introduced “the possibility to suspend [ESI] funds in the context of the Excessive Deficit Procedure and the new Macroeconomic Imbalances Procedure. This extends the provision foreseen for the Cohesion Fund in previous periods to the European Regional Development Fund and the European Social Fund” (Berkowitz et al., 2015: 5). The Commission may also request reprogramming of the ESI funds to support the implementation of country-specific recommendations (i.e. structural reforms). Second, the Commission reintroduced a compulsory “performance reserve”, an instrument of *ex post* conditionality as 6% of allocated funding is set aside and will be released conditional on the achievement of milestones toward the end of the programming period.

A first look at implementation of the *ex ante* conditionalities found there to be a generally high fulfilment rate, with thematic conditions more difficult to achieve than general ones. More developed regions had less difficulty fulfilling conditions and appeared to have existing strategies in place that they could adapt to meet conditionalities, whereas less-developed ones needed to create them. Fulfilment of the conditions was time- and resource-intensive, with financial resources required that were not always readily available. The process of addressing the conditionalities, although burdensome, was considered to have added value by target governments, particularly insofar as it strengthened attention, dialogue and co-ordination in key areas and revealed gaps in the operating environment for ESI funds.

Box A.2. Conditioning rewards on results: Italy’s national performance reserves

During the 2000-06 programming period for the EU’s Structural and Cohesion Funds, the European Commission set aside funds to reward programmes for meeting targets. This “performance reserve” conditioned release of 4% of Structural Funds monies on achievement of performance targets. Italy complemented the EU’s performance reserve with its own national reserve amounting to 6% of funds for regional development policy, effectively setting aside 10% of funds. Whereas the EU’s performance reserve applied to all Structural Funds recipients, Italy’s reserve applied to seven regions in southern Italy (and to some entities at the national level). The overall goal of the national reserve was to enhance regional governance. Regional performance was monitored via 12 indicators grouped into 3 priority areas:

1. institutional enhancement (ten indicators related to public administration, spending efficiency and sectoral reform)
2. integration (one indicator related to the incidence of territorially integrated projects)
3. concentration (one indicator of the concentration of financial resources on a selected number of measures).

National authorities needed to meet five targets. Assessment of regional performance was conducted in September 2002 and approximately 60% of targets were achieved on time, with substantial variation among regions. Funds were distributed based on the number of targets achieved. Of the funds left unallocated, 50% were redistributed to higher performing regions. Monitoring was extended for an additional year and a portion of the unallocated funds was distributed based on performance in September 2003. The remaining funds were distributed in 2004 and linked to results of the EU reserve.

Despite challenges, the national performance reserve was considered successful and renewed for the 2007-13 period (although the EU performance reserve was no longer mandatory). Changes were introduced. There was a shift away from monitoring outputs/processes (which were seen as distant from citizens’ experiences with public services and risked formalistic compliance) toward equity and outcomes. Eleven performance targets were established to promote minimum standards in quality and access to public services in which southern Italy lagged behind: education, child and elder care, urban waste management, and water services. It was up to regions to determine how they would achieve the targets. The shift toward outcomes appears to have presented challenges. While some regions and policy areas saw improvements (i.e. child and elder care where the financial incentive was significant compared to otherwise available resources), performance was hampered by the complexity of achieving some outcomes, managing shared responsibilities, and the weak pre-conditions for effective implementation.

References


Part II.
Case studies
Introduction

In April 2010, Greece became the first euro area country to request assistance from the International Monetary Fund (IMF) (IEO, 2016). It faced a crisis that had snowballed following the October 2009 announcement by then Prime Minister George Papandreou that Greece’s annual deficit would likely be 12.8% of gross domestic product (GDP) as opposed to the previously estimated 3.6% (it turned out to be 15.6%) (IEO, 2016). By December 2009, rating agencies had begun to downgrade Greek debt, borrowing costs began to rise, and by the following spring – having been shut out of financial markets – the country was facing bankruptcy (IEO, 2016; The New York Times, 2016). In May, the IMF contributed EUR 30 billion of a EUR 110 billion rescue package for Greece (IEO, 2016). The IMF’s engagement in Greece, along with its assistance to Cyprus, Ireland and Portugal, constituted its first direct involvement in adjustment programmes for developed, open economies involved in a currency union (IEO, 2016). For the European Commission, it was its first foray into designing and managing a bailout (although not named as such). The rescue package proved to be the first of three (2010, 2012 and 2015).

This short case study provides a cursory review of EU/IMF rescue packages for Greece and a look at what the difficulties implementing reforms imply for the use of conditionalities more generally. Notably, it is not an analysis of the Greek debt crisis, its causes or remedies. Its focus is the uptake (or not) of conditionalities associated with the rescue packages in order to reveal general lessons regarding their use.

The conditionalities

The May 2010 three-year rescue package brought together EUR 30 billion in funds from the IMF (through a Standby Arrangement) and EUR 80 billion in pooled contributions of 15 bilateral loans from European countries managed by the European Commission (IEO, 2016). Together with the European Central Bank, the IMF and the European Commission formed the “Troika”, an ad hoc mechanism created for jointly managing the rescue package. The 2010 package was followed by a 2012 package worth an additional EUR 172.7 billion, again bringing together IMF funds (this time via the Extended Fund Facility) with European funds (this time via the European Financial Stability Facility) (IEO, 2016). However, the third package – agreed to in August 2015 after Greece missed an IMF payment – saw the EU move forward without the IMF. The latter pulled out of negotiations, having viewed Greek debt as unsustainable. The EU provided an additional EUR 86 billion through its European Stability Mechanism (ESM, 2017). The conditions attached to the three packages have been “harsh”, demanding comprehensive structural reform (The New York Times, 2016) and “herculean” fiscal consolidation (Featherstone, 2016).

The IMF rules do not permit its funds to be dispersed based on the achievement of another organisation’s conditions (cross-conditionality) (IEO, 2016). As such, IMF and EU conditions have been separate ones. According to the IMF, its “approach to structural conditionality differed from that of the EU” (IEO, 2016: 25). IMF conditions emphasised short-term macro-critical policies (just under 50 structural measures in the Standby Arrangement [Wyplosz and Sgherri, 2016]), while the European Commission’s
conditions target medium-term structural reforms and changes to bring Greece into compliance with EU directives (IMF, 2012). Greer (2014: 58) notes that there was a “sizeable body of the EU law with which Greece was noncompliant.” EU-required reforms aim at “public administration, health, labour market, the judicial system, and sectoral competition” (IMF, 2012: 41). Differences exist in the precision of EU and IMF targets and “while the assessment of the [IMF’s] parsimonious conditions is straightforward, the large set of EC measures calls for a broad-based assessment of implementation prior to authorizing a disbursement” (IMF, 2012: 41).

While the EU and IMF conditionalities were not the same, from the national perspective they were considered together (IEO, 2016). Due in part to the absence of currency devaluation as a policy instrument, the number of conditions was high (IEO, 2016). They were not necessarily adequately prioritised, and imposed a heavy administrative burden on a public sector whose capacity was overestimated (IEO, 2016). Moreover, they increased in number and complexity over time (IEO, 2016; IMF, 2012), and (along with other euro area programmes) tended to be “deeper” than conditions imposed by the IMF for other borrowers, such as low-income countries (IMF, 2012). EU conditions were many (Featherstone, 2015) and covered a broad range of structural reforms.

Debt restructuring was not part of the initial package for Greece (IEO, 2016). While it may have been usual under other circumstances of IMF engagement, early objection to debt restructuring formed part of European support for a Greek rescue and was supported by a majority of IMF voting members (albeit with some internal scepticism) (IEO, 2016). This meant that Greece would need to get back on its feet via “official financing, fiscal adjustment, and structural reforms” (IEO, 2016: 16). Loan funds would be released in tranches contingent on meeting targets with respect to expenditure cuts, tax increases and structural reforms (Armitstead, 2012) set by the EU and IMF. Debt restructuring came later (in 2012) (Zettelmeyer, Kreplin and Panizza, 2017) and is expected again in 2018.

**Uptake of conditions**

While the relationship between Greece and its creditors has not been a smooth one, it is important not to understate what Featherstone (2016) calls the “herculean” task set before the Greek government. There has been a high level of performance with respect to fiscal consolidation and international acknowledgement for these efforts (as measured by the OECD “reform responsiveness” indicator, and the Berenberg Bank and the Lisbon Council “Adjustment Progress Indicator”) (Featherstone, 2016: 60). Despite this, however, progress by Greece has been criticised. While first and second round reforms focused on fiscal and labour market reforms, product market reforms have lagged behind (OECD, 2016). In many instances, a lack of co-ordination in related areas has undermined the effectiveness of reforms (OECD, 2016). Featherstone (2016) further notes that the underlying public institutions remain deeply flawed and distant from what is needed in terms of “good governance.” This said, examining the progress of reforms in June 2016, the European Commission (2016: 2) concluded that the ESM programme was “broadly on track”. The economy showed signs of picking up and the European Commission reported continued progress implementing reforms. These included (among others): modernising the income tax system, strengthening tax compliance and revenue collection, strengthening public procurement legislation, comprehensive pension reform, public sector pay reform, aligning the Code of Civil Procedure with best practice, and enhancing anticorruption measures (European Commission, 2016). The Commission acknowledged the need for further progress in various areas, including banking and non-performing loans, product market regulation, healthcare, and education and research. As of January
2017, the IMF also concluded that Greece still needed to implement changes in areas such as pension reform, income tax reform, tax evasion, labour market reforms and banking reforms (IMF, 2017).

Constraints on uptake

What contributed to uneven compliance with the conditionalities in the Greek rescue packages? First, the EU and IMF packages introduced a litany of conditions that were, according to the IMF, not well prioritised. In this regard, the IMF acknowledges that lessons learnt from the Asian financial crisis regarding the counterproductive nature of this approach were not applied to Greece (IEO, 2016). Similarly, following reviews of conditionality in the mid-2000s, both the World Bank and the IMF prioritised domestic “ownership” of reform. Yet here, there is a general consensus that Greek ownership of the reform agenda has been low (Featherstone, 2016; IEO, 2016) and political will for reform weak (Wallace, 2017). While the role of politics should not be discounted, a high number of conditionalities was likely counterproductive in this regard. Featherstone (2016) notes that the greater the scope of the conditionality, the harder it is to generate the “ownership” necessary for reform. He argues that not only are the Greek rescue packages large in scope with a sizeable number of conditions, but that the “space” available for domestic discussion, priorities and choice is thus limited. Ownership has been further undermined by opposition to reform by vested interests (OECD, 2016).

Box II.1. Debt sustainability, underlying assumptions and adoption costs of reform

Greek pushback against conditionalities has come in large part from popular discontent with the social effects of austerity measures implemented in response to bailout conditions. A difficulty is determining if, with sufficient fiscal and structural reform, Greece can return to growth and right itself with sustainable debt (making austerity worth it) – or if, despite demanding reforms, the debt is in fact unsustainable (bringing Greece back to where it started). This determination contributes to the calculation of domestic “adoption costs” of reform.

The EU institutions and the IMF have held different positions regarding debt sustainability in Greece. Whereas EU creditors consider the debt sustainable given sufficient reform, fiscal adjustment and some debt relief (Zettelmeyer, Kreplin and Panizza, 2017), the IMF has viewed it as “highly unsustainable” even if the country fully implements requested reforms and calls for “substantial debt relief” (IMF, 2017). Zettelmeyer, Kreplin and Panizza (2017) find that underlying these two positions are crucial differences in assumptions, particularly regarding the evolution of Greece’s primary surplus.1 The resulting divergence in positions has financial implications (as the IMF cannot lend to a country where it perceives the debt to be unsustainable) as well as implications for the uptake of conditionalities insofar as the utility of reforms can be called into question.

1. The authors conclude that further debt relief is required and make specific recommendations as to the form it could take.


Second, the costs of compliance have been high. The pushback against conditionalities has resulted, in part, from the effects of belt tightening introduced in response to loan conditions. Greece has seen a depression in which GDP declined by 26% between 2007 and 2015, anchored poverty tripled between 2007 and 2013, unemployment soared to
25% by 2014, and reported life satisfaction plummeted (OECD, 2016). While the European Commission’s June 2016 Compliance Report suggests the economy may be turning a corner, difficulties have been prolonged. Referencing Schimmelfennig and Sedelmeier (2004), Featherstone (2016) notes that the “adoption costs” for Greece have been extraordinarily high both economically and politically and the “size and speed of the rewards for compliance have been questionable” (p.50), compromising the cost-benefit assessment of conditionality and jeopardising the domestic support needed for reform.

The “size and speed of rewards” relates not only to compliance with conditionalities, but with the design of the package itself. The ability of the Greek packages to (ultimately) deliver sustainable recovery has been questioned (Stiglitz et al., 2015), and some assert that such approaches to structural reform (in Greece and elsewhere) are not properly prioritised around binding constraints, involve a “laundry list” of reforms that may work at cross purposes, and promote the idea of optimal rather than good practices (Rodrik, 2015). In addition, diverging views on debt sustainability between the IMF and the EU (Box II.1) are a high-profile symptom of another problem. The choice to provide loans, the design of bailout packages and the conditions attached to them are all predicated on assumptions that may be (far) less robust than anticipated (see, for example, the discussion of the IMF’s assumptions regarding the Standby Arrangement package in Wyplosz and Sgherri [2016]). This uncertainty in times of crisis is to be expected (Wyplosz and Sgherri, 2016), but where results on the ground diverge greatly from predictions (a possibility amplified by the number of conditionalities), benefits can be slow to materialise and adoption costs greater than anticipated.

Third, whereas Schimmelfennig and Sedelmeier (2004) point to the value of determinacy in facilitating compliance with conditionalities, Featherstone (2016) points to an over-determination of conditions that produced a backlash. Citing as an example the requirement that Greece shed 150,000 civil servants between 2011 and 2015, he notes that this figure was generated on the basis of cost savings and not on staffing requirements and thus difficult to defend domestically (Featherstone, 2016: 51).

Finally, Greece faces notable capacity constraints. Going into the financial crisis, Greece’s public administration and its capacity for reform were known to be weak (Featherstone, 2015). Despite this, creditors introduced numerous heavy reforms.

Greece’s capacity constraints have notably affected implementation reform; they also hamper designing effective policies in the first place (OECD, 2016). Greece’s former finance minister has suggested that the country’s institutional capacity is so weak, it merits extended assistance from the World Bank – on par with that provided to least developed countries (Wallace, 2017). Moreover, adaptation may have been further compromised by an administrative culture and preferences for reform that contrast sharply with the agenda pushed by the Troika (Featherstone, 2015). Both the IMF and the EU (via the EU Task Force for Greece) provided technical assistance to Greece to assist with reform. But the task of capacity building has been daunting, according to Featherstone, and the track record of the taskforce in supporting reform was mixed (European Court of Auditors, 2015). The IMF’s efforts in Greece were reportedly hampered by “lack of sufficient prioritization, ad hoc decision making, … moving targets under multiple initiatives… Greece’s severely limited absorptive capacity” and co-ordination challenges with EU technical assistance counterparts (IEO, 2016: 30).
Conclusion

The experience of Greece has not brought new lessons to the fore regarding the use of conditionalities. Instead, it reflects the tensions and limits of conditionalities long identified by development scholars and more recently by the IMF and the World Bank in the early 2000s. Observers are reminded of the downside of a proliferation of conditionalities, a lack of clear prioritisation, and the risks of weak domestic “ownership”. The diverging views on the sustainability of debt is a high-profile example of an inevitable weakness in a lender’s ability to ascertain good next steps: the (debatable) underlying assumptions. This extends to what conditions to apply, when and how.

What does stand out from the Greek case is the tension between the financiers of the largest bailout in history to safeguard their (constituents’) money with conditionalities, and the infringement on national preferences that each condition imposes. This tension was most visible in 2015 with the juxtaposition of externally imposed reforms that contrasted sharply with preferences revealed through national democratic processes. These infringements – which some may consider a temporary suspension of sovereignty – may be justified in clear cases to “right the ship” but become less defensible the longer the list of conditions (and in turn the potential for unintended negative interactions). The greater the number of conditions, the more difficult it is for the lender to prioritise and clearly identify the expected effects of the package. If results are disappointing, it is the borrower that nonetheless remains accountable.

Finally, institutional capacity plays a key role in the Greek experience. It is worth recalling that multiple reforms have been achieved, although their quality and the depth may be debatable. While conditionalities may push reluctant reformers forward, if benefits do not materialise, the reforms lose credibility. Here capacity constraints play a crucial role. Benefits will be slower to materialise when large numbers of conditions confront weak institutional capacity to fully implement them.

Notes

1. Greer (2014) notes the contested nature of two papers, Alesina and Ardagna (2009) and Reinhart and Rogoff (2010), that contributed to “the intellectual justification of the European response” to the debt crisis in Europe.

2. The taskforce was replaced by the Structural Reform Support Service, established in 2015 with a remit to assist EU member countries with reforms (European Commission, n.d.; 2017).

3. See Featherstone (2016) for a discussion of these tensions and their implications.
References


Stiglitz, J. et al. (2015), “In the final hour, a plea for economic sanity and humanity” [letter to the editor], Financial Times, 5 June.


Introduction

South Africa’s experience with intergovernmental grants and “conditionalities” is an evolving one. Not yet 20 years old, the system of conditional grants targets subnational infrastructure development by using transfers in the presence of spillovers to address national priorities and tackle infrastructure backlogs that are a legacy of apartheid. This case study provides a cursory examination of the conditional grants system and how it has evolved since its introduction in 1998/99. As the case study reveals, the grant programme is dynamic, characterised by changes to the number and size of grants, along with an evolution of the conditions attached. The case highlights the tension between the use of conditional grants to direct and improve subnational spending, and the required capacity needed at all spheres of government to do so effectively.

Overview of intergovernmental grants

South Africa is a unitary country with three spheres of government (national, provincial and local) and quasi-federal features. At the subnational level there are 9 provinces and 257 municipalities (8 metropolitan municipalities, 44 district municipalities and 205 local municipalities) (Main, 2017; OECD/UCLG, 2016). The spheres of government are interrelated and interdependent, but not seen as hierarchical. Subnational governments are responsible for shared and sole competences and have levels of public expenditure on par with OECD federal countries – accounting for 49.4% of general government expenditure in 2013 (OECD/UCLG, 2016). Provinces are responsible for social services (education, health and social development including housing), economic functions (agriculture and provincial roads), and provincial governance and administration (OECD/UCLG, 2016). Municipalities are responsible for basic service delivery (water and sanitation, electricity distribution, trash removal), storm water management, municipal transport and roads, and community services (OECD/UCLG, 2016). Both the provincial and local spheres play a role in infrastructure delivery, a role that is expected to grow in coming years (Ncube and Tullock, 2015).

Intergovernmental transfers play a crucial role in financing South Africa’s subnational governments. Nationally raised revenues are shared across spheres of government, with provincial and local governments receiving two main categories of transfers: a formula-based, unconditional “equitable share” (provincial and local government allocation) and conditional grants. Metropolitan municipalities also receive a share of the nationally raised fuel tax. Provinces have little own-revenue raising capacity and rely heavily on transfers (Makube, 2010; National Treasury, 2017a). Local governments receive the lesser share of grants but have greater revenue-raising capacity (Makube, 2010; National Treasury, 2017a). There are differences, however, between urban and rural municipalities. While urban municipalities raise most of their own revenues, poor rural ones generally rely on grants (National Treasury, 2017a). For the fiscal year 2017/18, provinces are expected to receive ZAR 538 160 million in transfers (43.4% of nationally raised revenue) and municipalities to receive ZAR 112 524 million (9.1% of nationally raised revenue) (Figure II.1). Allocations are made within a three-year medium-term expenditure framework.
For 2017/18, conditional grants constitute 18% of transfers to provinces and 39% of transfers to municipalities (with the fuel levy taken into account). These grants are intended to align subnational with national spending priorities; to address infrastructure backlogs, regional disparities and cross-jurisdictional spillovers; to help provide for standard service levels; and to support subnational capacity building (Makube, 2010). There are four categories of conditional grants (FFC, 2013), each corresponding to a schedule in the Division of Revenue Act:

- Schedule 4: Funds to supplement spending from subnational budgets
- Schedule 5: Funds for specific purposes
- Schedule 6: Allocation in-kind (indirect conditional grants)
- Schedule 7: Funds for disaster relief

Some conditional grants are allocated on a formula basis; none are matching (Makube, 2010). Matching grants are not particularly viable for provinces (as over 90% of their revenues come from transfers) (Makube, 2010) and would financially burden poor rural municipalities that also rely heavily on transfers. Matching could be a possibility for municipalities with greater own revenue (Makube, 2010). Although there are no formal matching requirements, conditional grants issued under Schedule 4 are intended to supplement subnational spending. There is thus a requirement for some level of subnational co-financing.
The number and volume of conditional grants has grown since their inception in 1998/99 (FFC, 2013; Makube, 2010). As of 2016/17 there were 26 provincial grants and 19 municipal ones. This figure has fluctuated over the years as new grants have been introduced, some grants consolidated and others terminated. The relative share of unconditional and conditional grants has also changed. Based on data in Makube (2010) and National Treasury (2017a), it appears that conditional grants as a share of total transfers has grown for provinces (from 11% in 2000/01 to 18% in 2017/18) and declined for local governments (from 58% in 2000/01 to 43% in 2017/18).²

There are two categories of conditional grants: direct and indirect. Direct conditional grants transfer funds from a higher sphere of government to a lower one. An example is the provincial (direct) education infrastructure grant to construct, maintain and refurbish schooling infrastructure (National Treasury, 2017a). An indirect conditional grant involves no cash transfer between spheres of government. Instead, the national government “performs a function on behalf of a municipality or province… any infrastructure developed becomes the responsibility of the relevant subnational government” (Mtantato and Peters, 2015: 60). Indirect conditional grants centralise government responsibility in instances where subnational capacity is deemed insufficient to undertake the activity. Responsibility for the asset is eventually transferred to the municipality. For example, a temporary (indirect) school infrastructure backlogs grant was created in 2011 and administered by the national Department of Education on behalf of the provinces. It was expected to merge with the direct grant in 2017/18 but has been extended for another year (National Treasury, 2017a). The use of such indirect conditional grants is on the rise (Ncube and Tullock, 2015; Mtantato and Peters, 2015).

**Infrastructure grants**

Most funds transferred via conditional grants target infrastructure, followed by capacity building and other grants (Makube, 2010). In 2017/18, 96% of municipal conditional grants are infrastructure ones (National Treasury, 2017a). These grants aim to address infrastructure backlogs that are a legacy of apartheid (Mahabir and Mabena, 2014: 245).

Local governments demonstrate a high reliance on conditional grants to finance their capital budgets. While many of these governments may have revenue-raising capacity, those funds are not necessarily directed to infrastructure development. In 2014/15, of the 269 municipalities for which data were available, 167 (62%) relied on conditional grants to finance 75% or more of their capital budgets (National Treasury, 2017d). At the municipal level, three infrastructure grants – the Municipal Infrastructure Grant, the Urban Settlements Development Grant and the Public Transport Network Grant – constitute nearly all (direct) conditional funding to local government (77% in 2016/17; Figure II.2). The Municipal Infrastructure Grant is the largest conditional infrastructure grant for municipalities and is allocated on a formula basis (National Treasury, 2017a). The Urban Settlements Development Grant is intended for metropolitan municipalities and, as a Schedule 4B grant, the local government must complement grant funds with its own spending.
Grant conditions

Conditional grants come with a variety of requirements attached. Many conditions are laid out in the Division of Revenue Act, others may come from national policy frameworks and sectoral ministries (departments) (DPLG, n.d.). The Division of Revenue Act generally lays out the conditions that apply to the transfer and administration/management of funds. In general, conditions relate to inputs and processes, and in only a handful of instances to outputs. Some conditions are common to multiple grants, such as adhering to guidelines for maximising labour-intensiveness (National Treasury, 2017a). Some grants incorporate tranche release requirements. Some of the conditions for the largest infrastructure grants are outlined below:

- **Provincial Human Settlements Development Grant:** This grant is associated with a lengthy list of conditions. Among them, release of the first tranche of funds is subject to national approval of provincial business plans consistent with the provisions of the Housing Act, 2017 Division of Revenue Act and the National Housing Code (National Treasury, 2017a). Conditions further outline (among other dimensions) administrative conditions, restrictions on the use of funding, and necessary alignment between funded projects and local strategic documents (National Treasury, 2017a).³

- **Municipal Infrastructure Grant:** This grant’s conditions are also extensive and come in three forms: those related to the Division of Revenue Act, those related to the policy framework and sector-specific conditions (DPLG, 2006). Certain conditions clarify priorities for investment, while others address planning and accountability. Among other conditions, in order to release the first tranche of funds, a municipality must have agreed to an implementation plan with the national Department of Cooperative Governance (which oversees the grant) prior to the year of implementation. Spending must align with the municipalities’
Integrated Development Plans and their three-year capital plans (DPLG, 2006). The local government must attain three-year basic service coverage targets and prioritise projects that are labour-intensive (DPLG, 2006). Municipalities must spend at least 60% of their first tranche before additional funds are released. Sectors also attach additional requirements to the grant, such as adherence to labour-intensive construction methods (DPLG, 2006). Indicators for all conditions are monitored via monthly and quarterly reporting (DPLG, n.d.). Funds may be withheld, stopped or reallocated to another municipality if a recipient does not comply with the conditions of the grant (DPLG, 2006). If the recipient does not perform in terms of the conditions attached to the grant, the allocation may be reduced in subsequent years (DPLG, n.d.).

**Urban Settlements Development Grant**: According to the Division of Revenue Bill, release of each of the three tranches of funding is subject to submission of quarterly and annual performance data, including non-financial performance information. The first tranche is also conditional upon submission of an annual performance matrix aligned with municipal strategy documents and national priorities. Local governments that fail to spend at least 60% of their grant by the end of second quarter may have subsequent transfers stopped and reallocated (National Treasury, 2017a).

**Public Transport Network Grant**: Strict eligibility conditions are being introduced for this grant, including requirements that cities demonstrate that their planned public transport systems will be financially sustainable (National Treasury, 2017a). This has led several cities to revise their plans (National Treasury, 2017a). Payments will be conditional on the attainment of milestones (set in consultation with cities) that are specified in the municipality’s grant allocation letter (National Treasury, 2017a). Release of the first tranche is subject to submission of a multi-year financial operational plan. The second tranche is subject to this plan being accepted by the National Treasury and the Department of Transport as a basis for future grant payments (National Treasury, 2017a).

Grant conditions have evolved over time, often in response to challenges encountered in grant implementation. In recent years, for example, the national government introduced incentive mechanisms into the grant allocation process to improve infrastructure planning. Historically, grant implementation was characterised by a lack of proper previous planning, a late start in getting projects off the ground, delays and underspending. Starting in 2013, provincial education departments had to undergo a two-year training on infrastructure planning to be eligible to receive an incentive component in addition to their basic infrastructure grant beginning in 2016/17 (National Treasury, 2017a). To receive the incentive component, the departments must participate in a two-year planning process, and have their infrastructure plans reviewed and approved by the national Department of Basic Education and the National Treasury in 2016/17 (National Treasury, 2017a). The plans were reviewed and scored (in collaboration with provincial authorities) (National Treasury, 2017a). A minimum score of 60 was required to receive the incentive portion of the grant. Six out of nine provinces received the incentive payment for 2017/18 (National Treasury, 2017a). A similar procedure was put in place for the provincial health infrastructure grant.

An incentive component has also been introduced for the provincial roads maintenance grant as of 2017/18 using performance indicators covering targets such traffic loads, safety engineering and visual condition (National Treasury, 2017a).
The Municipal Demarcation Board is the South African authority responsible for determining municipal boundaries. Because (re)determination of boundaries takes local capacity to execute assigned functions into account, the Municipal Demarcation Board undertakes municipal capacity assessments. These assessments evaluate the “adequacy of people, rules, resources and knowledge” to carry out the local responsibilities stipulated in the Constitution. The current approach to assessment, introduced in 2011, incorporates data from a web-based questionnaire sent to all municipalities, secondary data and a qualitative review of high-priority functions in a 20% sample of municipalities. The emphasis of the assessment is human resource, financial and governance capabilities. These assessments took place on an annual basis until 2008/09, but since the introduction of the new methodology in 2010, only the 2011/12 report appears completed – or at least readily available.

The relationship (if any) between the Municipal Demarcation Board capacity assessments and determination of which municipalities require indirect grants is unclear.


Capacity considerations

South Africa’s subnational governments consistently demonstrate capacity constraints in managing their conditional grants. Weak capacity is evidenced not least by consistent underspending. In 2014/15, municipalities spent 72% of their total direct conditional grants; the figure was higher for infrastructure grants, at 89.1% (National Treasury, 2017d). Underspending is generally more problematic in (the smaller) district and local municipalities than in metropolitan areas and secondary cities (Ncube and Tullock, 2015). The National Treasury (2017b: 22) attributes such underspending to numerous delays (in project registration, project approvals, with contractors, with environmental impact assessments), an absence of project management units, late-start planning, “failure to comply with supply chain processes leading to litigation and related delays, difficulties obtaining land and slow land registration processes”, and weak capacity. Ncube and Tullock (2015) also point to high staff turnover and a lack of skilled permanent senior staff. The rise in the number and complexity of grants is also bound to increase the administrative burden, particularly for small and rural municipalities.

The national government’s response to these capacity challenges appears to have been three-fold. First, indirect grants are employed in response to weak capacity of provinces and local governments to administer infrastructure grants. This suggests a centralising trend in response to capacity constraints. The specific guidelines for determining which municipalities are (in)capable of managing the grants is not obvious, but the national government does have municipal capacity data at its disposal (Box II.2). Here, the response is not to withhold funds until capacity is attained, but to substitute national for subnational capacity. Interestingly, however, analysis of the financial and non-financial performance of indirect grants suggests that in some instances the national government underperforms relative to subnational ones (Mtantato and Peters, 2015; Ncube and Tullock, 2015). Performance measures (the percentage of the grant spent, or the percentage of grant targets achieved) for indirect grants can lag behind direct ones –
indicating that there are capacity constraints at the national as well as subnational level. Some of this performance gap may be attributable to co-ordination challenges encountered by national departments operating at the subnational level.

National performance in designing and monitoring grants has also been subject to criticism. The expansion of the grant programme also requires increased capacity for oversight at the national level (Makube, 2010). There is some suggestion that while national departments view conditional grants as a way to influence subnational governments in delivering concurrent functions, the departments themselves lack sufficient capacity for effective design, monitoring and evaluation of the grants (FFC, 2013). Nor do they effectively complement grant allocation with clear guidance regarding standards (FFC, 2013).

A second response has been to introduce capacity building programmes and grants. In 2004, the national government introduced the Local Government Financial Management Grant to improve municipal financial management capacity (National Treasury, 2017d). It is the largest capacity building grant (ZAR 502 million in 2017/18; National Treasury, 2017a). Despite this and other efforts, the National Treasury (2017b: 33) reported “unsatisfactory” progress with respect to local public financial management. The national government has also undertaken the Local Government Turnaround Strategy of 2009, the Government-wide Outcomes Based Monitoring System, and the Back to Basics initiative (Hughes, Moseki and Losch, 2016) and funds the Infrastructure Skills Development Grant (ZAR 140.7 million in 2017/18; National Treasury, 2017a).

A final response appears to have been a slight enhancing of conditionalities associated with grants. Over time, there appears to have been some tightening of conditionalities (Nthite et al., 2006), the inclusion of performance targets and inclusion of incentive components of conditional allocations. The effect of these measures is difficult to judge. But, at minimum, the data suggest that there has been a general decline in underspending (which could also be attributable to other approaches to improving capacity). It is not clear if this has been accompanied by a rise in effective spending. While numerous grants require recipients to have planning documentation in place (often linked to other strategic documents), the quality of these plans is not clear. Moreover, there is a reported dearth of non-financial performance data (Makube, 2010) and relative absence of evaluation that makes the quality of spending difficult to judge. An examination of the relationship between the extent of compliance and spending outcomes is an area for additional research.

Conclusion

The conditional grant system in South Africa is evolving. Despite capacity challenges, it is not characterised by widespread conditionalities that require comprehensive reforms at the subnational level in order to access funds. That said, capacity challenges are, in some instances, a target of the grant conditions. In general, the conditions largely target grant administration, with incentives attached in some instances to improve infrastructure planning and implementation. These mechanisms, along with the potential to withhold funds or to centralise responsibility for infrastructure development, highlight a need for continued subnational capacity development, particularly in district or local municipalities. At the same time, the less-than-stellar performance of indirect grants hints that, in some ways, all spheres of government are “learning together”.

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Notes

1. At minimum, the description of each grant in the Division of Revenue Act includes a reference to the corresponding objectives of the Medium Term Strategic Framework 2014 to 2019, which in turn relates to the long-term National Development Plan.

2. This excludes the shared fuel tax for the purpose of comparison.

3. The local strategy documents are the municipal Integrated Development Plan (IDP) and the Spatial Development Framework; the Built Environment Performance Plan (BEPP) for metropolitan municipalities.
References


United States

Introduction

The history of federal grants to US subnational governments is long and characterised by a recurrent tension between states’ rights and the role of the national government (Dilger, 2015). For nearly a century after the country’s founding, policy makers were hesitant to extend federal influence to the subnational level through intergovernmental transfers (Dilger, 2015). It was only at the end of the US Civil War that greater federal activism in subnational affairs emerged on a consistent basis (Dilger, 2015). The first recurrent cash grant to states emerged only in 1879 (Dilger, 2015). The strong orientation toward states’ rights that prevailed for nearly a century is far from irrelevant for a 21st century understanding of US grants to states. The underlying tension between deference to states and promotion of federal priorities continues to take centre stage even today, recently in a high-profile court case involving the imposition of conditionalities. This case study provides a descriptive overview of conditionalities attached to federal grants-in-aid to states and highlights some of the trade-offs their use implies.

Overview of US federal grants

A federal country, the powers not assigned to the national government in the US Constitution are reserved to the states (or to the people). As such, states (and local governments) play a central role in the delivery of public services, accounting for a large portion of public sector expenditures and revenues.

Federal grants to states and local governments play an important role in financing subnational service delivery. They are an extension of congressional spending power. According to the United States Office of Management and Budget (2016a), in fiscal year 2015 the federal government distributed USD 624.4 billion in grants to state and local governments (3.5% of GDP) (OMB, 2016a). While most funding supports payments for individuals (74.2% of grants in 2015), the federal grants also target physical capital (12.4% of grants) and other purposes (13.4% of grants) (OMB, 2016a). In 2015, federal grants accounted for 25.1% of subnational spending and 22.3% of state and local governments’ gross investments (OMB, 2016a).

Most federal non-defence investment in physical capital is funded via grants to subnational governments (65% in 2012), generally with a co-funding requirement (CBO, 2013b). The majority of funds (~70%) target transportation, particularly for highways but also mass transportation and airports (CBO, 2013b). Via subnational grants, the federal government also invests in energy (e.g. energy efficiency, renewable energy projects), natural resources/environment (e.g. pollution control, water projects), community and regional development (e.g. construction and repair projects), and income security (e.g. housing assistance) (CBO, 2013b).

Overall, the number and volume of grants to subnational governments has increased over time, driven heavily by increases in payments to individuals, particularly for health (Figure II.3). Grants as a percentage of GDP has also risen, as have grants as a percentage of subnational expenditure (Figure II.4). However, there has been little increase in capital grants as a percentage of subnational gross capital spending since 1990, with the
exception of a temporary counter-cyclical increase in the wake of the 2008 financial crisis (Figure II.4).

**Figure II.3. Federal grants to subnational governments by category, 1940-2015**

Outlays in constant FY 2009 USD, billions


**Figure II.4. Federal grants as a percentage of GDP and subnational spending, 1960-2015**


**Types of grants**

All federal grants-in-aid to states and local governments are conditional grants. The federal government does not provide any unrestricted funds. The grants take one of two main forms: block grants or categorical grants. Block grants are not entirely unrestricted
funds, but they provide some flexibility to states to use the monies within a general category of spending. By one estimate, there were 21 block grants in FY 2014, totalling approximately USD 50.8 billion and accounting for less than 10% of total federal grants-in-aid (Dilger and Boyd 2014). The vast majority of federal grants are more restrictive “categorical grants” (Figure II.5). These grants can take different forms, which provides the federal government with greater or lesser discretion over funding levels and how monies are spent (Table II.1) (Dilger, 2015).

Figure II.5. Evolution of the estimated number of grants by category, 1902-2014

According to OMB (2016a), the majority of federal funding to states is mandatory (USD 438.5 billion in 2015), with the largest sum going to Medicaid, the low-income health insurance programme. Medicaid accounts for over 50% of total grant spending by the federal government (OMB, 2016a). Outlays for discretionary grants (USD 185.9 billion in 2015) – which are determined annually through the appropriations process – were considerably less than mandatory ones (USD 438.5 billion in 2015), with the largest amount of discretionary funds going to the Federal-Aid Highway Program (OMB, 2016a).

**Conditionalities attached to federal grants**

The federal government attaches a variety of conditions to intergovernmental grants that restrict how states and local governments may spend the funds. As the federal government provides no unrestricted funds to states, all transfers have some level of conditions attached. Posner (2007) suggests grant conditions are among those “federal policy actions with a centralizing effect” (p.391) on the intergovernmental system.
### Table II.1. Federal and subnational discretion associated with different types of grants

<table>
<thead>
<tr>
<th>Type of grant</th>
<th>Federal funding discretion</th>
<th>Administrative conditions</th>
<th>Subnational spending discretion</th>
</tr>
</thead>
<tbody>
<tr>
<td>General revenue sharing: Used for any purpose not expressly prohibited by law. [NOT CURRENTLY USED]</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Block grants: Used for a particular category of activity. Rules regarding their use exist in the authorising legislation, but states have substantial scope for choosing how to use them.</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Categorical grants – Formula: Used for narrowly defined purposes. Amount depends on factors specified in the grant’s authorising legislation (e.g. population, poverty rates). These grants are generally considered an entitlement.</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Categorical grants – Open-end reimbursement: Used for narrowly defined purposes. Amount depends on the level of subnational spending: the national government reimburses states a specified proportion of programme costs.</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Categorical grants – Formula-project: Used for narrowly defined purposes. Amount to states depends on a formula in the enabling legislation or in regulations. States then award the specific grants to recipients (e.g. local governments) using a competitive process that they determine.</td>
<td>Medium</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Categorical grants – Project: Used for narrowly defined purposes. Money is set aside for state and local governments on an annual basis and the grants are issued on a competitive basis by specific federal agencies.</td>
<td>High</td>
<td>High</td>
<td>Low</td>
</tr>
</tbody>
</table>


Conditionalities are not new. Even with the early grants to states in the 1800s, recipients found some (albeit few) conditions attached (Arneson, 1922). A handful of these early transfers provided very few restrictions\(^1\) and others with limited ones such as requirements related to “military training and the equal treatment of races” (Arneson, 1922: 445). However, by the time of World War I, heavier conditions started to feature more consistently and prominently in grants. Writing in 1922, Arneson points to the Smith-Lever Act of 1914, the Federal Aid for Roads Act of 1916 (as amended in 1921), the Smith-Hughes Act of 1917, the Industrial Rehabilitation Act of 1920, the Chamberlain-Kahn Act of 1918 and the Sheppard-Towner Act of 1921 as introducing more onerous conditions for states. The Smith-Lever Act introduced matching requirements, which also featured in some of the other acts. Among other provisions, the Roads Act required that federal highway grants be administered by a “single state agency” staffed with professional civil engineers, a requirement that meant changes to the constitutions of some states (Conlan, 2005). In nearly all cases the federal government set conditionalities with the possibility to suspend aid if the conditions were not met. In many cases this included the submission and approval of planning documents, but in the case of the Roads Act it also included possible sanction for failing to maintain roads built under the act (Arneson, 1922).

Today, there are various categories of conditions attached to grants: administrative conditions that shape how a programme is run (e.g. matching requirements, fiscal controls), programmatic conditions regarding service delivery (e.g. eligible beneficiaries/projects, types of roads that can be built), cross-cutting conditions that apply to all grants with certain characteristics (e.g. non-discrimination requirements, wage rates and benefits), and cross-over conditions that apply restrictions based on performance in another area
In general, they aim to promote accountable use of funds, align national and subnational priorities, and spur subnational action in areas that they would otherwise not take. For example:

- Title VI of the 1964 Civil Rights Act banned discrimination in federally assisted programmes on the basis of race, colour or national origin (ACIR, 1984). This groundbreaking, cross-cutting conditionality provided important financial leverage for implementing the act and set a precedent for subsequent use of cross-cutting conditions in the use of federal funds in areas including, but not limited to, civil rights (ACIR, 1984).

  It applied, for example, to Title I of the Elementary and Secondary Education Act of 1965 (ESEA) that created federal grants for local education agencies and schools serving a high proportion (or number) of children from low-income families (Cascio et al., 2010; US Department of Education, 2015). The ESEA required that, in order to receive funds, recipients must comply with the Civil Rights Act by desegregating their schools (Cascio et al., 2010). The effectiveness of this requirement is discussed later.

- The Federal-Aid Highway Act of 1962 required that transportation projects in urban areas with populations of 50,000 or more be based on a comprehensive transportation planning process involving states and local governments. This in turn prompted the emergence of regional planning organisations that today, known as Metropolitan Planning Organisations, play a mandatory role in urban transportation planning for activities supported by federal funds (Edner and McDowell, 2002; Solof, 1998).

- The 1984 National Minimum Drinking Age Act required that all states raise their minimum drinking age to 21 by 1986, or risk losing millions in federal highway funds (United Press International, 1987).

- The 2001 No Child Left Behind Act (NCLB) reauthorising the ESEA required that, in order to maintain eligibility for federal education funds, states had to adopt comprehensive student testing and accountability programmes (Galston and Davis, 2014; Klein, 2015; Liguori, 2006). Moreover, it defined “adequate yearly progress” and prescribed remedies for schools that failed to perform (Galston and Davis, 2014; Klein, 2015).

- “Buy America” provisions attach domestic content restrictions to grants administered by the Department of Transportation and other authorities “for various purposes, including transportation projects or for water-related infrastructure systems” (Manuel et al., 2016: 16). Grant recipients must use US-produced steel, iron and manufactured products in their projects (Manuel et al., 2016).

- The Clean Air Act requires states to provide the federal Environmental Protection Agency with a “State Implementation Plan” laying out how the state will comply with the National Ambient Air Quality Standards. Failure to submit an adequate plan can lead to a loss in federal highway funds (Bagenstos, 2012).

- The 2010 Patient Protection and Affordable Care Act (ACA) required states to extend Medicaid coverage to new categories of low-income individuals and to provide them with a specific package of benefits (Musumeci, 2012). Failure to do so could lead to a total loss of Medicaid funding.
• The Department of Transportation’s Capital Investment Grants programme for transit infrastructure requires projects to complete one or two multi-year development stages (project development/engineering) prior to receiving construction grants (Federal Transit Administration, n.d.).

In some cases, rather than impose reform through conditionality, the United States has also used competitive discretionary grant programmes, such as (the now defunct) Race to the Top, to incentivise and selectively fund states that demonstrate a pre-existing commitment to reform. Race to the Top provided grants to those states that best demonstrated commitment (plans) to implement education reforms in key areas favoured by the national government. It was defunded in the fiscal year 2016 federal budget (Russell, 2015).

In some instances, states are subject to “maintenance of effort” provisions, which require them to continue spending at a prior spending level in order to receive federal funds. “Maintenance of effort” requirements are used to ensure the additionality of grants. Approximately 69 grants incorporate state “maintenance of effort” requirements (Dilger and Boyd, 2014).

As grant making grew over the course of the 20th century, and particularly after 1960, the conditions attached to them increased, as did their intrusiveness and bureaucratic weight (ACIR, 1984). The late 20th century saw a rise in conditionality particularly in areas of national priority, such as civil rights and environmental protection (ACIR, 1984), with the latter having a notable influence in areas such as environmental impact statements, endangered species protection, wetlands protection and historical preservation – which affect infrastructure development and have tended to generate delays, added costs and conflict. With conditionalities, some have argued, the federal government (via its spending power) has extended its authority in areas that are otherwise the purview of states (Posner, 2007). By 2014, states confronted a landscape of an estimated 1100 grants – most replete with conditions (Dilger, 2015).

**Subnational government responses to conditionality**

**Compliance**

Subnational governments confronted with conditions attached to federal funds may pursue various options, not all of which are mutually exclusive. One response is to comply with the federal requirements (even if compliance comes with objections). As of July 1988, for example, all states were in compliance with the national Minimum Drinking Age Act (McCartt, Hellinga and Kirley, 2010). Even nearly 100 years ago, Arneson (1922) noted that states seem willing to accept in the form of conditionalities what would be unconstitutional via mandatory legislation. Critical to this outcome, he posits, is the ostensibly voluntary nature of the grant system, a point most recently underscored by the Supreme Court holding in *NFIB v. Sebelius* (discussed later).

Arneson raises a question as to whether compliance is more likely in certain domains than others: “Perhaps”, he writes, “it will be discovered that the encroachment of the national government in the field of education is less desirable than it is in the matter of public health, rehabilitation and road building.” Even in 1922 he would not have been surprised to learn that the NCLB conditions produced a backlash among state and local education agencies (Galston and Davis, 2014), eventually leading to reform in 2015 with the passage of the Every Student Succeeds Act – which nonetheless places significant demands on states (White House, Office of the Press Secretary, 2015). The acceptability of conditions and national “interference” may be more acceptable in domains characterised...
by clear cross-jurisdictional spillovers. Rehabilitation and (non-local) road building would fit.

Yet, compliance is not entirely pervasive. As Pasachoff (2014: 252) notes, “In just the last few years, states have failed to comply with … the food stamp grant program … the Medicaid grant program … [and] the federal special education grant program … States have failed to implement procedures that they agreed to take on when they accepted education funds under Race to the Top and the State Fiscal Stabilization Fund. Localities have failed to comply with the terms of federal housing grants…” She goes on to argue that faced with non-compliance, federal agencies have been reluctant to withdraw funding from grantees.

**Waivers**

States may apply for waivers that exempt them from certain grant conditions. For example, as of February 2015, 42 states and the District of Colombia had received federal waivers that provided flexibility in meeting performance targets under the NCLB legislation (CBO, 2013a; Klein, 2015). Waivers can also apply to the “Buy America” provisions, to Medicaid, income support programmes and the ESEA, for example. However, waiver authority is limited by statute and does not exist in all grant programmes. Where it does exist, it is intended primarily to provide subnational governments with the flexibility to experiment/innovate with respect to service delivery.

While waivers provide flexibility with respect to conditionality, they can also be burdensome for states (CBO, 2013a). The time-consuming process often involves negotiating with federal authorities, public consultation periods and federal monitoring of waiver implementation. The process can be administratively heavy. For example, the waivers associated with the NCLB exemptions noted previously averaged approximately 400 pages (CBO, 2013a).

**Funds exchange**

A third approach is an exchange of federal for state funds (CBO, 2013a). In some cases, states have offered local governments the possibility to swap their federal transportation funds for state funds. Although the local governments generally receive less state funding (approximately 80-90% of federal funds), it comes without federal conditions (CBO, 2013a). In Kansas, for example, local agencies exchanging their federal transportation funds were able to choose from a greater variety of project types and were subject only to state, and not federal, regulations (CBO, 2013a).

**Legal challenge**

Tensions around grant conditions also play out in the courts. This has happened on a variety occasions, such as state challenges in lower courts to No Child Left Behind (see, for example, discussion of Connecticut v. Spellings in Liguori [2006]). On a handful of occasions the Supreme Court has considered the constitutionality of the conditions attached to federal grants to states. In 1987, for example, the state of South Dakota challenged the Minimum Drinking Age Act, in particular the provision allowing the federal government to withhold 5% of highway funds for non-compliance (South Dakota v. Dole). The Supreme Court upheld the law and determined that the budgetary impact of the 5% penalty was sufficiently small so as not to coerce states. In South Dakota v. Dole, the Court laid out five general restrictions on congressional authority to condition receipt of federal funds. Specifically, “for Congress to place a condition on receipt of federal
funds by a state, the spending has to serve the general welfare, the condition placed on the state must be unambiguous, the condition has to relate to the particular federal programme, unconstitutional action cannot be a contingency of receipt of the funds, and the amount in question cannot be so great that it can be considered coercive to the state’s acceptance of the condition” (LII, n.d.). While on previous occasions the US Supreme Court found the federal conditions on state grants to be constitutional, for the first time in NFIB v. Sebelius the Court held that, in this specific case, the conditionality was coercive and unconstitutional (Box II.3).

Box II.3. NFIB v. Sebelius

In 1965, when Congress established Medicaid, the state-run, jointly-funded health insurance programme for low-income individuals, it provided for the “authority to enforce state compliance with federal Medicaid programme rules by withholding all or a portion of a state’s federal matching funds” (Musumeci, 2012: 1). In 2010, via the Patient Protection and Affordable Care Act, the federal government required states to extend Medicaid coverage to new categories of low-income individuals and to provide them with a specific package of benefits (Musumeci, 2012). The federal government would assume 100% of the expansion costs in the early years of implementation, gradually reducing that figure to 90% by 2020 (Musumeci, 2012). If states failed to implement the expansion, they would lose all federal Medicaid funds. Twenty-six states and others (Liptak, 2012) brought suit against the federal government, challenging aspects of the Affordable Care Act, including the constitutionality of this condition.

The US Supreme Court ruled on the case in June 2012. While the Court again upheld the constitutionality of conditionality, for the first time it found the conditions associated with Medicaid expansion to be “unconstitutionally coercive” (Musumeci, 2012: 4). The Court (albeit not unanimous) found that while conditions may be attached to grants to ensure that funds are spent in accordance with Congress’ view of “general welfare”, their legitimacy depends on “the states’ knowing and voluntary acceptance of the [grant’s] terms” (Musumeci, 2012: 5). The size of the potential loss of funds from a programme that states depended on, and an inability of states to anticipate the particular condition seemingly negated knowing and voluntary acceptance. The court’s solution was to limit the enforceability of the withholding condition (Musumeci, 2012), thus making participation in the expansion voluntary (Liptak, 2012; Musumeci, 2012) and eliminating the condition’s coercive aspect. The conditions themselves remain as part of the Affordable Care Act, but withdrawal of funds can only be enforced if a state (voluntarily) agreed to implement the expansion but failed to comply with requirements of the law (NFIB v. Sebelius, 567 U.S. [2012]; Musumeci, 2012). In the end, many of the states that brought the suit ended up opting for the Medicaid expansion.

Notes: 1. According to Musumeci (2012): Chief Justice Roberts reached this conclusion in an opinion joined by Justices Breyer and Kagan (the Roberts plurality). It was also was reached by four other justices (Scalia, Kennedy, Thomas and Alito), who further thought that the entire act should be invalidated. Two justices, Ginsburg and Sotomayor, disagreed with the majority view that the expansion was unconstitutional. 2. Particularly as the expansion was viewed by the Court not as a modification of an existing programme, but essentially the creation of a distinct one, thereby linking revocation of existing funding to participation in a new programme (Bagenstos, 2012). This appeared a step too far, creating too great a distance between the conditionality and the (original) programme (Kopel, 6 July 2012).

**Opting out**

Crucial in the US context is the option for states to refuse the grant. As discussed, numerous court cases have upheld the federal government’s right to provide grants-in-aid to states and to attach conditions to those grants – within certain parameters. Grants are viewed as contractual arrangements and the conditions attached to them must be such that “potential [recipients have] an option not to accept, so that the grant may be said to ‘induce’ but not ‘coerce’” (ACIR, 1984: 39). Although the contractual arrangements involved with grants do not necessarily put the national and subnational governments on equal footing, the possibility to decline grants is critical to the concept that compliance is voluntary (ACIR, 1984: 39).

There have been instances in which states or local entities turned down federal funds, albeit not always to avoid grant conditions. Concerns regarding state-related costs can be a key issue. Arizona declined participation in the Medicaid health insurance programme (for the poor) from 1965 through 1982 but eventually accepted the funds as local cost pressures rose and the public demonstrated discontent with paying federal taxes that subsidised benefits for other places while receiving no such benefit themselves (Khimm, 29 June 2012). Texas declined participation in the Children’s Health Insurance Program in 1998 but joined in 2000 (Khimm, 29 June 2012). Ohio declined USD 385 million, Wisconsin USD 810 million and Florida USD 2.4 billion in federal funds for rail projects citing cost concerns for their states (Khimm, 29 June 2012). Indiana opted not to pursue federal funding for preschools (using state and local money to fund a pilot project instead) precisely to avoid grant conditions (Pence, 2014). Three school districts in the state of Connecticut opted out of (small) federal education grants due to concerns about the administrative burden accepting the monies would pose, as well as the NCLB conditions attached to it (Méndez, 2003).

**Benefits and trade-offs**

Conditional grants can be effective, particularly in aligning subnational priorities with federal ones. Bagenstos (2014: 98) points to collective action dynamics among states that would leave “many very worthy government objectives [unachieved] without a strong federal policy and financial role.” There is some evidence to suggest that the threat of sanctions (conditions linked to loss of funds for non-compliance) have an impact in the domain targeted by the conditions. Cascio et al. (2010) find that making receipt of Title I education funding conditional on school desegregation did, in fact, facilitate such desegregation in southern schools in 1966 and lightened the future burden on federal courts – particularly among districts with larger grants at stake. There is some evidence that raising states’ minimum drinking age to 21, consistent with the National Minimum Drinking Age Act, is correlated with a reduction in youth mortality due to motor vehicle accidents (Carpenter and Dobkin, 2011). The cross-state evidence of impact of No Child Left Behind is mixed and likely hampered by the variability of state responses to the grant conditions. Studies identify (among other findings) some positive indications of improvements in student learning as well as unfortunate evidence of gaming and other strategic behaviours with negative effects for students (Hansen, 15 December 2015).

Yet, the proliferation of waivers and numerous court challenges highlight the tension between the federal spending authority and state autonomy. The federal character of the relationship between the national government and states tempers the acceptability of conditionalities. *NFIB v. Sebelius* clarified the importance of the non-coercive, voluntary nature of federal grants-in-aid. Even where conditionalities are constitutional (as they
generally are), their use involves trade-offs. While they may align national and subnational priorities, address interjurisdictional spillovers, or ensure responsible grant implementation – there is a risk that conditionalities undermine the benefits of decentralised service provision (by weakening the ability of subnational authorities to tailor services to local conditions), overcompensate for spillovers (with matching rates higher than what they need be), and place substantial financial or administrative burdens on subnational authorities. The challenges faced by states under the NCLB suggest that the burden can be substantial. The burden is even more acute in times of fiscal stress, when subnational capacity is constrained financially (fewer resources for matching/co-financing) and/or in terms of personnel (fewer skilled staff to manage and/or apply for grants). A Government Accountability Office analysis of four municipalities found that in times of fiscal stress, the municipalities’ capacity to secure and manage grants was notably diminished (GAO, 2015).

There are alternatives to conditional grants. One option, which favours federal priorities, is to centralise service provision nationally (although this is unlikely given that conditional grants often touch competences that are largely reserved for the states). A second option, which favours subnational preferences, is to collapse categorical grants into more flexible block grants. This has happened in the past but has met with resistance in recent years, particularly where funding may be reduced.9 The option of general revenue sharing is highly unlikely. This leaves state initiatives such as grant swaps, mechanisms such as waivers, and more co-operative approaches – such as performance partnership grants10 – that emphasise output/outcome-oriented accountability and offer subnational governments more autonomy while retaining a priority on national objectives.

Conclusion

As noted previously, conditional grants effectively achieve particular goals. They can align subnational spending with national priorities and stimulate spending in targeted areas. They can facilitate outcomes where local preferences are at odds with general welfare, such as anti-discrimination policy. They can also prompt public discussion around local policy options and outcomes, such as with test-based accountability regimes.

On the other hand, for a federal country, the tool can be a heavy-handed instrument that weakens downward accountability and puts states in conflict with the federal government. It can encroach on state autonomy – something that is highly valued in the US context. There is a great deal of discussion about the implications of the NFIB v. Sebelius ruling and the extent to which it will prompt court challenges to conditional grants (Bagenstos, 2012). Bagenstos (2012) argues that challenges are likely, but may not be successful due to the unique holding of the Court. That said, he does acknowledge that the threat of court challenges may well shift the dynamic between national agencies and states, with the former – reluctant to engage in costly litigation – more inclined than in the past to issue waivers. It may further undermine agencies’ pre-existing reluctance to withhold funding in sanction, as described by Pasachoff (2014). This shift, even if not a momentous one, may encourage a search for more co-operative rather than coercive mechanisms.
Notes

1. Arneson (1922) refers to three tax-sharing arrangements (the National Forest Fund Act, the Oil Leasing Act and the Water Power Act) which placed restrictions only on the domain in which funds were to be spent (education and roads).
2. See also ACIR (1984) for a discussion of cross-cutting requirements and cross-over sanctions.
4. T. Conlan, e-mail to author, 9 May 2017.
5. Writing earlier, Arneson (1922: 453) asserts: “It is very clear that the inauguration of the conditional subsidy system greatly increases the power of the central government and permits an encroachment upon the states which would clearly be unconstitutional if brought about by mandatory legislation.”
7. For examples, see Liguori (2006).
8. The greater the potential loss of funds, the more likely a school district was to shift away from token desegregation (2% integration of black students) toward slightly higher levels of integration (2-6%) (Cascio et al., 2010)
9. For example, the fiscal year 2006 President’s budget included a proposal to combine 18 existing community and economic development grant programmes totaling USD 5.6 billion into a USD 3.7 billion block grant and a results-oriented bonus programme. The proposal was rejected (Dilger and Boyd, 2014).
10. Performance partnership grants permit grant consolidation within and/or across agencies and offering greater flexibility in using the grant in exchange for a negotiated agreement regarding performance, such as a partnership agreement or work plan. Performance partnership grants have had limited uptake. They have been used by the Environmental Protection Agency to consolidate Environmental Protection Agency grants and recently to consolidate grants across a number of federal agencies to finance pilot programmes for “disconnected youth”. For more see GAO (2017) and Conlan (2005).
References


