Conditional Grants in Principle, in Practice and in Operations: A Primer
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Manager: This Practice Note was prepared under the guidance of Tracey Lane (Practice Manager, EPSPA).

Authors: The note was drafted by Sierd Hadley (Research Fellow, ODI), Tim Williamson (Sr. Public Sector Specialist and Global Lead Subnational Governance, EPSPF); and Serdar Yilmaz (Lead Public Sector Specialist and Global Lead Subnational Governance, EEAG2).

Contributions: The paper has benefitted from contributions from Andyan Diwangkari (Consultant, EEAG1), Petar Stoykov (Consultant, EPSPA), Jamie Boex (Senior Fellow, Duke Centre for International Development), Gundula Löffler (Research Fellow, ODI) and Tom Hart (Senior Research Fellow, ODI) provided comments and guidance on early drafts.

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How to use this primer on conditional grants

The primary objective of this primer is to help World Bank teams to understand, use and strengthen a country’s intergovernmental fiscal transfer system as part of World Bank operations, with a specific focus on “conditional” grants. It is written for World Bank teams working in decentralised contexts, where subnational governments have responsibilities for delivering public services which are partly financed through transfers from central government. Whether intentionally or not, most operations working in these contexts will raise questions about the design and use of conditional grants. This note provides a basic introduction to conditional grants, how they are managed and why they matter for World Bank operations.

1.1 The relevance of conditional grants to World Bank programs

In most countries, subnational governments are responsible for delivering important services and infrastructure in the context of broader multi-level governance arrangements (OECD/UCLG, 2019). In 2016, subnational government spending accounted for 24 percent of total public spending and close to 9% of GDP on average (unweighted) for a global sample of 106 countries with available data. Health and education services are often significant components of subnational budgets, while services such as agriculture and water supplies are also decentralised in a wide range of countries. It is also well established that cities and municipalities will be at the forefront of global efforts to combat climate change and that adaptation will need to respond to localised needs.

Conditional grants are widely used to finance public services and investments that are the responsibility of local governments. Intergovernmental fiscal transfers are often the most
important source of financing for subnational governments and the service providers that they oversee. Central governments (and sometimes middle-level governments) employ conditional grants to fund specific activities that are the responsibility of lower-level governments and to create positive performance incentives. Common examples include grants to local governments that are earmarked for primary schools, district hospitals or agricultural extension services. The conditional grant system defines how these grants are deployed and governed across sectors and subsectors.

A good understanding of conditionality in the grant system can be critical for enhancing the impact of World Bank operations. Conditional grants offer an entry point for increasing financing to specific activities and for channelling World Bank lending to local governments in a way that respects and reinforces the legal responsibilities across levels of government. Conditional grants also offer a means to influence the equity of funding allocations, to shape the performance incentives of subnational governments and service providers, and to improve reporting and other aspects of administration. However, there are many practical considerations in designing operations that are transferring funds from national to subnational level. Poor design choices in these implementation arrangements can undermine the goals of an intervention, introduce funding arrangements that are difficult to sustain beyond the project and even exacerbate underlying challenges in governing subnational services (by fragmenting allocation decisions, for example).

The design choice in the flow of funds is important as many World Bank operations are already financing conditional transfers to subnational government services – even if this is not always recognised as such. A background review of projects under the World Bank’s Governance Practice conducted for this note found that 190 out of 200 projects were making (or expected to make) payments directly to subnational governments. Examples from other portfolios are also easy to identify – such as the various performance-based grants provided to urban local governments, health providers and schools (see Box 1 for some examples). Transfers such as these are effectively conditional grants, whether they are delivered through the grant system or not. In this sense, operations that are helping governments to finance subnational services or improve the way services are managed are already making decisions about how they will work with the system of intergovernmental fiscal transfers.

Box 7.2. Activity Plan for GovEnable / GovBottlenecks Process

World Bank operations often use existing de jure fiscal transfer systems or create de facto fiscal transfers when they finance subnational services and investments. Some examples from different World Bank practices include:

**Performance-based grants for urban infrastructure in Uganda.** The Uganda Support to Municipal Infrastructure Development Program aims to enhance institutional capacity of selected municipalities to address urban service delivery gaps. (Project ID: P117876)

**Grants for village level services in Karnataka State, India.** Karnataka Panchayats Strengthening Project financed grants from the state government to fund services in the gram panchayats (village) participatory plans and budgets. (Project ID: P078832)

**Fiscal transfers for upper secondary education reforms in Brazil.** The Support to the Upper Secondary Education Reform helps finance fiscal transfers to the state secretariats of education to implement the upper secondary reform, prioritizing vulnerable schools. (Project ID: P163868)

**Performance-based grants for primary health services in Nigeria.** The State Health Program Investment Project for Nigeria deploys performance-based grants for financing maternal and child health interventions and improving the quality of care at selected health facilities in the participating states. (Project ID: P120798)

Source: World Bank project pages
1.2 What is in the paper

This toolkit offers a practical introduction to conditional grants, how they are used to finance delivery and incentivise improved performance, and how this is relevant to the design of World Bank operations.

Section 2 reviews the basic features of conditional grant design – the purpose of a conditional grant, the types of condition(s) used, and how grant allocations are decided. It also looks at how conditional grants fit into the broader financing landscape subnational government services and describes some of the common ways conditionality is used in different countries. One key message from this section is that there is huge diversity in the design of conditional grants and how they are used in different countries as part of the broader system for financing basic services.

Section 3 looks at how conditional grants are managed. This section describes some basic features of the grant management cycle: how grants are introduced, budgeted for, transferred, and monitored. A key distinction in this section is between ad hoc approaches to managing conditional grants and more integrated approaches that set common rules and procedures with the aim of supporting a coherent grant system in policy terms and lowering the administrative burden on local governments. World Bank operations, and other donor projects, are often an important part of this landscape.

Section 4 identifies some of the common challenges involving conditional grants. There are some basic tensions that emerge in any decentralised setting, including inevitable disagreements over local and national spending preferences. In some cases, a well-designed conditional grant or reform to the institutional arrangements may help to manage these tensions. In other cases, these tensions result in the poor design and management of conditional grants. This section describes some of the challenges that will be worth considering as part of the design of any new operation.

Section 5 discusses the implications for World Bank operations. This section considers options for identifying potential bottlenecks in the conditional grant system that are affecting service delivery; it describes some basic elements that should be considered where a World Bank operation aims to create or use conditional grants for addressing the bottlenecks identified; and it offers pointers for using fiduciary work to improve the coherence of different World Bank projects and with national systems.

Across all five sections, the paper references a range of examples and other resources which Task Teams can draw on to inform their work. Because of limitations with the evidence base (particularly outside the OECD), the paper does not attempt to offer a systematic review of the evidence of “what works, where” for the use of conditional grants. It relies instead on a range of examples, including a more in-depth review of practices in six countries with varying levels of national income and different approaches to using conditional grants to fund services: Australia, Ethiopia, Indonesia, Kenya, Rwanda, South Africa, Tanzania and Uganda. The note also draws from the authors’ own experiences in this field.

While the paper focuses on lessons that are relevant to the design and use of conditional grants for local government, some parts of the paper summarise lessons from intergovernmental fiscal transfers more generally. This is particularly true for section 2 (where the distinction between conditional and unconditional grants is not always clear) and section 3 (because conditional grant management will be embedded in the broader governance of intergovernmental fiscal transfers). It is also necessitated in parts by gaps in the literature on conditional grants.

1.3 Other relevant resources

This note is accompanied by two more general introductions to fiscal decentralisation:

- Jamie Boex, Tim Williamson and Serdar Yilmaz, 2022, “Decentralization, multi-level governance and intergovernmental relations: a primer”. This paper will help systematically identify the strengths and weaknesses of a country’s overall approach(es) to decentralization and to leverage, whenever possible, a country’s intergovernmental systems in order to improve the effectiveness of the public sector’s performance in achieving public sector results.

- Jamie Boex, Tim Williamson and Serdar Yilmaz, 2022, “Fiscal decentralization, intergovernmental fiscal architecture, and intergovernmental fiscal relations: a primer”. This paper looks more explicitly at the fiscal
aspects of decentralisation – the way that subnational governments are financed from different sources of revenue, and the role of intergovernmental fiscal transfers. It is intended to help task teams identify the options and instruments for strengthening the systems of intergovernmental finance, of which conditional grants will be a specific element.

While the dedicated literature on conditional grants is relatively slim, there are resources that will be useful to supplement the general background provided in this paper (see Box 2). There are also numerous examples of country level analysis of fiscal transfers, which often include discussions of conditional grants. These are discussed in the context of World Bank operations in Section 5.2 (Box 17).

**Box 2: Useful resources for understanding conditional grant in theory and practice**

**Understanding the fiscal transfer system**

- Urban Public Finance in Developing Countries (R. Bahl, J. Linn, 1992)
- World Observatory on Subnational Government Finance and Investment (OECD, 2019)
- Source Materials on Decentralisation (J. Steffensen, 2010)
  - Annex 1: Principles of Expenditure Assignments
  - Annex 2: Overview of Costing Methods for LG Expenditures
  - Annex 3: Grant allocation principles

**Understanding the theory and typologies of conditional grants**

- Conditioning Intergovernmental Transfers and Modes of Interagency Cooperation for Greater Effectiveness of Multilevel Government in OECD Countries (P. Spahn, 2012)
- General grants versus earmarked grants, theory and practice a report from the Copenhagen Workshop of 2009 with case studies of OECD countries (Kim, J. et al. 2009).
- Using special purpose grants to achieve developmental goals: some practical considerations (J. Harris, 2021)
- Performance-Based Grant Systems: Concept and International Experience (J. Steffensen, 2010)

**Resources for understanding conditional grants in different contexts**

- Intergovernmental Transfers and Decentralised Public Spending in OECD counties (D. Bergvall, et. al., 2006)
- Fiscal Transfers in Asia: Challenges and opportunities for financing sustainable development at the local level (UNDP, 2019)
- Local Public Finance and Capacity Building in Asia: Issues and Challenges. (J. Kim, and S. Dougherty, 2020)
- Intergovernmental Fiscal Transfers in Federations (S. Yilmaz, F. Zahir)
- Intergovernmental fiscal transfers, equity and service delivery: lessons from Uganda (C.Long, et al., 2021)
- Chapter 5 of the 2014/15 Submission for The Division of Revenue (Financial and Fiscal Commission, 2013a)

**Resources for understanding conditional grants in different sectors**

- An Intergovernmental Perspective on Managing Public Finances for Service Delivery: Assessing Neglected Challenges in the Health Sector (P. Smoke et al., 2021)
- Intergovernmental Fiscal Transfers for Health: Overview Framework and Lessons Learned (A. Glassman, Y. Sakuma, 2014)
- The Role of Intergovernmental Fiscal Transfers in Improving Education Outcomes (S. Al-Samarrai, B. Lewis, 2021)
- Decentralization and Infrastructure: From Gaps to Solutions. (J. Frank, J. Martinez-Vazquez, 2014)
- Subnational Competitiveness Grants (SCGs) Guidebook (J. Salhab, et al. 2021)
Understanding the design of conditional grants

As Smart and Bird (2009, cited in World Bank 2012:106) observe: “in almost every jurisdiction, the world of intergovernmental grants turns out to be a complex and convoluted confusion of labels, intentions, and realities”. Terms like unconditional or special purpose grants, equalisation or block transfers and matching or performance grants are used widely, but often in different ways. This section offers an introduction to conditional grants in order to help task teams understand the purpose, conditionality and allocation principles that shape the design of specific transfers in a given context. As noted, the discussion focuses on lessons for conditional grants, but draws from the broader literature on intergovernmental fiscal transfers where there are gaps in the literature or where the distinction between conditional grants from the rest of the fiscal transfer system is not necessary for sound analysis and judgement.

2.1 Fiscal transfers in systems of multi-level governance

Conditional grants need to be understood and analysed in the context of the broader governance and financing arrangements for subnational services. The Toolkits on “Intergovernmental Fiscal Architecture and Intergovernmental Relations” and “Multi-Level Governance enabling Delivery” offer a more in-depth discussion of the differences in these arrangements across countries and the implications for World Bank programming. This section offers a short summary of some of the important factors that can help understand the role the fiscal transfer system (and conditional grants more specifically) plays in financing service delivery in different contexts.
The way services are delivered and financed is strongly shaped by the extent that they are decentralised. A typical distinction is between:

- *decentralized* governance systems where delivery is the responsibility of a central government unit located within a subnational region (e.g., District Health Management Teams in Zambia);
- *delegated* systems where responsibility for delivery is given from central government to semiautonomous or quasi-public corporations (e.g., the Ghana Health Services Agency); and
- *devolved* systems where authority, responsibility and resources are transferred from the central government to (elected) local governments (e.g., primary health services in Uganda and Kenya).

**Intergovernmental fiscal transfers are used to finance devolved services.** The IMF Government Finance Statistics Manual describes transfers as “a transaction in which one institutional unit provides a good, service, or asset to another unit without receiving from the latter any good, service, or asset in return as a direct counterpart.” Intergovernmental fiscal transfers are used by higher levels of government to finance the activities of lower levels of government. That may be from a central government to a provincial government, for example, or from a provincial government to a local government. It is also increasingly common to see countries providing transfers for schools and health facilities to manage under the oversight of local governments. Fiscal transfers may also be referred to as grants, and these terms are used interchangeably in this paper.

**The degree of devolution may vary across countries, but also across sectors within a country.** Primary health services have been devolved to county governments in Kenya and local governments in Uganda and are funded mainly by intergovernmental grants in both countries. However, a higher degree of political, administrative and fiscal decentralisation means that county governments in Kenya have more authority over health spending than their Ugandan counterparts. On the other hand, primary and secondary education have not been devolved in Kenya and are instead delivered through deconcentrated arrangements under the control of central government. These form part of the budget of the ministry of education and are not transfers.

Service delivery will often involve a mix of different governance and associated funding arrangements, as illustrated in the figure below. Resources may be transferred to local communities (group 3) through direct provision of public services by central government (group 1b), delegated spending through local service providers or extra-budgetary entities like a road fund or health insurance scheme (group 1c and 1d). In addition, various locally raised or earmarked revenues (group 2) and private financing (group 4) can finance local service delivery. The relative importance of the different funding flows can vary considerably. In their review of local financing in OECD countries, for example, Bergvall et al. (2006) find that grants in Mexico accounted for 95% of total revenues at the state level, while in Belgium this figure was just 10%. Equally, in federal systems, states or provinces establish their own fiscal transfers to lower levels of government or service providers (Shotton and Gankhuyag, 2020).
While there may be many sources of financing for service delivery, intergovernmental fiscal transfers (or grants) are usually one of the most important for devolved service delivery. That is because, in most countries, the cost of delivering the service delivery mandate assigned to local governments far outstrips the potential revenues from the tax bases that local governments collect and retain. In the literature on fiscal decentralisation, this is known as the “vertical fiscal gap”. While there may be scope to increase revenue collections, a large fiscal gap means that grants from central government will almost always be needed to finance local government services.¹

There is significant variation in the way fiscal transfers are designed and used in different countries. Each individual grant can be described using some basic characteristics. One is the nature and degree of conditionality associated with any grant (see section 2.3). Another is the allocation principles that determine the size of the overall budget for the grant and the distribution of the grant across eligible local governments (see section 2.4). Related to both the allocation principles and the degree of conditionality is the economic (incentive) nature of the transfer – whether it is paid as an ex-ante lump sum, reimburses expenditures incurred by local governments, or is based on some measure of performance.

¹ Worldwide, locally raised revenues account for around half of total local government revenues in an average country, but typically much less in developing countries (Gadenne and Singhal, 2014; OECD/UCLG, 2019). This figure is less than 10% in nearly all countries in East Africa for which data was recorded. And where the share of local financing collected by local governments is high, it is often because of the low value of fiscal transfers, as in Zimbabwe or Cambodia. Though there is potential for improving local revenues in most countries, there are also reasons not to devolve greater tax authority to subnational governments. Challenges with the mobility of tax bases and tax competition across local jurisdictions mean that local governments rarely have responsibility for collecting personal or corporate income taxes, for example, and tend to rely mainly on property tax collections, as well as fees and fines related to local services.
The overall grant system can be described in terms of the balance between these characteristics. For example, Figure 2.1 describes transfers from central government to local government as unconditional or conditional. To generalise, unconditional transfers can be used for any local government activity permitted in the law. They are typically provided in order to allow local authorities to finance their mandated responsibilities at their own discretion. Countries such as Kenya and South Africa fund local government services mainly through unconditional grants. In the case of Indonesia, unconditional financing is provided partly through revenue sharing and partly through centrally funded grants (World Bank, 2020). In contrast, Uganda and Tanzania rely more on conditional grants to fund local services.

Figure 2.2 Balance between conditional and unconditional funding for local governments in different countries

![Graph showing the percentage of GDP for different countries]

Source: Authors’ calculations; Kenya County Revenue Allocation Act 2013/14; South Africa National Budget 2013/14; Uganda Approved Estimates of Revenue and Expenditure 2013/14 (Volume II); Tidemand et al. (2014) for Tanzania; World Bank (2020) for 2014 data for Indonesia.

2.2 The role of conditional grants

The role of conditional grants will differ depending on the overall structure of the grant system. This will be strongly influenced by political considerations. For example, radical decentralisation reforms in Indonesia, Kenya and Nigeria were introduced largely as a reaction to the perceived over-centralisation of powers under previous political regimes. As a result, political forces have protected the autonomy of subnational governments by mandating large fiscal transfers with few strings attached. Conditional grants in these settings have often evolved to target national policies that are neglected or underfunded by subnational governments. In Uganda and Tanzania, the decentralisation process has evolved differently, with local governments having some political autonomy but more limited administrative and fiscal powers. In these contexts, conditional grants are used to pay for the full costs associated with the vast majority of local government services. The design of a new conditional grant needs to pay careful attention to these considerations including the political, legal and functional roles of fiscal transfers to local government.

Within that general framework, there are a number of principles which can guide the decision to provide conditional or unconditional funding. There are theoretical principles based mainly on the literature on fiscal federalism which emphasises the subsidiarity principle when it comes to

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2. For example, Indonesia has introduced capitation grants for primary and secondary schools and preventative health care services. The latter was introduced for some regions to address the relative neglect of preventative health care and failure of some regions to meet minimum standards. Similarly, South Africa uses conditional transfers predominantly to top-up allocations for provincial services (like tertiary education) or to fund a specific national programme delivered through the provincial government, (such as the national school nutrition programme). More details are available in Schedules 1-7 of the 2014 Division of Revenue Bill for the Republic of South Africa.
the allocation of local government functions and financing. There are **political principles** which reflect the tensions between national and local government priorities. There are also **practical reasons** for using conditional grants, including to allocate funding from donor projects for subnational services and infrastructure development. Each of these is discussed briefly in turn.

**Fiscal federalism theory** argues that local government spending should be financed through the fiscal transfer system using unconditional grants, except in certain circumstances:

- **There are ‘spill over’ effects.** When there are positive spill-over effects, a service funded in one jurisdiction benefits populations in another jurisdiction and the costs are not shared fairly. A regional hospital financed by one sub-national jurisdiction but provides services to residents of neighbouring sub-national governments is a common example. In these circumstances, it is appropriate for central government to either take on the responsibility for regional hospitals or to offer targeted conditional transfers to address this spill over effect. Negative spill-over effects emerge where a lack of investment in one locality impact on service costs in another. Weak investment in sanitation in one district may lead to a spread of disease to another, for example.

- **There are capacity shortfalls or political dynamics** that lead to inefficient allocation choices or inequities in service provision. In South Africa, the central government offers in-kind support to local government that are judged to have insufficient capacity to implement projects themselves. Uganda retains control over teacher recruitment and deployment and funds salaries through a conditional grant in order to distribute scarce human resources across local governments. More generally, conditional grants may be used to limit what is called the “tragedy of the commons”, where the political cost of taxation is not priced into local government policy and spending decisions leading to overspending (Sato, 2007).

- **There is a need for central government to use local governments to deliver national policy or services.**

This often emerges in discussions related to the equity of service delivery. A government may, for example, want to deliver a national policy for free maternal healthcare in a context where the delivery of healthcare services is the responsibility of subnational governments. Conditional grants can be used to directly finance these services or to provide incentives for local governments to use their own resources to deliver national priorities.

- **There are clear economies of scale** for managing at higher levels of government. This typically an argument for centralising the procurement of medicines, textbooks, fertilizers and other high-volume inputs which are then allocated to subnational governments in-kind or through a credit line. It may also apply to social security and other areas of spending that help pool risks across a population (Boadway and Eyraud, 2019). These arguments rarely apply specifically to conditional grants but is noted in the same literature on fiscal federalism.

**The choice over conditional and unconditional funding will also be shaped by political goals.** The political rationale for using conditional grants comes into play when national priorities intersect with sub-national mandates for service delivery. In Uganda, the national government committed through its 2016-2021 manifesto to ensure that all sub-counties (the administrative level below a district) have a school and a ‘level 3’ health centre. Conditional grants are used to fund local governments to deliver this policy. This is not unique to lower income countries. The UK Government launched a Towns Fund to support urban regeneration and local economic development as part of its broader commitment to tackling geographic inequities (Hanretty, 2021; Institute for Government, 2021). While these examples are strongly influenced by specific manifesto pledges of the ruling parties, the need to support national development goals can lead to a more general case for using conditional grants. Discussions in Indonesia, for example, are encouraging a more general increase in the use of conditional grants to ensure the central government can provide direct funding for national priorities (World Bank, 2020).

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3. The principle of subsidiarity means that public sector functions should be performed by the lowest level of government that can perform the function efficiently. Following this principle closely implies that subnational governments should also be funded in a way that permits different regions to give greater or lesser priority among the services under their control. Ideally services should be paid for using locally raised revenues, but where there is a funding gap, higher levels of government should provide discretionary (or unconditional) grant financing through the intergovernmental fiscal transfer system to allow for the mix of services provided to be aligned with the preferences of the local constituency. Refer to the toolkit on intergovernmental fiscal relations for a fuller discussion and examples.

4. These allocations are listed in Schedule 6 of the Division of Revenue Bill (for fiscal year 2014-15). The central government undertakes the project before handing over to the subnational government on completion to operate and maintain. In-kind allocations may be accompanied by capacity building support from the implementing department or agency. This approach has attracted criticism in the past. Issues have been raised over the lack of transparency of the allocations (some local governments were not aware of the allocation or its purpose), the inability of local governments to operate and maintain the service once the project has been completed (even after capacity building) and the complications that in-kind support creates for oversight and municipal planning (Financial and Fiscal Commission, 2006).
Finally, there are also practical reasons to use conditional grants. One of the most important in low- and middle-income countries is to integrate donor financing into the national financing system. A range of development agencies provide funding for services managed by subnational governments through national or local government projects, or even by directly funding service providers such as schools, health facilities or local utilities providers. The intergovernmental fiscal transfer system offers a means to align these funding sources more closely with the government’s own support to service delivery. This is discussed further in section 5 in relation to World Bank operations, though there are other examples such as UNCDF’s Local Climate Adaptive Living Facility (LoCAL).

### 2.3 Types of conditionality in the grant system

While it is common to distinguish between unconditional and conditional grants in general terms, actual practices are more complex. There are different kinds of conditionality which may be employed. Central governments can tightly specify the conditions or raise the consequence of non-compliance, or they can impose more limited conditions and give local governments greater discretion over spending.

There are three ways in which grant allocations can be conditional:

- **Earmarking or input conditionality** where resources need to be spent on a specific type of expenditure. In this way resources are tied to a specific sector, project, service or budget item.

- **Policy and results conditionality** where resources are tied to delivering against performance criteria for a given function, process or service.

- **Grant management conditions** where transfers are dependent on a sub-national governments’ adherence to certain processes related to the grant management cycle. These may include the preparation of a work plan or budget in advance and the provision of reports.

The design of any grant is a mixture of these different types of conditions, but also the ‘tightness’ of those conditions. The distinction between conditional and unconditional grants usually begins by considering whether or not it is earmarked for specific purposes. However, even grants which would usually be considered unconditional, may have conditions attached. Kenya’s equalisation grant (known as the “Equitable Share”) is used to fund most county services and is a good example of a highly unconditional grant. Yet, even this grant has de facto conditions imposed in the law, most notably the requirement to spend a minimum of 30% of county budgets on investment expenditures. Nonetheless, the input conditionality is considerably lighter than for neighbouring Uganda’s Discretionary Development Equalisation Grant, which must be used to fund capital investments in eligible sectors. Uganda’s local governments are also subject to an institutional performance assessment which influences the final allocation from this grant. Table 2.1 provides a summary of these differences alongside a more typical conditional grant – Tanzania’s education development grant which has components that are tightly earmarked to school meals and school running costs (i.e. “capitation grants”). The rest of this section unpacks these categories further still.

### Table 2.1: different types and degrees of earmarking, examples from East Africa

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<th>Types of conditionality associated with the grant</th>
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<th>Intergovernmental systems in place/functional?</th>
<th>Intervention modality</th>
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<tr>
<td>Earmarking</td>
<td>Low</td>
<td>High</td>
<td>Medium</td>
</tr>
<tr>
<td>Results</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Grant management</td>
<td>Low</td>
<td>Low</td>
<td>Medium</td>
</tr>
</tbody>
</table>

Source: Authors

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For more information, see: [https://www.un.org/ldcportal/local-climate-adaptive-living-facility-local/](https://www.un.org/ldcportal/local-climate-adaptive-living-facility-local/)
Variations in earmarking: Allocations can be earmarked to a specific sector or services (e.g. primary education), to economic classifications of spending (e.g. capital spending or the purchase of drugs) and/or to specific administrative units (e.g. district education office). A grant may employ one or all of these forms of earmarking at different degrees of specificity. The table below offers a general illustration of the continuum of earmarking from fully discretionary to highly specific. (Box 7 in Section 3.3, describes how these different levels of earmarking are used in Uganda.)

Table 2.2: understanding the tightness of earmarking

<table>
<thead>
<tr>
<th>Tightness of earmarking</th>
<th>Sector or programme (purpose of spending)</th>
<th>Economic item (spending on)</th>
<th>Administrative level (spending by whom)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td>Sectoral spending requirement (e.g. education)</td>
<td>Expense type (e.g. recurrent / capital)</td>
<td>Provincial or regional government</td>
</tr>
<tr>
<td></td>
<td>Programme spending requirement (e.g. primary education)</td>
<td>Expense (e.g. use of goods and services)</td>
<td>Department or lower level of local government</td>
</tr>
<tr>
<td>High</td>
<td>Activity level mandate (e.g. school meals)</td>
<td>Item (e.g. drugs or specific project)</td>
<td>Service delivery unit / cost centre</td>
</tr>
</tbody>
</table>

Note: Earmarking is often closely linked to the overall budget structure and chart of accounts. Conditions may be communicated through a “positive” or “negative” list of spending that is permitted under each heading, particularly in multi-sectoral grants and in cases where there is detailed earmarking at the economic item level.

Different types of policy and results conditions. Grants can be tied to policy or results conditions in several ways. At the looser end of the spectrum the central government may offer a general statement of the policy objectives and will monitor local government performance against those objectives. In other cases, the government may tie grant allocations directly to some measure of performance to incentivise better institutional or service delivery performance. Funding schools on the basis of reported enrolment is a simple example that has been adopted relatively widely across countries, but there are also more complex applications with strict minimum standards which must be met to gain access and multi-indicator performance metrics used to determine the final allocation to a local government or service provider. These “performance-based grants” are summarised in Table 2.3 below which illustrates how performance conditionality and earmarking are combined in practice. Matching grants may also be considered in this general category as they aim to incentivise additional spending in specific areas – what Searle and Martinez-Vazquez call financial conditions.

Table 2.3: examples of performance-based grants

<table>
<thead>
<tr>
<th>Degree of discretion over grant</th>
<th>Multi-sectoral use</th>
<th>None</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional performance</td>
<td>Common (e.g. Performance-based development grants for urban services)</td>
<td>Rare (e.g. Philippines health sector; Uganda health, water and education)</td>
</tr>
<tr>
<td>Service delivery outputs</td>
<td>Rare (e.g. pilot testing in Nepal)</td>
<td>Common (e.g. results-based financing for health)</td>
</tr>
</tbody>
</table>

Source: adapted from Steffensen et al. (2022)
Grant management conditions. For these conditions, the main distinction is between conditions that simply require adherence to general public financial management rules for budget preparation, execution, reporting and auditing and special conditions other than general PFM rules which local governments must follow. Many donor-funded grants require meeting different standards for fiduciary controls, for example. In general, looser conditionality will have fewer rules and less punitive penalties. As a stricter example from Uganda, up to 2012, local governments were required to submit quarterly performance reports in order to receive the next disbursement in funding during budget execution. However, this has since been eased due in part to the political concerns that disruptions caused by these sanctions were unfair on service providers and local citizens.

Box 3: Grant management conditions in South Africa and Uganda

Conditions based on the grant management cycle are commonly used to incentivise adherence to key elements of the grant management cycle. Conditions relating to the grant management cycle are typically assessed and applied in-year. A budget, work plan or execution report may be required to access releases. For example, from 2000 to 2012 in Uganda local governments were required to submit quarterly reports as a condition of accessing quarterly releases. In South Africa, many of the conditional grants carry such process requirements. To release an allocation from most conditional allocations for health, for example, a province was required to submit a business plan to the National Department of Health which could either approve it or ask for the plan to be revised.

If grant management is based on specific processes around an individual grant program, system-wide benefits are limited and they have little benefit beyond ensuring procedures for that grant are being followed. If grant management conditions are based on core financial management processes, then grant management conditions can encourage basic, albeit narrow, improvements those processes which benefit the management of all local revenues and expenditures. In Uganda, for example, reporting requirements for transfers were shifted from reports on individual grants to overall local government budget performance reports. Ideally, central governments should use grant management conditions to effectively oversee local governments. However, in many countries including Uganda, it is not clear that the central government has been able to make effective use of local government budget performance reports to improve their oversight of local governments.

2.4 Principles for allocating conditional grants

Another important aspect of the design of intergovernmental fiscal transfers, including conditional grants, is the way funds are allocated. One set of factors considers how to determine the overall size of transfers to subnational governments (vertical allocation) while another concerns the distribution across regions (horizontal allocation). To understand either the vertical or horizontal allocation of funding, it is also important to consider what level of government will receive the transfer and control the way it is used.

Both the vertical and horizontal allocations of fiscal transfers may be (i) formula-based, (ii) reimbursements (or “match”) of subnational expenditures, or (iii) decided at the discretion of the central government in a more ad hoc manner. Some of these approaches are common in the fiscal transfer system, and for conditional grants more specifically, while others are rare. For example, the 'origin of revenue collections' tends to be used for allocating unconditional grants in revenue sharing arrangements, and not for conditional grants.6

Decisions over the overall budget for conditional grants tends to be left to the discretion of the central government (or province). However, it is possible to identify examples of all

---

6. Revenue sharing arrangements are used when local governments are entitled to a share of the overall revenues but no control over the tax base. This is the case, for example, with the distribution of oil revenues in Nigeria which also uses the origin of revenue principle loosely as a basis for increasing the share of funding provided to the Delta region. Indonesia applies this principle more directly for some tax and natural resource revenues, though the approach varies for different revenue sources (McLeod & McLeod, 2010). However, it’s important to stress that revenue sharing does not necessarily imply using the origin of revenues principle.
of the three general principles for setting the ‘size of the cake’ for conditional grants:

- **Reimbursing** approved expenditures or costs incurred. This approach is rare for fiscal transfers in general. Boadway and Shah (2007) offer examples such as South Africa’s grant to teaching hospitals and the grants used in Canada before 2004 to match transfers for social assistance. Spahn (2012) also offers examples of “intercepts” in the US where the state pays district debts but withholds a share of the equalization payments to cover these costs.

- **Formula linked to the share of revenues.** This is less common for conditional than unconditional grants. As one example, Nigeria’s Universal Basic Education Act (2004) provides that 2% of the Consolidated Revenue Fund should be provided as a conditional grant for funding basic education infrastructure and services under states and local government authorities. Nigeria has since replicated this approach in the health sector under the National Health Act (2014).

- **Ad hoc or discretionary** allocations determined on a periodic basis or as decided by the central government are widespread. It is common for the global allocation to a conditional grant to be decided through the annual budget process, with funding levels at the discretion of the central government. This is the practice for most conditional grants in Uganda or Tanzania, but also in countries OECD countries such as the UK.

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**Figure 2.3: Principles for determining the pool of funds used for conditional grants**

All three allocation principles are relatively common for determining how allocations are shared between subnational governments:

- **Formula-based allocation.** Most countries will have at least some allocations which are formula-based. These will often include variables that approximate relative supply, cost or demand across subnational governments, although this may be as simple as a fixed equal share. Performance benchmarks and assessment results may also be included as a variable. Annex 1 provides some good practice principles for allocation formula.

- **Full or partial reimbursement (or ‘matching’).** Grants which are allocated using an open-ended reimbursement
approach are likely to use reimbursement as a basis for horizontal allocations as well. However, it is also possible to set a ceiling on the total allocations for a grant or to each subnational government (through a formula) while applying matching principles to determine the actual size of the grant. This is sometimes called a ‘closed-ended’ matching grant (Boadway & Shah, 2007).

- Ad hoc distribution based on other criteria. This could include wage grants based on the number of civil servants in post, development grants which are used to incorporate donor projects into the national budget, and grants where horizontal allocations are determined at the discretion of the government executive or legislature. Another example which has been applied relatively widely is competitive bidding, which is discussed in Box 14 in the context of Indonesia.

Underlying these approaches – even more ad hoc allocations – there may be calculations of the expenditure needs of subnational governments (Boadway and Shah, 2007; J. Steffensen, 2010). This tends to be easier for grants that are earmarked to a sector or service, than grants which subnational governments can allocate across sectors. It may involve an extensive ‘bottom-up’ costing for the services to be provided, but it is also common to find estimates that use data on historical allocations, regional disparities or international comparisons. Regardless of the methods used, such analysis can be an important reference point for the Government even when there is significant central government discretion over allocations. Italy’s minimum standards are a useful illustration of this (Kim, 2020). However, it is also common to find unrealistic minimum service standards that are set far in excess of the resources available.

A further practical consideration is whether a conditional grant is permanent or time-bound. Conditions relating to improved performance or to new policies may be established as a permanent feature of the financing of local government activities. These will endure until there is a special decision by the government to revoke that allocation, often years or decades after they were first introduced. However, in some instances conditions are time-bound. These are usually used to incentivise a change in behaviour or introduce new services. An obvious example is donor financing, which is provided for a given period before it is withdrawn (or replaced with a new grant). However, Australia also uses allocations tied to time-limited agreements that set out mutually agreed objectives, outputs and performance benchmarks. These are used to finance both delivery of specific projects, and improvements in service delivery or reform. Box 6 in Section 3.2 summarises some of the key features of these National Partnership payments as part of the discussion on grant management. South Africa also used to include information on the planned duration of a conditional grant as a part of the annexes to the Division of Revenue Bill.

2.5 Conditional grants in practice

Each country has a different mix of conditional and unconditional grants. Some rely mainly on unconditional financing, while others use mostly conditional grants. In systems where most financing is unconditional, governments like South Africa and Indonesia commonly use conditional grants for services that are neglected or under-funded, but other concerns may prevail such as concerns with financing minimum standards in Italy and South Korea (Kim, 2020). Governments that use conditional grants also choose to give subnational governments different levels of discretion – opting for multi-purpose sector block grants (see Box 4) or creating many specific grants earmarked to different activities or services. In a more fragmented system coordination between grants in terms of the way they are allocated, used and managed will be important.

It is common to find that conditional grants are used differently to fund recurrent and capital spending. Conditional allocations for capital investment can represent a much larger proportion of local capital spending, even in countries that provide large discretionary grants to subnational governments. Conditions tied to results are also more prevalent for capital grants than in recurrent grants. On the other hand, while grants for capital spending are usually transferred to the provincial or district level, recurrent transfers may also be earmarked and transferred to service delivery units. When the system is fragmented in this way, coordination between recurrent and capital (or development) grants is important.

Performance conditionality is generally applied to individual grants and is rarely a feature of the intergovernmental fiscal transfer system as a whole. Australia is one example where performance conditionality is used relatively widely.
Grant allocations from National Partnership Agreements are dependent on performance against a small number of timely, comparable, accurate and cost-effective performance measures. These measures are set in accordance with the Performance and Accountability Framework and overseen by the Council of Australian Governments, comprising the Prime Minister, State Premiers, Territory Chief Ministers and the President of the Australian Local Government Association. Critically, allocations that come with performance criteria are not allowed to have additional input conditions, and payments are made in arrears, once services are delivered, rather than in advance. However, National Partnership Agreements still represent a relatively small share of funding for Australian states, which depend mostly on redistributed Government Sales Tax revenues and also receive earmarked funding through Specific Purpose Payments.

Any fiscal transfer will have some influence on the incentives of subnational governments, and many countries will carefully design grants to reinforce positive incentives, including through the formula used to allocate funds. Matching grants are a notable example of this and there is some evidence that these can help incentivise higher levels of spending in target areas (Lewis, 2013; Lewis and Smoke, 2017). However, it is not always the case that matching grants generate a stronger budgetary response from local governments than non-matching grants (Gamkhar and Shah, 2007). Yet it is more common to find grants with formulae that carefully select variables to incentivise local governments and service providers to increase output, rather than employing more explicit financial incentives like matching.

Some countries have employed more “high-powered” incentives, by setting clear performance conditions and link financing to verified outputs or institutional assessments. In lower income countries, such performance grants tend to be supported by donor projects, including World Bank operations. This is common in grants for local government infrastructure investment, for example (Steffensen 2010; Steffensen et al. 2022). Performance-based financing for health services is another example, but such financing is often implemented outside the fiscal transfer system in low- and middle-income countries (Shroff et al., 2017; Piatti-Fünfkirchen, Hadley and Mathivet, 2021). Many OECD countries also use financial performance incentives to finance subnational services, particularly for earmarked sector grants (B. J. Steffensen, 2010). Section 4.4, offers a more in-depth discussion of performance grants.

Grants are also being paid to schools, health facilities and other service providers. In the education sector these grants are often called “capitation grants” as they are usually paid in proportion to the number of students enrolled at a school. In the health sector, this practice is referred to as “direct facility financing” because funding is directed to facility bank accounts. The practice of giving service providers budget autonomy is common in the OECD, but is a more recent reform in many lower-income countries. In Kenya, Tanzania and Uganda, grants to schools and facilities were introduced partly to compensate service providers for the removal of user fees (Opwora et al., 2009; Soucat et al., 2017; Mtei, 2020). There is some evidence that combining higher levels of spending with greater autonomy can improve service delivery in resource constrained settings (Opwora et al., 2009; Kapologwe et al., 2019; Khanna et al., 2021). However, releasing funds directly to schools and facilities may also lead to a stronger influence of central government on allocations within a local government, which could undermine longer-term efforts to build the legitimacy and capacity of subnational governments (Smoke et al., 2021). There are also cases to note, where the decentralisation process has reduced the financial autonomy of service providers, as was observed in relation to hospitals in some counties in Kenya (Barasa et al., 2017).

Ultimately, each country and conditional grant will exhibit a unique blend of conditionality. This is illustrated in Box 4 using Ethiopia in the mid-2010s as an example. Ethiopia’s Federal Block Grant is a good example of a more loosely earmarked grant which might otherwise be considered an unconditional grant. The performance-based grant for subnational infrastructure is a useful illustration of more high-powered results conditions. Both have been vehicles for international financing of services in the country in the past.

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7. These agreements are publicly available for the National Health Reform and National Education Reform Agreements on the federal financial relations website: http://www.federalfinancialrelations.gov.au/
Box 4: Ethiopia’s Federal Block Grant

The Ethiopian federal government has transferred subsidies to subnational governments since 1993 to meet regional expenditure needs. These needs are substantial given the high level of decentralisation of responsibility for service delivery. The largest component of the grants system is the federal-regional block grant (FBG), first introduced in 2002 its value rose to around 30% of overall government expenditure and approximately 70% of regional resources. The FBG funds recurrent and capital activities, though the donor funded supplement to the transfer (the Protecting Basic Services grant) covered recurrent activities only.

The vertical allocation of the federal-regional block grant (FBG) is set annually in the federal budget. There is no explicit formula governing the size of the transfer envelope and it is at the discretion of the federal government, but there is an implicit rule that the assignment may not decrease. The horizontal allocation of federal regional transfers is determined by a formula approved by the House of Federation and covering a period of five years. Regional formulas for providing block grants to the third level of government, woredas, follows a similar procedure to the FBG, with some variations.

The inter-governmental transfer system in Ethiopia is often referred to as an example of a largely unconditional system with peripheral specific purpose grants. However, although regions and woredas have discretion in allocating the FBG, the funding is not unconditional: it is linked to the implementation and achievement of common national strategies and targets and includes some detailed directions on expenditures, specifically instructions on staffing levels of agencies. In addition, there are common financial management systems and the federal government has the right to audit the FBG (and any donor funds).

The inter-governmental transfer system also includes a capital investment grant, the MDG fund, which is allocated using the FBG formula, but carries additional conditions. There are also a number of Specific Purpose Grants (SPGs). SPGs are earmarked to specific sectors and expenditures without an overarching formula determining allocation. They do not always appear in regional or woreda budgets and there are also other substantial resource flows which are off budget at woreda level, including community contributions as well as project aid from official donors and NGOs.

Sources: Brosio and Gupta (2007); Gebre-Eziabher and Woldehanna (2014); 2010/11-2011/12 BOOST; Zimmermann-Steinhart and Bekele (2012); Vaillancourt (2013)

2.6 Key messages

Nearly all countries use a combination of conditional and unconditional transfers to support local government services. More often than not, fiscal transfers are necessary to bridge the gap between the cost of delivering services which local governments are required to deliver and the revenue sources they are permitted to collect and retain in order to fund these services. This gap is likely to remain over the longer term and makes the system of fiscal transfers essential for service delivery.

However, countries differ in the balance of unconditional and conditional funding in the intergovernmental fiscal transfer system. Theoretical reasons for using conditional grants relate to the allocative efficiency of grant allocations, but it is usually political considerations that prevail. These often stem from demands to implement national policy priorities in services over which subnational government have important discretion over spending choices.

The role of conditional grants will be shaped by the broader institutional landscape for decentralisation and service delivery. Any new conditional grant will have to take account of the broader financing landscape and the laws which govern intergovernmental relations. A thorough and in-depth understanding of this context will be critical for designing World Bank operations that will strengthen service delivery systems and not just fund specific short-term outcomes. Examples of diagnostic work on fiscal transfers are provided in Section 5.
Against that backdrop, conditional grants are mostly used to either:
- fund subnational governments in order to (a) implement their functions; (b) support national policy objectives; (c) compensate for asymmetric costs and externalities (spill-overs); and/or
- incentivize subnational governments to deliver minimum service delivery standards or improve certain aspects of their performance.

The design of a new conditional grant will need to reflect a number of features. These include the different types of conditions they impose (input, performance and grant management) and how “tight” those conditions are (e.g. education services in general or school meals specifically). Conditionality may also be a permanent feature of the grant system, or be time-bound to introduce new policies or behaviours that are incorporated into the general grant system over time.

### Table 2.4: Summarising key design elements of a conditional grant

| Purpose | • Supporting allocative efficiency, particularly addressing spill-overs  
|         | • Political concerns, including delivery of national policy commitments  
|         | • Practical considerations, such as ensuring a certain function is funded |
| Conditionality | • Earmarking inputs to a type of spending or specific sector, function or service  
|              | • Performance-based triggers for disbursing funds deciding allocations  
|              | • Administration or grant management rules for budgeting, reporting, etc. |
| Allocation | • Level of government receiving the grant  
|            | • Vertical allocation between different levels of government  
|            | • Horizontal allocation between subnational governments  
|            | • Permanent or timebound allocations |

### Box 5: Key references – the design of conditional grants

There is a broad literature on the design of fiscal transfers, including the theoretical justifications for conditionality and lessons from the design of earmarked grants, matching grants and performance grants. Bank teams can also use the broader literature on intergovernmental fiscal transfers: there are useful lessons from the literature on equalisation grants for the design of conditional grant allocation formulae, for example, and from unconditional grants in terms of the incentive effects of crowding in or crowding out local government revenues.

**Design of conditional grants**
- **Conditioning Intergovernmental Transfers and Modes of Interagency Cooperation for Greater Effectiveness of Multilevel Government in OECD Countries** (P. Spahn, 2012)
- **General grants versus earmarked grants, theory and practice** a report from the Copenhagen Workshop of 2009 with case studies of OECD countries (Kim, J. et al. 2009).

**Basics of fiscal transfer design and management**
- **Source Materials on Decentralisation** (J. Steffensen, 2010)
  - Annex 1: *Principles of Expenditure Assignments*
  - Annex 2: *Overview of Costing Methods for LG Expenditures*
  - Annex 3: *Grant allocation principles*

International comparisons can also benefit from the basic information provided by the *World Observatory on Subnational Government Finance and Investment* (OECD, 2019)
Understanding the way conditional grants are managed

While the previous sections have provided a general framework for understanding the design of conditional grants and the context in which they are used, this section offers insights into the way the grant system is managed. It covers the way conditionality is agreed, how allocations are set and communicated in the national budget process, the release and flow of funding to local governments and service delivery units and some approaches used to oversee and enforce conditionality. Again, the focus is on conditional grants, but many of the basic elements of grant management such as budget formulation and execution will apply to the intergovernmental fiscal transfer system more generally.

3.1 Institutions for managing fiscal transfers to local governments

The overall framework for institutional arrangements for intergovernmental fiscal transfers will usually be set in law. The national constitution, public finance laws, local government laws and related legislation will often describe the general rules which govern the financing of subnational public services. This may specify the nature of grants which can be provided, the way they are agreed and the principles for allocating grants and the routine of public financial management. Some grants might be mandatory while others may be at the discretion of the executive, for example. There will also be specific definitions over what constitutes a local government and rules that shape how these may be financed.
There are four broad categories that describe where the main responsibilities lie for policy making and implementation (Boadway and Shah, 2007). There are systems led by a central agency, by the national legislature, by an intergovernmental forum or by an intergovernmental forum supported by an independent agency. The most common model worldwide is the central agency model though the agency in charge tends to vary across central government departments. Uganda (ministry of finance) and Tanzania (president’s office) offer typical examples of this model, but there are also examples in high-income countries like the Netherlands. There are also a number of countries – particularly those with federal structures or highly devolved states – which use intergovernmental forums (e.g. Kenya, India and South Africa). Very few countries use the legislative model, though Brazil is one. Experiences with different models are documented in the literature on intergovernmental fiscal coordination (Boadway and Shah, 2007; Spahn, 2012; Ter-Minassian and Mello, 2016).

However, the management of grants will always involve a wide range of organisations for different tasks. Even where the finance ministry is not the custodian of the grant system, it will usually support the preparation of grant budgets and making transfers to local governments. The local government ministry will typically be given responsibilities for coordinating support to local governments and defending their interests in the central government, while line ministries will play roles in setting standards and policies which local governments to guide the provision of local services and providing the necessary support to ensure these are implemented. In central agency models there can still be public organisations that support negotiations between central and/or offer a challenge on the central government’s decisions in relation to grant management. The national legislature is almost always responsible for authorising the final allocation for intergovernmental fiscal transfers in the national budget (a process called appropriation in Anglophone countries).

These institutional arrangements will be unique to the country, reflecting the specific history of decentralisation and institutional development more broadly. Kenya’s devolution process has created a new set of institutional arrangements under the 2010 Constitution, adopting the model of an intergovernmental forum supported by an independent agency and borrowing heavily from the systems used in South Africa. The Kenya Commission on Revenue Allocation makes recommendations to the Government on the allocation of the main “equitable share” grant to county governments in the County Allocation of Revenue Bill, while the National Treasury is responsible for preparing the Bill and the Senate has final authority on the vertical and horizontal allocations. The Constitution also created the Office of the Controller of Budget which oversees the implementation of county budgets and approves the transfer of funds from central to county governments in line with the County Allocation of Revenue Bill. While this system has man similarities to the institutional arrangements in South Africa, it is different from Uganda which uses a central agency model with the finance ministry at its center.

3.2 Establishing and modifying conditional grants

One general distinction to make is the degree that the creation of new conditional grants is regulated in the law and in practice. On the one hand there may be systems that leave significant discretion to the government executive to create new conditional grant and to modify the terms or even terminate existing grants with few guiding rules and principles. These could be considered ad hoc arrangements. However, other countries will adopt a more rules-based approach.

More formalised arrangements provide a basis for communication and (in many cases) negotiation between central and local governments over the terms of conditional grants. These are important for developing a shared expectation over how resources should be used and reported on. They also provide an anchor for the policy analysis and discussions that shape the way conditional grants are developed. Three commonly used frameworks used to formalise the creation of new conditional grants are:

- Intergovernmental agreements, where the conditions of a grant are set forth in one or more intergovernmental agreements which both levels of government agree to abide by, rather than in a law passed by parliament; this may be on a comprehensive basis, sector by sector basis or grant by grant. This is used in many European countries, especially in Scandinavia and Eastern
Europe. Uganda has also adopted intergovernmental agreements. In Uganda, line ministries drafted letters of understanding for individual grants setting out conditions developed by the ministry, which they then signed with local governments. These were later harmonised, but they still represented an imposition of conditions by central government. Later a series of annual negotiations between central government and local government were introduced for each sector, though there remain some question marks about the effectiveness of the process.

- **Grant-by-grant legal arrangements**, where the provisions for each grant are set out in separate laws for each grant. Australia and the United States have adopted this approach to varying degrees. A notable feature of the grant-by-grant legal arrangements is that details are negotiated and settled at a higher level than intergovernmental agreements. Generally speaking, whilst these agreements require a high degree of accountability for grants, if the institutions for intergovernmental coordination are weak, there is a risk that the focus on individual grants may come at the expense of the coherence of the overall allocation and use of subnational resources.

- **Comprehensive legislative arrangements**, where a single act or instrument sets out on an annual basis the provisions for all grants. South Africa and Rwanda both use variants of this approach. In Rwanda the finance ministry is legally required to document the purpose, conditionality and entity responsible for grants provided to local governments. This is done through the Districts’ Earmarked Transfers Guidelines. South Africa issues similar documentation through the Division of Revenue Act. In both countries, many of the details of grant conditionality are agreed between sector ministries and local governments, and then approved elsewhere (by Parliament in South Africa or the Ministry of Finance in Rwanda). The details of the final ‘grant agreement’ are published and the standardised features are presented in table 3.1, below.

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### Table 3.1: The structure and content of conditional grant guidelines in Rwanda and South Africa

<table>
<thead>
<tr>
<th>South Africa Division of Revenue Bill Annex</th>
<th>Rwanda Districts’ Earmarked Transfers Guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transferring ministry or department</td>
<td>Background to conditional grants under the transferring ministry or department</td>
</tr>
<tr>
<td>Grant purpose</td>
<td>• The mission, goals and objectives of the transferring institution and legal references</td>
</tr>
<tr>
<td>Outcome statements</td>
<td>• Existing conditional grants, by programme</td>
</tr>
<tr>
<td>Outputs</td>
<td>• Relevance of conditional grants to national policy on decentralisation, poverty reduction, and other cross-cutting programmes</td>
</tr>
<tr>
<td>Priority outcomes of the government that the grant primarily contributes to</td>
<td>• Inclusion in the district Action Plan</td>
</tr>
<tr>
<td>Details contained in the business plan</td>
<td>• Progress in the current fiscal year</td>
</tr>
<tr>
<td>Conditions</td>
<td>Objectives of the conditional grant</td>
</tr>
<tr>
<td>Allocation criteria</td>
<td>• Programme and sub-programme</td>
</tr>
<tr>
<td>Reasons not incorporated in the equitable share</td>
<td>• Outputs and activities</td>
</tr>
<tr>
<td>Past performance</td>
<td>• Allocation formula</td>
</tr>
<tr>
<td>Project life</td>
<td>• Allocation by district</td>
</tr>
<tr>
<td>MTEF allocations</td>
<td>• Performance indicators</td>
</tr>
<tr>
<td>Payment schedule</td>
<td>• Disbursement modality and frequency</td>
</tr>
<tr>
<td>Responsibilities of the department transferring the grant</td>
<td>• Reporting requirements for financial and non-financial reports</td>
</tr>
<tr>
<td>Responsibilities of the provincial department receiving the grant</td>
<td>• Monitoring and evaluation methods and frequency</td>
</tr>
<tr>
<td>Process for approval of the business plan</td>
<td></td>
</tr>
</tbody>
</table>

Source: South Africa Division of Revenue Bill 2014; Rwanda District Earmarked Transfer Guidelines 2012/13
These formal arrangements can also be accompanied by principles to guide the review of conditional grants. This was a central recommendation of the Financial and Fiscal Commission report (2013a:60) on conditional grants in South Africa, which called for a more standardised system for introducing, reviewing and terminating conditional allocations to local governments. The recommendations included enhancing or standardising a number of processes at all stages of the grant cycle, as will be discussed in the next section, but also on guiding principles for using conditions. As an example, Australia has some general criteria to guide the use of conditional grants, largely echoing the principles outlined in Section 2.8 Annex A1 offers some general principles to guide the design of allocation formula, based on international experiences in low- and middle-income countries in particular. However, it is also important to note that these decisions are often the result of negotiations between sector ministries, the finance ministry, the local government and other stakeholders, which may even include Cabinet and independent commissions.

Ultimately, the quality of the grant management framework also depends on how well it is implemented. As the country examples will highlight, the choice between intergovernmental agreements, grant-by-grant legal agreements and comprehensive legislative arrangements is not in itself a barrier to effective grant management. While it is reasonable to expect systems to become more formalised over time this can happen in different ways and it is important that the systems put in place actually serve the purpose that they are intended for. As noted in the example of Uganda, studies have highlighted some challenges with the way the systems are implemented in practice (ODI, 2017). Negotiations are poorly resourced, are not prioritised by line ministries and are often held too late to influence the planning process at the national level. Most agreed actions are not implemented, and there are no formal sanctions for failing to follow-up on agreed measures.

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**Box 6: Australia’s National Partnership Agreements**

The Intergovernmental Agreement on Federal Financial Relations (IGA) governs national financial relations with the States in Australia. It was passed in 2008 by the Council of Australian Governments (COAG)9, representing a major shift in intergovernmental relations.

The general aim of the IGA is to provide a framework for Commonwealth and State and Territory governments to collaborate on policy development and service delivery and facilitate the implementation of economic and social reforms. It provides for two broad types funding to the States. The first are unconditional transfers worth approximately AUS$ 55bn (in 2014-15) under General Revenue Assistance (GRA). The second are conditional transfers for specific purposes worth a further AUS$ 46bn. These conditional transfers include AUS$ 13bn in National Partnership payments to support the delivery of specific services and projects.

National Partnership payments are time-limited agreements that define the mutually agreed objectives, outcomes, outputs and performance benchmarks or milestones related to the delivery of specific projects, improvements in service delivery or reforms. The terms of each National Partnership Agreement are published online. As well as the overarching objective, these Agreements include detailed information about the respective responsibilities for delivery, outputs targets, performance indicators, implementation plans, and the financial costs.

Most National Partnership payments are conditional on States demonstrating performance against the milestones set out in the relevant agreement. Input conditions are not permitted, but some allocations do have a matching requirement. Milestones should be an action or event marking completion of a phase of a project. These should be clearly defined, understandable in terms of achievement or non-achievement, not open to any subjectivity and verifiable. Achievement of the milestone should trigger in-arrears project payments – managed on a monthly basis.

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9. COAG is the peak intergovernmental forum in Australia. The current members of COAG include the Prime Minister, State and Territory Premiers and Chief Ministers, and the President of the Australian Local Government Association.
At the national level, responsibility for the governance and monitoring arrangements of National Partnership agreements is shared between portfolio agencies and the Treasury. Payments are made to the States by the Treasury based on information provided by portfolio agencies, though Treasury officials still perform quality checks before approving each payment. Portfolio ministers are responsible for initiating and leading the review of National Partnership agreements, generally one year before they are due to expire. Reviews provide a means of assessing whether the objectives of the National Partnership have been achieved and inform decisions regarding the treatment of expiring National Partnerships.


3.3 Budgeting for conditional grants at the national level

The process for establishing conditional grants needs to link to the budget process used to allocate available resources. In low- and middle-income countries the budget process is an annual affair involving several stages through which the budget estimates become more realistic and more specific over a period of 6-9 months before the draft budget is submitted to the legislature for approval for the next financial year. The rituals of the general budget process will impose deadlines for different aspects of grant management – establishing and reviewing grants, calculating the vertical and horizontal allocations, communicating allocations to local governments and providing the necessary support for subnational budget preparation. In South Africa, the budget timetable is communicated as part of the medium-term expenditure framework guidelines issued by the National Treasury each year and features both the national and provincial processes (table below).

Table 3.2: South Africa’s provincial budget process

<table>
<thead>
<tr>
<th>ITEM</th>
<th>DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical Committee on Finance (TCF) Lekgotla</td>
<td>Mid July</td>
</tr>
<tr>
<td>Budget Council meeting (provisional)</td>
<td>End July</td>
</tr>
<tr>
<td>Provincial treasuries submit first draft 2015 Budgets</td>
<td>12 August</td>
</tr>
<tr>
<td>Provincial treasuries submit first draft 2015 Budgets</td>
<td>12 August</td>
</tr>
<tr>
<td>Technical Committee on Finance meeting</td>
<td>26 September</td>
</tr>
<tr>
<td>Provincial benchmark exercise for 2015 Budget</td>
<td>02-12 December</td>
</tr>
<tr>
<td>Provincial benchmark exercise for 2015 Budget (2nd round)</td>
<td>19-23 January</td>
</tr>
<tr>
<td>Technical Committee on Finance meeting</td>
<td>End January</td>
</tr>
<tr>
<td>Provincial benchmark exercise for 2015 Budget</td>
<td>End January</td>
</tr>
<tr>
<td>Provincial benchmark exercise for 2015 Budget (2nd round)</td>
<td>End January</td>
</tr>
<tr>
<td>Technical Committee on Finance meeting</td>
<td>End January</td>
</tr>
<tr>
<td>Final allocation letters issued to provinces</td>
<td>End Jan/Early Feb</td>
</tr>
<tr>
<td>Budget Council meeting</td>
<td>End Jan / Early Feb</td>
</tr>
<tr>
<td>Provincial 2015 Budgets tabled at provincial legislatures</td>
<td>End Feb / Early March</td>
</tr>
</tbody>
</table>

Source: National Treasury (2014c)
This process involves considerable coordination. The finance ministry will typically be focused on the overall level of funding but may also play a role in communicating budget ceilings for conditional grants and other fiscal transfers to local governments. That is the case in South Africa and Uganda, for instance, both of which have dedicated units to facilitate the process. Line ministries will generally be responsible for informing local governments of changes to policy, and also for leading the calculation of horizontal grant allocations using formulae and other means. The ministry of public service (or equivalent) may be involved in calculating wage allocations for local governments. These various strands of information must also be absorbed by local governments as they prepare their budgets for submission to the local council. The timetables can be very tight, and delays are common. In some cases, the final budget allocations for a local government may not be clear until the national budget has been adopted by the legislature. The additional administrative demands created by results conditionality – whether in performance-based grants or matching grants – can be particularly challenging to maintain when there are already difficulties coordinating the budget process (Searle and Martinez-Vazquez, 2007).

Allocations for conditional grants can be included in the national budget in different ways with implications for how they are ultimately controlled. Rules related to budgeting will be contained in the national public financial management laws and regulations. The most important relate to the level of legislative control. This note has already highlighted that Kenya and South Africa pass specific legislation on the allocation of conditional grants which provides a horizontal distribution for the conditional grants appropriated under each ministry vote. Uganda and Tanzania do not use a legislative vehicle, but they do publish a separate volume of the national budget estimates that reflects the specific grant allocations for different subnational governments. In principle at least, this gives the executive in Uganda and Tanzania greater flexibility to change budget allocations during the year than in Kenya and South Africa.

Box 7: How central government enforces conditionality in Uganda

Uganda funds local government services through 31 different grants alongside a range of donor projects and delegated spending (e.g. drug procurement and grants for road maintenance). Each sector can create a grant for wage, non-wage and development spending and further grants may be established to support more ad hoc policies or financing needs. These grants are earmarked further as sub-grants which are increasingly closely controlled during budgeting and budget execution using the government’s financial information system.

The grant structure for health is summarised in the table below with four grants earmarked to the sector (health) and economic spending category (wage, non-wage and development). The non-wage recurrent grant has a further five sub-grants requiring that the local government distributes specific shares to health facilities and hospitals, both public and not-for-profit (administrative level earmarking).

The sector development grant is also partly earmarked to meet government commitments to upgrade health facilities (sector activity earmarking). The remainder can be used by local governments for their sectoral infrastructure priorities. However, the formula for this second sub-grant includes the results of an annual assessment of the institutional performance of the district health office (performance conditionality).

The government enforces the earmarking in a number of ways. The finance ministry communicates planning figures

<table>
<thead>
<tr>
<th>Health sector grants</th>
<th>Sub-grants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage recurrent grant</td>
<td>None</td>
</tr>
<tr>
<td>Non-wage recurrent grant</td>
<td>District health office</td>
</tr>
<tr>
<td></td>
<td>Health facilities – public</td>
</tr>
<tr>
<td></td>
<td>Hospitals – public</td>
</tr>
<tr>
<td></td>
<td>Hospitals – not for profit</td>
</tr>
<tr>
<td>Sector development grant</td>
<td>Facility upgrades</td>
</tr>
<tr>
<td></td>
<td>Performance-based allocation</td>
</tr>
<tr>
<td>Ad hoc development grant</td>
<td>None</td>
</tr>
</tbody>
</table>

10. In Uganda grant allocations are published for each district and municipality. This makes the budget more transparent than in Tanzania, where the budget is presented at a regional level, with no further breakdown offered for specific local government authorities.
for budget preparation at the level of the sub-grant for each local government (and for each hospital and health facility when it comes to non-wage recurrent grants earmarked to these cost centres). Local governments use these to prepare the budget and submit it to the council for approval. The finance ministry then repeats the process for each quarter of the financial year as part of the budget execution process. Local governments use these figures to apply for a release of funds through the integrated financial management system. Where the request differs from the planning figures, staff at the finance ministry may ask for additional information or reject the release request until there is an agreement.

The government is also testing a new approach to checking whether local governments are adhering to sector grant guidelines. This involves tightly specifying conditions that are measurable such as the earmarking of grants to eligible activities in the budget using the detailed codes in the chart of accounts.

Source: Authors based on information for FY2020/21

The structure of the budget is also an important tool for supporting sector policy coordination. Recording of sector level expenditures at the local government level facilitates the coordination. The chart of accounts in each country typically includes a number of different ways to classify an expenditure, which are closely linked to the discussion from Section 2 on the way funds are earmarked. There are typically codes that distinguish between administrative units (e.g. different ministries), different economic items (e.g. wages or capital spending) and different programmes or activities (e.g. primary education). This provides a basis for earmarking funds in the budget, often at a level much more detailed than what is recorded in the overall budget. It can also facilitate communication and oversight of conditional grants, when national and local governments use a harmonised chart of accounts. Before South Africa introduced a single chart of account for all levels of government, the national and provincial governments used different coding structures which made it difficult for line ministries and the Treasury to oversee the activities financed through conditional grants.

### 3.4 Funding flows and fiscal transfers

Once the budget is approved the process of making intergovernmental fiscal transfers to local governments will begin. Countries can have very different systems to expenditure management (Pattanayak, 2016), and conditional grants are no exception. As a general illustration, the finance ministry will issue ministries with the authorisation to spend for the forthcoming quarter. The line ministry will respond to the finance ministry with advice on the level of funding to be allocated to each local government for the next quarter. Funds will be issued by the finance ministry to each local government treasury which then holds resources on behalf of the different local government departments a well as lower levels of government and the various service providers under its control. However, the actual process and actors involves in executing a grant transfer will vary significantly from country to country.

The process for releasing funds to local governments will be influenced by many factors, including:

- **The general approach to expenditure control and cash management.** Once the legislature approves the budget, the finance ministry issues line ministries with the authorisation to spend. The mechanisms which grant the power to spend may be called warrants, allotments, *décret de répartition* or other have another name in the national PFM law. For conditional grants, certain features may be particularly important. One is whether the warranting process is determined by the local government or if a line ministry responsible for the conditional grant has a say over the level and distribution of the grant during the year. Another is whether the warranting process is used as a way to limit spending to a more affordable level in countries where the budget is not fully financed or subject to significant revisions (Stasavage and Moyo, 2000).
- **Specific features related to different kinds of grants.** Line ministries may have a greater role in determining in-year allocations for conditional grants than for unconditional
grants, for example. Conditional grants may be handled differently, as is the case in Uganda where wage grants are executed in line with the payroll of local governments, grants to schools are released three times a year to coincide broadly with the school terms, and capital grants are released over the first two quarters of the year to allow sufficient time for contracting and completing works before the end of the financial year.

- **The conditions imposed on the release of funding.** The release process is often used to impose specific conditions on grant management. Some may be general features applied widely to different grants. As noted earlier, local governments in Uganda used to be required to submit quarterly performance reports before the subsequent release was issued by the finance ministry. In other cases, the conditions may be limited to specific grants. In South Africa the conditions attached to the provincial relief grant in 2020 included a provision explaining that “Funding may be released in tranches, with the first tranche based on an initial assessment, verification of the immediate disaster relief needs and the submitted cash flow projection. The next tranches will be released once proof is submitted that the first tranche has been fully spent or committed”. 11

- **The entities authorised and able to receive conditional grants.** Historically, the flow of funds in many low-income countries was from the finance ministry to the line ministry and thereon to the local government. The many service providers under the local government would access allocations from the local government treasury. However, today there are a wider array of organisations at the local government level that are themselves spending entities and may receive funding directly into their own bank accounts. Schools are a common example. In countries where local governments have significant autonomy over policy and administration, these arrangements may vary not just between sectors but also between local authorities. While some Kenyan counties provide grants to health facilities and grant them powers to spend directly, others retain the facility budgets under the county treasury. As an important concern for the health and education sectors, this is discussed further in section 4.5, below.

### Understanding the flow of funds and the responsibilities of different actors involved in executing grants to local governments is important for designing new conditional grants.

Tanzania’s efforts to implement a capitation policy experienced challenges during implementation. A commitment to pay capitation grants worth TShs 25,000 was established, but fiscal constraints meant that this was rarely fulfilled in practice and releases were issued at unpredictable intervals (see ICR for SEDPII, June 2017). Indonesia’s central government created a national health insurance scheme which – among other goal – was expected to enhance the performance incentives of facilities by tying resources to specific outputs provided. However, only around 20% of health centre were able to retain the payments made, with others remitting funds to the local government to manage. This threatens to break the link between payment and health facility management. Though not an intergovernmental fiscal grant as defined in this paper (ThinkWell, 2020).

### 3.5 Allocating grants to service delivery units

It is increasingly common to find governments that directly finance service delivery units such as schools and health facilities through conditional grants. In many countries, especially those with unitary systems and relatively small local governments, conditional grants have historically been allocated to subnational governments, which acted as the budget holder for schools and health facilities, as well as lower levels of administration (e.g. wards or sub-counties). This has changed with the introduction of capitation grants offering limited, but reasonably discretionary funding to support the day-to-day running costs of schools. Though not as widely used as in education, there are similar initiatives emerging in the health sector where direct facility financing provides discretionary grants to health centres (including not-for-profit providers).

**There are two general arguments that have been used to support this change.** The first is to ensure that resources reach service delivery units in a predictable manner. A number of public expenditure tracking surveys have shown that when faced with tight budget constraints or budget rationing, ministries or mid-level governments will retain resources for their needs before passing on the balance to lower levels of administration or service delivery (Gauthier, 2010; Welham et al., 2017). Being able to allocate transfers to individual service delivery units is expected to reduce this risk. If transfers are

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remitted directly to facilities or schools, then it is also possible to cut administrative delays associated with processing transfers through each level of government. The second argument is related to the subsidiarity principle – because schools and health facilities will make the most efficient decisions over how to allocate the budget for day-to-day running costs. In many cases, however, grants were introduced to replace user fee revenues which had been reduced or abolished entirely (Opwora et al., 2009; Al-Samarrai et al., 2018).

There is evidence which suggests that providing direct transfers to schools and health facilities has a positive impact on services. A limited number of random control trials have shown that increasing funding and autonomy in health facilities improves performance (Khanna et al., 2021). Research in Tanzania found a link to improved learning materials in schools receiving capitation grants, though learning outcomes did not improve as a result of the change in financing (Al-Samarrai and B. Lewis, 2021). The World Bank’s support has also found that making payments directly to schools from the finance ministry cut out delays involved in the process of distributing funds via local governments (ICR for Education Program for Results, June 2017). Similar findings have also been reported in Uganda and Cambodia where there has been a shift to making transfers directly to service providers and/or lower levels of government (Welham et al., 2017).

However, there are also potential risks and challenges, so the benefits of greater financial autonomy of service providers depends on how carefully this change is implemented. From a fiscal decentralisation perspective, there is a risk that paying transfers directly to facilities will lead to more centralised allocation decisions and reduce the discretion of local governments. It is the experience in Uganda, where the switch to direct health facility financing and school capitation grants has given increased control of resource allocations to central government. From a theoretical perspective, this has potential to restrict the benefit of decentralisation, where the local government will be able to tailor funding decisions to reflect local preferences and needs. It also undermines accountability between the local government executive and council. There may also be concerns over the capacity (or incentives) of health facilities or schools to manage funds well, and the time it takes frontline staff to account and report on how grants were used. This may vary depending on the type of spending facility. Hospitals often have the means to pay for an accountant, but grants also tend to be larger which increases concerns over fiduciary risks. In contrast, primary facilities or schools will receive smaller allocations but must dedicate time of frontline staff to administration.

Critically, grant management practices for service delivery units vary considerably across countries and sectors within a country. Looking just at the approaches used to finance health facilities in East Africa offers an illustration of this. Tanzania set eligibility criteria for health facilities to qualify for direct facility financing. They also set indicative percentages to guide how the budgets should be allocated. Dedicated systems were set up to support accounting and reporting. The approach in Uganda is quite different. Eligibility criteria exist only for private-not-for-profit facilities, the indicative guides for spending levels were rarely applied, and while facilities report using the standard formats set out in the facility grant guidelines, this was not part of a standardised ICT system. While these examples all relate to basic health services, similar points could be made about the variation in financing arrangements for schools (Al-Samarrai et al., 2018).

3.6 Key messages

Effective use of conditional grants depends not just on good design, but also the way transfers are managed. Grant management processes influence the way a grant is established and modified, including the way the grant objectives, allocation, formula and conditions are agreed (or negotiated) between stakeholders. They are used to integrate the grant into the financial management processes for preparing, approving and executing the national budget. This has implications for the way the grant is executed through national government structures. Finally, these processes reinforce the accountability of local governments to the central government over the way conditional grants are used and also set expectations for the support that central governments will provide in return – beyond just the financing. These are summarised in Table 3.3 below.
A key characteristic of the overall system is the degree to which it has been harmonised across different grants and integrated with broader governance processes, most notably for financial management. The management of conditional grants involves numerous actors and processes. Some will be specific to the use of fiscal transfers (e.g. the forums used to negotiate the grant conditions) while others will be dictated by the general approach to managing public finances (e.g. approval of budget allocations by the legislature). Some aspects will be specific to a sector (e.g. reporting on non-financial performance through sector specific management information systems), while others will apply to all sectors (e.g. the release of funding by the ministry of finance). The degree to which these have been harmonised is a notable feature of the overall process for grant management. In some countries systems are more fragmented and less formalised than others, with consequences for the coherence of the overall intergovernmental fiscal transfer system and for sector funding.

More generally, a good understanding of the institutional environment is critical for any efforts to improve the financing of local government services, including as part of World Bank operations. This will help to refine the design of specific projects and to think about the implications of World Bank operations on the broader governance of local government services. It is also a reality for lending projects that aim to finance services that are under the control of local governments, particularly in countries with highly devolved local governments. In Nigeria, loan disbursements to Kaduna state were blocked by the national Senate, reportedly over concerns with the levels of state debt. In Kenya, there have been challenges amending the budget during the year to include World Bank project provisions (see Annex A3). 

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Table 3.3: Summarising critical components of grant management

| Establishing and modifying conditional grants | • Legal basis for the overall grant framework and conditional grants  
• Principles for creating and allocating conditional grants  
• Basis for establishing and communicating grant informational |
|-------------------------------------------------|---------------------------------------------------------------------|
| Financial management                            | • Process for setting the final budget allocation  
• Structure of the budget and the chart of accounts  
• Process for releasing and accounting for funds |
| Oversight and reporting                         | • Financial reporting requirements and systems  
• Non-financial reporting requirements and systems  
• Mechanisms for providing institutional support to local services |

**Fragmented**
- Communicating Grant Allocations: Individual projects and programmes communicate amounts separately and at different times.
- Planning & budgeting in local governments: Separate grant-based work plans and budgets prepared, not integrated into budget.
- Execution & Accounting: Separate bank accounts and accounting procedures.
- Reporting: Reports for each allocation.

**Harmonised**
- Communicating Grant Allocations: Unified process of communicating indicative ceilings to local governments across all transfers.
- Planning & budgeting in local governments: Local government plans and budgets used for grant funds.
- Execution & Accounting: Use of local government accounting processes; use of a common chart of account structure across levels of government.
- Reporting: Use standard budget reports for all allocations.

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12. missing
Box 6: Key references - understanding grant management

There is only a limited formal literature on grant management systems and how they operate in practice in different countries, with almost none focused exclusively on conditional grants. However, useful resources include:

- Conditioning Intergovernmental Transfers and Modes of Interagency Cooperation for Greater Effectiveness of Multilevel Government in OECD Countries (P. Spahn, 2012)
- Local Public Financial Management (A. Shah, 2007).
- An Intergovernmental Perspective on Managing Public Finances for Service Delivery (P. Smoke et al., 2021)

However, country specific information can often be found in public expenditure reviews (Uganda, 2015; Indonesia, 2020) and public expenditure tracking surveys (Brazil, 2006; Kenya, 2012).
**Common opportunities and challenges for using conditional grants**

There is no perfect system for financing local government services. While there is evidence to suggest that decentralisation is likely to support more efficient service delivery, it is by no means equivocal (Channa and Faguet, 2016). Moreover, every country will have challenges with fiscal decentralisation, the intergovernmental fiscal transfer system, the use of conditional grants and even the design and implementation of specific conditional grants. Table 4.1 summarises some of the common issues with fiscal transfers in general and conditional grants more specifically. This may relate narrowly to the design or implementation of a specific conditional grant, or (more often) to the overall system for financing local government services.

**Table 4.1: Common challenges with financing local services and the management of conditional grants**

<table>
<thead>
<tr>
<th>Problems</th>
<th>Effects</th>
<th>Possible causes for weakness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low or inefficient mix of funding</td>
<td>• Policy commitments not being realised</td>
<td>• Low political priority</td>
</tr>
<tr>
<td></td>
<td>• Inefficient mix of inputs (e.g. high admin or wage costs)</td>
<td>• Overly ambitious and/or poorly costed policy commitments</td>
</tr>
<tr>
<td></td>
<td>• Ad hoc rationing of spending and services</td>
<td>• Insufficient tax assignments and/or fiscal transfers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Weak and/or fragmented policymaking and grant allocation processes</td>
</tr>
</tbody>
</table>
Underlying tensions in fiscal decentralisation

Many of the challenges outlined in Table 4.1 are rooted in the politics of decentralisation. The degree of decentralisation of powers and resources in a country is always contested (Boadway and Shah, 2007; Spahn, 2012). Common fault lines include disagreements over the services to be decentralised, the adequacy of resources to deliver those services, the fairness of grant allocations between subnational governments, and the balance between prioritising national policy objectives and responding to local preferences. The compromise for any given country is likely to be unique – because the relative weight of importance lent to these issues will be different across countries. It will also evolve over time, with political and bureaucratic pressures in central government likely to favour increased use of conditional grants over time.

In particular, decentralisation is a compromise between (a) the central government’s desire to develop and implement national policies and (b) the need for local governments to deliver services which respond to the specific local needs. It is normal that subnational governments will want to maximise their autonomy, whilst central government ministries and agencies will want to exert influence over local policy design and delivery. It is also common to find examples where the priorities of local and national politicians differ, raising difficult questions over which preferences should prevail. One of the main challenges in any system of decentralisation is to strike an acceptable balance between these views in the design and implementation of new policies and programmes which are the responsibility of local governments to implement. Conditional grants are one of the mechanisms available to support this compromise, but they too require a degree of political consensus (Spahn, 2012). This means that the issues described in this paper are not just technical, but also highly political.

The compromise reached will evolve over time, sometimes dramatically, but more often incrementally. Major decentralisation reforms generally accompany broader changes in the political environment. The examples of Kenya,
Indonesia, Nigeria and South Africa have been raised earlier in this paper – with each moving rapidly to a more devolved system of governance as a means to resolve or avoid future conflict.\(^13\) Outside of these particular reform “moments” change tends to be more marginal and bureaucratic incentives often play a stronger role, including by encouraging an expanding role for conditional grants. Notably, some countries that decentralised rapidly – as Indonesia and Kenya did – have gradually reintroduced conditionality into the system of fiscal transfers in response to the perceived failings of unconditional funding (World Bank, 2012).\(^14\)

Beyond these tensions, there are some common challenges associated with the process of decentralisation.\(^15\) One occurs when responsibilities (and/or resources) are transferred to local governments without the resources, systems and/or capacity to needed to perform them. A second is the difficulties central government faces in changing its role from being a direct provider of services to focus on policy, regulation and oversight. More generally, it is common to find a gap between the stated legislation and policy for decentralisation and the way this is implemented in practice. Again, many of these challenges are influenced by politics rather than technical decisions. The World Bank recommended in Kenya that responsibilities be transferred gradually from national to county governments in the wake of the 2010 Constitutional changes (World Bank, 2012). However, there was a strong political resistance to this idea among proponents of devolution who were concerned that the central government would use this as a means to delay the devolution process, and perhaps avoid it altogether.

While many of the challenges raised so far are strongly influenced by politics, the way grants are designed and managed is also crucial. Problems with the allocation formulae for conditional grants may produce unintended consequences, including incentives to oversupply services or adopt an inefficient mix between different service delivery inputs. The processes by which grants are agreed also have important implications on the coherence and effectiveness of the framework for fiscal transfers. Similarly, the processes by which they are managed by central and subnational government have a bearing on the administrative burden the transfer system places on both central and local governments. While these have many causes, international experiences suggest that countries with a more fragmented, ad hoc approach to managing conditional grants face particular problems. While World Bank teams will need to be cognisant of the political nature of their support, and must structure their engagement accordingly, there remains potential for using operations to improve the outcomes from conditional grants.

### 4.2 Inadequate allocations for meeting minimum service standards

A key foundation of decentralisation is the functions assigned to local governments and the vertical allocation of resources between central and local governments. A key debate that comes with this process is the degree to which adequate resources are provided for local governments to deliver these functions. As noted earlier, revenue raising powers of local governments rarely match the responsibilities they are allocated in the law. When fiscal transfers are also insufficient, the local government will have an “unfunded mandate” (Boadway and Shah, 2007). There will be disagreements between stakeholders over what standards are realistic and what level of resources are needed to meet them. Finance ministries may harbour unrealistic expectations that local governments can become ‘fiscally autonomous’ without devolving a larger share of the national tax base. There may also be concerns that local government politicians are not prioritising the resources they have at their disposal well enough – particularly in systems where local governments depend on unconditional grants (or donor project financing).

The reasons that unfunded mandates emerge are varied and cut across all aspects of local government finance, as summarised in Figure 4.1 (Smoke et al., 2021). In some countries, service delivery is poorly funded in general and local government functions are no exception. Nigeria’s general government expenditure rose significantly after the start of civilian rule in 1999, but peaked at just 9.5% of GDP before falling to just 4.4% of GDP in 2017 on the back of a collapse in oil revenues.\(^16\) While over half of the Federation Account (derived mostly from oil revenues) and VAT pooled fund is transferred to States and Local Governments, along with powers to raise personal and corporate income taxes, spending on basic services remains restricted because

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13. Bird and Smart 2002 (p.908) write “Examples of acting in haste with respect to intergovernmental fiscal arrangements and repenting at leisure are not hard to find. Brazil’s post-military constitution of 1988, South Africa’s post-apartheid constitution, and, perhaps most dramatically the situation in many central and eastern European countries after the dissolution of the Soviet Union provide instances.”

14. These countries include Uganda and Indonesia (World Bank, 2012).

15. For example, Smoke (2003) identifies a number of key challenges with decentralisation efforts in Africa, including insufficient coordination and linkages between key actors (central-local, government-nongovernmental, domestic-external) and the regular absence of a coherent, politically-backed strategy for decentralising.

domestic resource mobilisation is low for a middle-income country. However, other reasons may be more specific to certain sectors or even individual grants:

- Functions are ambiguous or not clearly assigned to different levels of government.
- Poor costing of specific functions and service delivery standards.
- Funding allocations are not well coordinated with sector standards.
- In-year rationing restricts actual transfers below the budget level.

Figure 4.1: Subnational service delivery and functions

When combined with fragmented funding systems and other political factors, tight fiscal constraints may also result in inefficient allocations. In Uganda, this has wage, non-wage and development grants to local governments have been treated differently as the government shifted the focus of the budget from social services to the productive sector. While wage grants for primary education nearly doubled in real terms between 1999/00 and 2011/12, the value of non-wage capitation grants and development allocations declined by more than half in real terms (Figure 4.2). This trend was repeated in other sectors in Uganda, and similar downward trends have been observed in Tanzania (Tidemand et al., 2014). In Kenya, counties are required to allocate at 30% of the budget to development spending. However, some counties inherited large salary bills as part of the change in governance arrangements that accompanied devolution after 2010. Operating budgets were squeezed as a result, contributing to poor quality service delivery.

Figure 4.2: Real value of wage, non-wage and development allocations for primary education in Uganda

Source: Williamson et al. (2014)
Supporting the financing and management of conditional grants in this context has potential to help reduce the funding gap. A recent study suggests that both general purpose and conditional grants have been used successfully to increase spending on local education services in a number of countries, though only a few use fiscal transfers to ensure resources are “adequate” (Al-Samarrai and B. D. Lewis, 2021). The basis for allocating conditional grants tends to reflect a minimum funding level per pupil rather than a true estimate of the costs associated with providing education services. More generally, the study also notes that resources may be earmarked in principle, but fungible in practice, so local governments may use conditional grant funding to displace other more flexible sources of financing, reducing the overall gain made by providing the grant. This can happen at a sectoral level – as has been observed in Indonesia and Kenya with respect to health services. It can also potentially affect very targeted grants within a sector, such as targeted transfers for immunization in the health sector.

Matching principles are used in many countries to reduce the risk that conditional grants will displace existing spending by subnational governments or lower revenue effort. Austria, Belgium, India, Mexico, Nepal, Nepal, Solomon Islands, Switzerland and Tanzania have all used matching principles in the grant system (Bergvall et al., 2006; Steffensen, 2010a; Steffensen, 2010b; UNDP, 2019). One of the best studied examples of matching grants in low- and middle-income countries is the DAK-Fisik in Indonesia – a capital grant which could be used across a wide range of sectors (Lewis, 2013). However, the matching component of this grant was dropped in 2016 and recent analysis of the “crowding in” effect suggests that while DAK-Fisik raised capital spending that may have been at the expense of expenditure on maintenance (Box 8). In general, the evidence that fiscal transfers displace own source revenues or existing spending varies between countries and studies.

Experience also suggests that matching grants can be difficult to implement well. In theory, un-capped (open-ended) matching grants can offer better incentives for local governments to increase spending on particular services, but these are rarely used in practice because of concerns with overall budget control; while closed-ended matching may not raise spending if the value of the conditional grant is less than what subnational government already spends on the services the grant is earmarked for (Boadway and Shah, 2007). Matching grants are also poorly suited to addressing inequities across regions, which is often an important concern in World Bank operations. The risk of gaming also increases if subnational governments receive multiple matching grants and when matching is based on the ex-ante budget allocation rather than final expenditures (UNDP, 2019). As a result of factors like this, matching grants may fail to deliver on expectations. In Nigeria, for example, the matching grants for primary education investment initially had limited impact as many states initially chose not to access the funds available.

Box 8: The impact of fiscal transfers on district revenue collection and expenditures in Indonesia

The main intergovernmental transfer in Indonesia is unconditional (Dana Alokasi Umum – DAU). Until 2021, regulations mandated that the DAU pool should amount to at least 26% of total net domestic revenues, with 90 percent of the pool transferred to districts and only 10% to provinces. Consequently, since 2001, DAU transfers have consistently made up the majority of districts’ revenues, though this share has fallen from over 70% of aggregate district revenues in 2001 to just over 40% in 2020.

The DAU is complemented by a smaller conditional grant (Dana Alokasi Khusus – DAK) with capital (Fisik) and recurrent (non-Fisik) components. Originally designed as part of the equalization grant (Dana Perimbangan) to address backlogs in infrastructure, DAK has increased significantly in size and complexity since its introduction in 2003. In 2016, DAK financing doubled in size, when the Government of Indonesia reclassified funding previously managed by the central government into the DAK Non-Fisik, which provides recurrent cost financing of service delivery, such as school and

17. Bulgaria is noted as a country which allocates funding each year based on estimates of the actual costs of providing education per pupil. However, it should be noted that efforts to establish and cost minimum service delivery standards are notoriously challenging (Steffensen, 2010; Boadway & Shah, 2007). Moreover, the likelihood of being able to replicate this approach across sectors is low because it introduces a rigid budget allocation process that reduces discretion in fiscal management in a way that most finance ministries would not tolerate or it would create pressures to regularly adjust the standards that are being financed in order to maintain an affordable budget.

18. This issue has been raised in Nigerian news outlets: https://guardian.ng/news/ubecs-n51b-lying-fallow-as-states-fail-to-access-fund/
4.3 Inequitable funding allocations across and within local governments

Some countries face hotly contested debates on the fairness of the allocation of resources between subnational governments, which may raise questions about the equity of service provision, achieving minimum standards or helping some counties ‘catch up’ with others. Subnational governments differ in their ability to collect local taxes to fund their mandate: a large metropolitan area will have a more vibrant economy than a remote rural region, for example. There may also be differences in the demand for, or cost of, services across different parts of the country. Some regions may be ‘lagging behind’ in terms of economic development or service delivery. Local governments with older populations may need to spend more on health services, while local governments with younger populations will need more funding for schooling.

While the tax system may play a role in supporting greater equity across regions, this has a number of limitations in low-income countries, so redistributive policy tends to be a function of the intergovernmental fiscal transfer system. Many countries use unconditional or highly discretionary grants to local governments to support “equalisation”. These include the Equitable Share in Kenya and South Africa, for example, which are largely unearmarked. In Uganda, the equalisation grant is enshrined in the law and was implemented through a non-wage recurrent grant until recent reforms merged a number of grants with equalisation mandates into a Discretionary Development Equalisation Grant. In contrast, earmarked conditional grants may be used to support more equitable spending in specific sectors or services (Glassman and Sakuma, 2014; Al-Samarrai and B. D. Lewis, 2021), or to reflect other targeted needs such as building resilience to climate change.

In practice, there can be large disparities between the best and least well-funded local governments in per capita terms. Figure 4.3 illustrates the extent of disparities in Uganda and Tanzania which both rely heavily on conditional grants to fund local services. Determining whether this has a direct impact on the provision of services is not always easy, but there are numerous studies that suggest financing is poorly targeted at the areas with greater service delivery needs. Dodd et al. (2019) find lower than average per capita allocations for poorer regions for both education (in six of seven countries) and health (in six of eight). They also find that per capita allocations for health and education are lower for regions with worse health and education outcomes. While financing is only one of the many factors that will shape service delivery outcomes, such observations are worthy of investigation (Miller, Hart and Hadley, 2021).

21. An additional rupiah of DAK leads to significant increases in capital spending (1.06 rupiah). But this increase is likely due to a substitution of spending away from materials (0.33 rupiah) to capital spending. Maintenance spending is one type of expenditure under the materials category, and the results imply that the DAK negatively affects maintenance expenditure.
The underlying causes of inequitable local government financing will vary enormously. Overall inequities in Nigeria result directly from the design of the formula for grants from the Federation Account and VAT Pooled Fund, which are the largest fiscal transfers provided to States and Local Governments. A number of problems with the design of the formula have been identified, but one of the most notable is that 40% of the overall allocation is distributed equally across all 36 States, regardless of their population (Martinez-Vazquez and Boex, 2001). Population data are highly contested in Nigeria, which contributes the persistence of this variable in the formula design. In Uganda, local governments have been financed through a fragmented mix of ad hoc, historical and formula-based allocations. Even after reforms to increase the use of allocation formulae, significant inequities remain for a number of reasons, including the scale of support provided to selected urban local governments through the World Bank’s Uganda Support to Municipal Infrastructure Development project (Long et al., 2021). However, there are other factors as play, including the use of fixed allocations and standard staff structures in the context of a growing number of local governments, many of which are urban centres with small populations.

Box 9: Examples of changes to grant allocation formulae in the health sector

Colombia reduces disparities in health spending (Bossert et al., 2003; Glassman & Sakuma, 2014)

As part of its decentralisation reforms, Colombia shifted in 1995 from the use of ad hoc historical practices to a formula-based approach allocating grants to provinces (called departments) and municipalities. The ratio between LGAs in the top and bottom deciles for national funding from health declined from 6.11 to 1.18 from 1994 to 1997. Equalisation of municipal health spending was even more dramatic, with the ratio of the top and bottom deciles falling from 41.5 to 11.9. The formula used the following variables for the two fiscal transfers:

- “Municipal participation” - Poverty level, unmet basic needs, own-source fiscal contribution, administrative efficiency, and quality-of life indicators
- “Situado fiscal” - Equal allocations to all departments and municipalities, per capita expenditure and use, rate of inflation
There are, nonetheless, some general patterns that stem from the way local government services are funded. In countries which rely more on unconditional funding to support service delivery and equalisation, like Nigeria, there may be opportunities to strengthen the allocation formula or shape the spending of local governments through targeted conditional grants or clearer minimum service delivery standards. In countries which have highly conditional funding systems, like Uganda and Tanzania, allocation formulae may help reduce inequities in a particular sector, but there will usually be a need to improve the coherence of different grants as well as the systems for grant management. This is particularly true when there are multiple grants for wage recurrent, non-wage recurrent and capital investments allocated using different processes. Multiple conditional allocations may be introduced which work at cross-purposes. Allocation processes may focus on inputs for existing infrastructure or reflect the current demand for services, and so reinforce existing disparities. More generally, it is worth considering the extent that formulae are being applied, reviewing special considerations given to smaller or sparsely populated regions (e.g. islands), and analysing the role that donor projects play in addressing or reinforcing inequities (Davies, Geddes and Wabwire, 2021).22

Uganda introduces more equitable non-wage recurrent funding formulae (Davies et al., 2021)

Uganda has been reforming its intergovernmental grant system since 2015, with a new grant structure accompanied by new allocation formulae. In the health sector, new formula was introduced for the non-wage recurrent grants for (i) primary health care and (ii) district hospital services. On the primary health care grant a new formula aimed to cut the funding ratio between the highest and lowest funded local governments from 12 to 3. Subsequent revisions incorporated refugee populations into the formula to reflect the additional health care needs created by over a million refugees hosted in a small number of districts. The district hospital formula was also revised, replacing the district population with an estimate of catchment population that the district services supported as more than half of the country’s 127 districts did not have a district hospital.

- Primary health care non-wage recurrent grant: Infant Mortality (5); Number of health providers (50); Population, including refugees (30); Population in Hard to Reach Areas, including refugees (5); Poverty Headcount Ratio (10)
- District hospitals non-wage recurrent grant: Hospital catchment population (60); catchment population in Hard to Reach Areas (10); Infant mortality (10); Poverty (20)

India adopts a formula that is overly targeted on a small part of the population (Intergovernmental Fiscal Transfers for Health Working Group, 2015)

The 13th Finance Commission introduced a performance-based allocation to states that reduced infant mortality. The indicator was chosen because there was consistent (and relatively independent) data available every year. The allocation formula was based on the “relative improvements from the median and used a weighted average to calculate the share of the funds going to each state”. However, the exclusive focus on infant mortality and the design of the formula meant that 65% of the grant allocations went to states that accounted for less than 10% of the total population. And the main beneficiaries already had relatively good indicators for infant mortality.

Useful resources on the design of allocation formulae

Annex A1 provides some good practice principles for the design of new formula. Glassman and Sakuma (2014) use a similar framework to explore lessons in the health sector. Al-Samarrai and Lewis (2021) provide examples of formulae from the education sector as part of their specific case studies. Boadway and Shah (2007) offer a more general overview of allocation formulae, with a focus on equalisation and references to more specific sectoral grants such as school funding in the USA. Boex and Martinez-Vazquez (2007) look at options for developing allocation formulae with imperfect data – a common challenge in many lower income settings.

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22. Ethiopia, the formula for allocating grants was dependent on a complex set of data, which was not consistently available for all local government entities.
4.4 Poor performance incentives

Concerns with performance are virtually universal in systems of multilevel governance (Lewis and Smoke, 2008; Brollo et al., 2013; Gadenne, 2017; Tsofa et al., 2017). Some stem from the basic tensions between national and subnational priorities that emerge in any context where responsibilities are shared. Others relate to the incentives and capacity of local politicians, bureaucrats and front-line staff to coordinate, regulate or deliver basic services. These often manifest in debates around three general problems – a lack of spending, inefficient spending, and low quality of services and investments.

As with other parts of the public sector, many countries have experimented with financial performance incentives to help improve the quality of subnational services and investments. As explained in Section 2, all conditional grants aim to shape the budget choices of subnational governments in one way or another. Earmarking is designed to ensure that subnational governments dedicate a certain level or share of spending for a specific purpose – whether that is funding agricultural extension services or improving local infrastructure. Matching grants offer even more explicit incentives for altering the spending of local governments, as discussed in Section 4.2. However, a range of performance-based grants are also being employed across different sectors to more directly shape the quality of governance and efficiency of spending at the subnational level. These are strongly shaped by agency and public choice theories and vary enormously in their design.

Section 2 showed that two general models of performance-based grant are increasingly common in low- and middle-income countries, partly as a result of World Bank operations. The first is performance-based capital grants to local governments where funding is linked to the results of an annual assessment of institutional performance. The second is non-wage recurrent grants paid to health facilities on the basis of the number and quality of outputs delivered. These are discussed in turn, but share many common features (Figure 4.4). Firstly, there is a financial incentive where the value of a conditional grant is adjusted based on a measure of performance. The level of performance of a local government or service provider is assessed and monitored through a formal process. This is ideally separated from the responsibilities of the ministry or agency calculating the value of the grant. The grant itself is usually designed to provide significant discretion to the local government or service provider, as a way to reinforce the financial incentive and to allow them to improve performance. Finally, the package of incentives is complemented by capacity building support to help local governments or service providers improve their performance. As well as motivating better behaviours of those being assessed, this architecture is also expected to strengthen overall oversight and foster a more active system of learning about performance (Soucat et al., 2017).

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Figure 4.4: The basic features of a performance-based grant

<table>
<thead>
<tr>
<th>Performance-based capital grants for local government</th>
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<tbody>
<tr>
<td>- Performance ranking influences grant allocation alongside more typical formula</td>
</tr>
<tr>
<td>- Annual assessment ideally conducted by an independent agent, with quality assurance</td>
</tr>
<tr>
<td>- Local government has discretion over priority projects to implement.</td>
</tr>
<tr>
<td>- Central government capacity building for poor performers</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Basic features of a performance-based grant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial incentive</td>
</tr>
<tr>
<td>Performance-based grants</td>
</tr>
<tr>
<td>Performance assessment / verification</td>
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<tr>
<td>Budget discretion</td>
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<tr>
<td>Capacity building support</td>
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</tbody>
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<table>
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<tr>
<th>Performance-based operating grants for health facilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Allocation based on score of quality-adjusted outputs</td>
</tr>
<tr>
<td>- Monthly / quarterly reporting and verification by district (quantity) and hospitals (quality).</td>
</tr>
<tr>
<td>- Facility has discretion over how to use funding, including staff salary top-ups.</td>
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<tr>
<td>- Capacity building support for facilities from district and hospitals.</td>
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</table>
Many countries have established performance-based grants to fund local government capital investments and incentivise better management (Steffensen 2010; Steffensen et al. 2022). A large share of these systems is supported directly by the World Bank or other development agencies, such as UNCDF. The World Bank’s Social Urban Rural and Resilience Global Practice alone had 19 such operations in June 2021 (see Steffensen et al. 2022 for a review of this portfolio). Uganda was an early pioneer with the Local Government Development Programme and Uganda Support to Municipal Infrastructure Development Program. Kenya established the Local Authority Transfer Fund (LATF) in the early 2000s while the Kenya Support to Devolution project has introduced new grants after the 2010 Constitution led to a process of rapid devolution. In some countries, like the Solomon Islands, these have been self-financed and managed (at least for a period of time). However, in others, performance grants have remained as projects and are not fully integrated into national systems (see Box 13), for an illustration from Indonesia).

These grants typically involve:

1. A standardised annual assessment of core institutional processes that subsequently informs grant allocations to local governments. This may include a set of minimum conditions that need to be met in order to access grant funding and a performance ranking which gives local governments with higher scores a larger share of the overall grant than they would get under the standard allocation formula. The performance assessment (year t) informs the budget for the following year (t+1) in order to provide a local government with a fixed budget envelope with which to plan its investments. The assessment often includes indicators linked to local revenue collections, audit and other areas of financial and human resource management.

2. A discretionary grant that allows local governments to choose from a broad investment menu. Once funds are accessed, grant resources can usually be used for a wide range of capital investments, provided they fall within the mandate of the local government. This flexibility reinforces the political incentive to improve performance on the annual assessment (because more funding can go on investments that are important for constituents). But it is also important for supporting integrated infrastructure investments that cut across sectors. The added financial incentives are also expected to increase the importance of the performance assessment scores for local politicians and administrators.

3. A package of support for poorly performing local governments. The provision of grant funding is itself aimed to improve local government capacity – by supporting a ‘learning-by-doing’ approach for managing investments, and by allowing some of the grant funding to be spent on improving the scores in the annual assessment. However, poorly performing local governments also be offered targeted support to address bottlenecks for improving their scores in the annual performance assessment.

Experience points to a number of good practices in the design of these performance-based capital grants (Steffensen 2010; Steffensen et al. 2022). Financial incentives need to be both predictable and meaningful to those receiving the grants. Performance measures should be based on activities or efforts that are attributable to the local government and its staff. These measures also need to be objectively verifiable and easily understood by those being assessed. The performance assessment itself needs to be transparent and delivered in a way that cannot be easily influenced by local governments, and there needs to be careful consideration of any potential conflicts of interest in the broader governance of the scheme. Capacity building is needed to support poor performers and to improve the outcomes of the incentive system more generally (Erman et al., 2021). Many of these suggestions are echoed in the portfolio review for the World Bank’s Social Urban Rural and Resilience Global Practice (Box 10).

Box 10: Lessons from a review of performance-based grants for urban infrastructure

The World Bank’s Social Urban Rural and Resilience Global Practice reviewed its portfolio of operations in 2021. This identified 19 performance-based grants in 81 Urban financing operations (as of June 2021). The review drew lessons from a subset of 9 projects supporting performance-based grants in 7 countries.

Results in operations supporting performance-based grants
In aggregate terms, local governments improved their scores on the annual performance assessments in all six countries for which there was data. While this is likely to capture many procedural changes there are indications that projects were successful in shaping fiscal and financial behaviours in meaningful ways. In Uganda, for example, the number of local
governments with unqualified audit opinions rose from 8 to 22 over the length of the project; while all local governments in Ghana also received a clean audit opinion by the end of the project. Own source revenues collected by local governments increased by between 48% and 168% in all 7 countries studied. Evidence from Mozambique suggesting that a package of performance-based grants and capacity building support was an important factor behind the increase in own-source revenues collected (see Erman et al. 2021).

Lessons for designing effective performance-based grants for urban services
The size of the grant and the performance incentive are important. Grant allocations should support medium-to-large scale investments in absolute terms ($200,000 or more) and relative terms (nominal size of the grant should not be less than $5,000 per capita). Paying attention to this is particularly important as the coverage of a performance-based grant scheme increases to take on new local governments or activities. Similarly, performance-based grants must be significant as an overall share of funding for the services being targeted in the project. Where that is not the case, the design of a performance-based grant will need to consider how to influence the use of other sources of funding (rather than just the grant itself) – as was the case in the Kenya Devolution Support Program (KDSP).

Lessons for designing an effective performance assessment system
Indicators need to be prioritised carefully. Indicators used in a performance assessment need to be closely linked to the behaviours and outcomes that the government and project want to improve. Measures must be under the control of the local government in order to attribute changes in a score to their performance. And there is a potential trade-off between comprehensiveness in terms of the range of indicators and the importance of individual indicators as a focus for behaviour change.

It is important to ensure participating local governments trust in the assessment process. A performance assessment will always have a degree of subjectivity, but it is critical that the process and the results are considered to be fair in order to retain support for the system. The performance assessment should ideally be conducted by a trusted third party that does not have a direct stake in the allocation process. Once an assessment has been conducted, further external quality assurance of the results in a “two layer” system may help improve credibility.

Other considerations for World Bank operations
Capacity building is critical to the success of a performance-based grant system. External technical assistance is easiest to implement through Investment Project Financing, while dedicated resources will be needed in local governments and departments overseeing them. Allowing local governments to use part of the performance-based grant for capacity building activities is one way to facilitate this. More generally, capacity building should be focused on the results of the annual performance assessment and it should be targeted at the local governments that have the weakest scores.

It is increasingly common to find operations integrating periodic value-for-money audits to complement the annual performance assessment.

Source: Steffensen et al. (2022); Erman et al. (2021); Steffensen (2010)
There are also a few cases where the performance-based grant model just described has been applied to development grants earmarked for specific sectors (rather than multisectoral grants). This was tried in Tanzania, for example, but was ultimately not sustained (Steffensen, 2010). Another example is Uganda’s local government performance grant system which links a performance assessment of sector management processes at the district level with conditional development grants for water, health and education (Box 11). UNCDF’s LoCAL programme has also used performance-based grants to support climate change adaptation (De Coninck, 2017). These experiences may be useful to explore further in countries where local government oversight or investment is considered a binding constraint to improving delivery. However, it is not directly incentivising changes in behaviour in service providers.

It should be noted, however, that the performance-based grant model described here is generally focused on addressing basic governance constraints, such as compliance with statutory financial management requirements. Gains in these systems may be a necessary condition for improving the quality of local government investments in future, particularly in lower-income country settings. In some contexts, it can also help create the foundations of a fiscal transfer system (in Puntland State of Somalia, for example). It is not, however, a model that is used extensively in OECD countries. The Comprehensive Performance Assessment implemented in England had many similar features before it was replaced in 2009 and subsequently abandoned in 2009. At least one study of this scheme suggests it was successful in raising revenue and service quality, particularly in councils where electoral competition was weak (Lockwood and Porcelli, 2013). However, it is more common for OECD countries to use activity or output-based payments, to set only minimum access conditions, or to use matching or reimbursement principles (Steffensen, 2010).

Box 11: The Uganda Discretionary Development Equalisation Grant

Uganda was an early pioneer in the use of performance based grants for local governments. A combination of national and donor-funded schemes has been a feature of the grant system since the 1990s. Reforms to fiscal transfers which started in 2015 with support from the World Bank consolidated several grants into a Discretionary Development Equalisation Grant (DDEG) and established a new performance framework and assessment process. The DDEG is the main source of discretionary development funding for most local governments. However, the grant is still earmarked in a number of ways:

- **Earmarking to administrative levels**: rules stipulate a share of the grant which districts and municipalities must transfer on to their respective subcounties and divisions. This share ranges from 65% for districts to under 2% for some municipalities supported by the Uganda Support to Municipal Infrastructure Development project.

- **Earmarking to economic purpose**: at the district and municipal level, at least 80% of the grant should be allocated to infrastructure projects, while divisions and subcounties must spend at least 80% of the grant on infrastructure projects or livelihood and income generating projects for community groups. The balance may be used for investment servicing costs, planning and monitoring and (for districts and municipalities) capacity building initiatives linked to the annual performance assessment process.

- **Earmarking to sector activities**: Guidelines specify a broad list of eligible investments across all sectors under the responsibility of a local government but excludes some activities such as investments or technical and vocational education.

Under the new performance regime, development grant allocations are linked to results of an annual performance assessment. The annual allocation of the DDEG is linked to the scores for cross cutting performance measures for revenue mobilisation, financial management, and transparency, among others. The allocations of sector development grants for agriculture, education, water and health are linked to sectoral measures of institutional performance, such as the accuracy of reporting on non-financial performance. The assessment and quality assurance are contracted out and overseen by a technical steering committee after concerns were raised about the previous approach which used a team...
of officials from different ministries to conduct the assessment. Performance improvement support is provided to local governments that scored lowest.

Since the system was implemented, local governments have generally responded by improving their performance in relation to the indicators assessed (see chart below). However, there remain concerns that allocations remain insufficient to make meaningful investments or to incentivise continued improvements against the criteria in the performance assessment.

**Trends in LG performance within core procedures and systems**

![Trends in LG performance within core procedures and systems](image)

Sources: Government of Uganda 2020/21 DDEG grant guidelines; Online Transfer Information Management System

Results-based financing for service providers is more directly funding service delivery outputs, and is most prominent in the health sector. There are many different models for what is commonly referred to in the health sector as “performance-based financing” or PBF (Fritsche, Soeters and Meessen, 2014; Josephson et al., 2017; Renmans et al., 2017). However, PBF for health services typically involves the transfer of funds to hospitals or health facilities in return for them providing a pre-agreed set of services to appropriate standards of quality and administration. PBF makes these transfers to facilities conditional on the verified delivery of services, with the aim of giving them an incentive to improve the quality of their services (Chalkley et al., 2016). This is typically accompanied by granting health facilities greater autonomy over their budgets, including flexibility to top up staff salaries, and complemented by efforts to strengthen facility level oversight.

In 2021 the World Bank alone was supporting PBF operations in 27 countries around the world, including 20 in Africa. While these are health sector focused, the model has also inspired a handful of pilot projects for results-based financing for primary and secondary education, including by the World Bank and Cordaid. Rwanda and Burundi are often highlighted as the most successful examples of PBF schemes supported by donors in Africa (Box 12). Other notable examples supported by the World Bank include Afghanistan, which relied on non-state providers in a fragile context, as well as Argentina’s Plan Nacer and Brazil’s Primary Care Access and Quality programme. Most advanced economies also use some form of pay-for-performance system, though the goal of these schemes is often about restricting “over-delivery” rather than encouraging higher quality and raising demand which is more often the concern in low- and middle-income countries (Chalkley et al., 2016).

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23. More information on the PBF portfolio can be found at [https://www.rbfhealth.org/](https://www.rbfhealth.org/)
24. Cordaid’s (2015) work in Central Africa dates back over a decade. The World Bank Results in Education for All Children (REACH) Trust Fund is also supporting greater experimentation with results-based financing in the education sector (Lee and Medina, 2019). One of the studies from this work evaluated the impact of introducing performance grants for schools in Jakarta, Indonesia (Al-Samarrai and B. D. Lewis, 2021). Cameroon and Mozambique are further studies.
There remains considerable debate over the use of facility level PBF, particularly in low- and middle-income countries (Ma-Nitu et al., 2018; Paola Bertone et al., 2018; Paul et al., 2018; Cattel and Eijkenaar, 2020; Gage and Bauhoff, 2021; Zaresani and Scott, 2021). Studies provide mixed evidence over the impact of RBF in different contexts. In a handful of cases, PBF has been compared to simpler models for giving facilities greater budgets and budget flexibility. These comparisons suggest that the gains from PBF pilots are often generated through higher funding and greater autonomy for health facilities (Khanna et al., 2021). Where PBF was more effective in increasing utilisation, it may not have been cost effective compared to more basic models of financing. It is also important to note that PBF projects have typically been implemented in parallel to fiscal transfers and have also struggled to make the transition from pilot to national system (Shroff et al., 2017; Piatti-Fünfkirchen, Hadley and Mathivet, 2021). This is important as evidence from DR Congo suggest that the end of RBF projects undermines health worker motivation, at least in the short-term (Maini et al., 2019).

Box 12: Performance-based financing in the Rwandan health sector

Performance-based financing (also sometimes referred to as results-based financing) was scaled up in Rwanda in 2008 following successful piloting in 2001 and 2002. PBF was implemented for health centres and district hospitals and included facilities run by NGOs. Over time it has also developed as the basis for paying provincial and referral hospitals as well.

The 2018 guidelines explain the governance of PBF and how this differs for health facilities and hospitals. For health facilities, performance contracts are agreed between the Ministry of Health and the districts, between districts and health centre management committees and between the health facility and its employees. These clarify roles and the responsibilities, the monitoring system used, services covered by PBF, financial incentives provided and the conditions for payment to the health facility.

Health facilities are paid based on the quantity of services provided according to a standardized fee structure, adjusted (downwards) by a quality score that is calculated and verified each quarter. An illustrative example is provided below. Verification of the quantity of services provided is the responsibility of the district health management team, while hospitals take the lead on quality. Districts submit an invoice to the Ministry of Health which communicates a consolidated request to the Ministry of Finance and Economic Planning.

**Example of how payments to health facilities are calculated**

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Quantity</th>
<th>Unit Cost</th>
<th>Amount / Fr</th>
</tr>
</thead>
<tbody>
<tr>
<td>VTC: number of clients tested</td>
<td>899</td>
<td>500</td>
<td>449,500</td>
</tr>
<tr>
<td>PMTCT: The number of pregnant women tested</td>
<td>101</td>
<td>250</td>
<td>25,250</td>
</tr>
<tr>
<td>ART: Number of patients on treatment</td>
<td>134</td>
<td>2,500</td>
<td>335,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>809,750</strong></td>
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<tr>
<td>Evaluation quarterly score for quality</td>
<td></td>
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<td>87%</td>
</tr>
<tr>
<td>Amount to pay</td>
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<td>704,483</td>
</tr>
</tbody>
</table>

Once paid, facilities have significant discretion over how they use the funds, though there are also standard formulae to guide the bonuses paid to staff based on their individual performance contracts.

25. Research finds that PBF has supported improvements in the use of maternal health services in Rwanda (Basinga et al., 2011), Burundi (Bonfrer et al., 2014) and Tanzania (Binyaruka et al., 2015) and shaped health provision in other important ways (Brenner et al., 2017; Hadley and Beard, 2019); but other studies have found no effect on the use of maternal health services in Malawi (Brenner et al., 2020), Afghanistan (Engineer et al., 2016), and the Republic of the Congo (Zeng et al., 2018).
In general, performance-based grants raise two important concerns in terms of the way that they are designed and implemented. Of course, the design of any grant can have unintended consequences. Indeed, it may also be possible that high dependence on fiscal transfers itself weakens accountability to local residents and increases corruption (Bird and Smart, 2002; Brollo et al., 2013; Gadenne, 2017). However, using financial incentives raises two distinct challenges: they can be demanding on national systems and they induce gaming behaviours (Sandefur and Glassman, 2016; Sabbi and Stroh, 2020).

Performance-based grants are more demanding on national systems than standard earmarked grants. Results-based grants rely on having accurate, consistent and timely statistics and reports. Without this the budget process can be delayed or incorrect allocations may be made to local governments (Steffensen, 2010). Indicators and targets need to be regularly reviewed in order to maintain relevance and respond to gaming (discussed below). Performance assessments need to be delivered in a timely manner in order to feed into the budget process, otherwise improvements in institutional arrangements may be offset by inefficiencies in spending choices. More generally, performance-based conditional grants require sufficient capacity in central government and often raise concerns about the costs of verification of results. These conditions are not always in place.

Tighter earmarking and stronger performance incentives are known to create gaming behaviours. Input conditionality provides relatively little assurance that results will be achieved, and is difficult to enforce in practice (Boadway and Shah, 2007). This is often evident in the desire of central ministries to follow the money, but not the quality of expenditure. There is also evidence that spending units will look for ways around the limits that are imposed – bending definitions of what constitutes administrative spending, for example (Hood and Piotrowska, 2021). However, it is also the case that strong financial incentives encourage gaming behaviours. Three common behaviours that have been identified by the study of performance targets (Hood, 2004, 2007) are:

- **Ratchet effects**: when targets are set as an incremental advance on the previous year managers have more limited incentives to improve performance in a single year.
- **Threshold effects**: when all units in a system have the same targets, there is less of an incentive to excellence and may even incentivise a top performer to deliver less as long as they meet the target.
- **Hitting the targets, but missing the point**: where targets are reported as achieved by manipulating the assessment or distorting how results are delivered.

Such adverse incentives are not generally introduced by design and managing all these different incentives is not a realistic ambition, especially when the scale of these behaviours is not known. Nonetheless, it is useful to consider the possible incentives of providing conditional allocations and to review the impact of new schemes periodically.

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**Box 13: Integrating performance-based grants into national systems in Indonesia**

With support from the World Bank, the Government of Indonesia has gained substantial experience with performance-based grants. One key precedent is the World Bank’s Local Government and Decentralization Project (LGDP), which used the IPF instrument with output-based disbursement (DLIs). Implemented between 2011 and 2017, the LGDP required independent verification of DAK Fisik-financed project outputs by the Government Internal Audit Agency (Badan Pengawasan Keuangan dan Pembangunan - BPKP) in the road, water, irrigation, and sanitation sectors. The independent output verification emphasized compliance with technical specifications, reference unit costs, competitive procurement, and environmental and social safeguards, based on both desk and physical output verification. By the end of it, the project was scaled to 267 districts in 22 provinces: over half of the total districts in Indonesia.
The Government has only partially mainstreamed the above experience into the DAK-Fisik, the country’s main conditional capital grant for provinces and districts. Since the completion of LGDP, the Government has discontinued the BPKP physical output verification for the DAK Fisik. Instead, the Government relies on the local inspectorate agency (Aparat Pengawasan Intern Pemerintah - APIP) to review SNGs’ reports on DAK financial and output as conditions for fund disbursement in each of three tranches. For the first tranche, the disbursement is mostly conditioned on the last year’s DAK financial disbursement and the timeliness of contract document issuance for DAK projects. For the second tranche, the disbursement is conditioned on the minimum spending rate (75%) from the previous tranche. For the third tranche, the disbursement is conditioned on the minimum spending rate (90%) and a minimum of 70% of the output achievement rate. This measure of output achievement, however, is not physically verified. A recent survey of local government officials suggests that many APIPs lack the capacity and funding to appropriately conduct their review (World Bank, forthcoming). In most cases, their review merely focuses on document checks. Holding local governments to account for results from DAK Fisik spending has also been challenging because clear results frameworks for the grant are only emerging. The lack of interoperable DAK Fisik data across different systems (i.e., KRISNA (proposal), OMSPAN (disbursement) and E-Mon (sector reporting) also complicates any efforts to track SNG accountability for results.

Nonetheless, Indonesia has made significant strides towards introducing performance-based grants in recent years, especially in the health sector. In 2021, the Government for the first time linked part of the operational grants to primary care facilities (BOK) to performance. This initiative is supported by the World Bank’s I-SPHERE project (Indonesia Supporting Primary Health Care Reform). The BOK Kinerja incentivizes a few critical maternal and child health indicators. The grant focuses on a few critical indicators and incentivizes improvements, rather than performance levels. However, the introduction of the performance grant has also put the need to invest in data quality into the limelight. In the short term, it has highlighted the need to invest in independent verification of administratively reported coverage data, to discourage overreporting and to ensure that rewards are allocated fairly. In the long term, it also calls for improving the measurement of the quality of care, in view of incentivizing both coverage and quality.

Source: World Bank (2020); World Bank (Forthcoming) DAK Fisik Implementation Review

4.5 Fragmentation of grants and accountability

A number of countries have experienced challenges using ad hoc approaches for managing grants, and conditional grants in particular. Conditional grants quickly proliferated in the late 1990s in Uganda due to political enthusiasm for reforming service delivery. Initially, each grant was introduced with its own conditions and management framework. This created a complex array of grants with excessive reporting requirements. In Tanzania, efforts were made in the early 2000s to set up a coherent approach to recurrent transfers, but today the government presents transfers differently and inconsistently in the recurrent and development budget, which makes it difficult to build a comprehensive picture of intergovernmental grants (or sector financing more broadly) needed for effective oversight. Even highly decentralised OECD countries such as Denmark, Norway and Sweden have seen the use of earmarked conditional grants increase since they were consolidated as part of the broader fiscal reforms implemented in the 1990s (Kim, 2020).
The *ad hoc* proliferation of grants and administrative requirements will impact on local governments in many ways. It undermines the coherence of local government resource allocation, the consistency of approaches to service delivery and local incentives to use resources effectively. It also adds to the administrative burden faced by subnational governments, adding strain to those with greater capacity constraints. Over time, this can lead to much greater erosion of local government discretion than was originally intended, weakening the potential benefits of decentralised service provision.

The factors that contribute to the proliferation of grants and reporting requirements are numerous. Ad hoc decision-making structures may be the outcome of political or administrative incentives which value discretion or simply reflect challenges with policy coordination in general. Central government actors may seek to assert controls in response to perceived failings of local governments. While local governments generally seek to maximise their discretion, there may also be support from local government officials to earmark funding if it protects their activities and interests – especially if funds are tight and political priorities lie elsewhere. Donor organisations, including the World Bank contribute through the creation of new projects and grants tied to their specific interests without sufficient regard to the coherence of the broader system of fiscal transfers and accountability. Weak institutions to mediate these pressures and a tendency to impose conditional grants on local governments rather than negotiate them are often part of the picture.

As discussed in Section 3, there are three generic and interlinked types of response to these types of problem:

- firstly, a process of formally agreeing grant allocations and conditions may be introduced;
- secondly, there may be efforts to have principles for grant specific allocation and conditions established; and
- thirdly, there may be an effort to introduce harmonised grant management processes.

As an example, South Africa has developed a relatively harmonised system for managing conditional allocations to their provinces. This is underpinned by strong coordination through the finance ministry (the National Treasury) though negotiations on the details of the allocation are held predominantly between line ministries and the subnational government. Departments considering new transfers are issued guidance from the National Treasury, which also provides training on an annual basis and technical support on request. This arrangement is monitored by an independent Financial and Fiscal Commission, which provides a report on...
The Financial and Fiscal Commission is required to make recommendations on the division of revenue and conditional grants at least 10 months before the start of the financial year. Importantly, the grant management system continues to change as lessons are learnt and communicated with the National Treasury. Conditional allocations are assessed individually on an ongoing basis, and there are periodic reviews of the full conditional allocation system.

While desirable, the shift from ad hoc to more systematic and harmonised grant management is not a simple reform. The experience of South Africa shows that even using a comprehensive legislative arrangement will not guarantee that grants will be designed and implemented in a systematic and uniform way. In 2003, the number of conditional grants was consolidated, but quickly proliferated again rising from around 20 in 2005/06 to nearly 50 in 2013/14. A review by the Financial and Fiscal Commission noted that these evolved in an ad hoc manner, sometimes as a “kneekerk” response to the perceived failures of local government to prioritise national policy (Financial and Fiscal Commission, 2013a, p. 60). While many of the conditional allocations were important, this proliferation had negative consequences for the budget management of local authorities. While this system has generally been better than the ad hoc approaches used in Uganda and Tanzania, there continues to be a need to monitor the overall framework and how it is shaping the evolution of the intergovernmental fiscal transfer system and the role of conditional grants.

There are also broader challenges with fragmentation of funding flows and service delivery which go beyond the scope of this note. As noted in Section 2, virtually all countries that use fiscal transfers to fund services will also employ other sources of funding. Health sector funding, for example, may combine fiscal transfers, donor projects, in-kind distribution of drugs and supplies, direct provision by the central government in areas such as vaccines, and other forms of support. A review in Tanzania showed that there were at least 11 funding streams supporting subnational health services, excluding off-budget aid flows (Cammack et al., 2021). Research in Uganda has shown that these sources are often allocated in ways that create significant inequities across local government areas (Davies et al., 2021). Ensuring there is consistency within the grant management system is important, but World Bank teams will also need to consider the broader landscape of financing and implementation support in target sectors.

4.6 Weaknesses in grant and financial management

There are often notable weaknesses in grant and financial management at both national and local government levels. A number of these have already been identified in earlier discussions in Sections 3 and 4. Grant management arrangements may be fragmented and dominated by central government concerns, creating challenges for policy oversight and adding to the administrative burden on local governments. The grant management cycle may be poorly aligned with the national budget calendar, impacting on the time that sectors or local governments have to plan effectively for service delivery. A lack of budget credibility can lead to unpredictable in-year budget cuts to grant allocations or contribute to delays in funding. Donor projects may complicate or even add to these problems. Each of these issues has already been highlighted in relation to national governments.

Coordination of national and local policies is always a challenge in decentralised contexts but may be complicated further when there are weak links between planning and budgeting at different levels of government. In South Africa, reports have identified misalignment between provincial plans for health services and municipal plans for urban infrastructure needed to serve health facilities, such as roads and water; there has also been insufficient coordination between provincial health departments and health providers in setting annual budget ceilings (Smoke et al., 2021). In Indonesia, coordination was complicated by the lack of a common budgeting and financial reporting standard for local governments, while in Nigeria there have been long periods where no organisation has taken responsibility for compiling state and local government spending data for different services. In both cases, this has limited the ability of central government to understand the impact that conditional grants may be having on subnational services such as health, education or nutrition.

26. The Financial and Fiscal Commission is required to make recommendations on the division of revenue and conditional grants at least 10 months before the start of the financial year. The National Treasury responds to these recommendations on behalf of the Government in an appendix to the Division of Revenue Bill. There is also regular informal communication between the National Treasury and the Financial and Fiscal Commission before changes to the Division of Revenue Act are proposed in the annual Medium-Term Budget Policy Statement and Budget Speech.

27. Financial and Fiscal Commission (2013b, p.2) writes “This proliferation results in grants that duplicate goals and objectives and increases the administrative burden on provinces and municipalities.” In the longer report, the Commission explains that “national departments often see conditional grants as one of the few ways they can influence provincial government and local government behaviour in delivering concurrent functions. However, they often neglect other crucial elements of their leadership role, such as setting (and monitoring and evaluating) clear norms and standards. Furthermore, while National Treasury and the provincial treasuries have, to varying degrees, the skills to support effective grant design and to monitor and evaluate grant implementation, these skills are often lacking in national departments and unevenly distributed across the treasuries.” (Financial and Fiscal Commission, 2013a, p.65)
Weaknesses in subnational financial management may also contribute to challenges absorbing fiscal transfers. Examples of programmes which are under executed are commonly identified in case study work (Welham et al., 2017; Smoke et al., 2021). These often result from multiple factors, some of which reflect responsibilities of central government, including the late release of funds. Other factors will be under the control of subnational governments, which tend to score less well than national governments on international benchmarks for financial management. As an example, the National Treasury identified weak planning capacity at the subnational level as an important factor behind low implementation of capital spending in South Africa. In response, the conditional grant system was revised so that provinces had to submit infrastructure plans two years before project implementation begins (see Division of Revenue Bill, National Treasury, 2014b, p.68).

Box 14: Challenges with a proposal-based allocation mechanism for Indonesia’s DAK-Fisik

In 2016, the Government of Indonesia undertook a significant reform of the Dana Alokasi Khusus Fisik (DAK-Fisik), Indonesia’s conditional grant for capital expenditures. It replaced a formula-based allocation with a proposal-based allocation mechanism. Under the new system, subnational governments are required to submit proposals for individual projects that they seek funding for. As one major objective, the reform sought to tighten central government oversight over the allocation of the DAK and over the execution of capital projects.

Recent analysis suggests, however, that the reform has had significant unintended consequences. The proposal-based mechanism appears to have made DAK Fisik allocations less well targeted to subnational governments with the greatest needs. The World Bank’s Indonesia Public Expenditure Review (2020) shows the DAK allocations to districts in 2016-18 were less correlated with service delivery need indicators than in 2015, especially for drinking water and sanitation. In addition, the proliferation of sectors/sub-sectors and district recipients has contributed to diluting DAK’s targeting.

The proposal-based mechanism has also made the allocation process inefficient, with districts spending significant resources and time on preparing many proposals for small projects – despite low chances of success. In FY2019, the average proposal approval rate was only 12%. Proposed projects are numerous, but small, on average. In 2021, the average project size was, for example, IDR 340 million (US$23,000) in the water sector and IDR 35 million (US$2,500) in the health sector. Nevertheless, districts continue submitting many proposals because they rely strongly on the DAK Fisik to finance their infrastructure project and because they follow a “the more you propose, the more you get” logic. In the health sector, for example, for health facility (Puskesmas) construction projects, the number of proposals is a strong predictor of the DAK allocation.

A recent reform of the law on intergovernmental finance provides the GOI with an opportunity for improving the targeting and efficiency of the DAK Fisik, based on these findings.


4.7 Key messages

Many common challenges with conditional grants stem from broader – and highly political – tensions in the decentralised system of governance. World Bank operations that aim to increase financing and support improvements in service delivery performance at the local level will be entering into a discussion about political as well as technical challenges. Even issues as mundane as the use of population data as a basis for grant allocation can be highly contested – as the example from Nigeria showed – and create unintended effects (Sandefur and Glassman, 2016). Working with the grain of domestic political pressures will be important for producing solutions that last.
Issues are often closely linked, with ad hoc approaches to grant management in a constrained fiscal landscape a common underlying problem. Overall budget allocations are often under strain with finance and sector ministries struggling to balance the demand for new services and systems with the resources and capacity available to deliver them. Weak institutions for intergovernmental coordination and ad hoc approaches to grant management are often insufficient for steering inevitable compromises and providing the necessary scrutiny over both individual grants and the overall framework for fiscal transfers. These problems are generally more complex in low-income countries which fund local governments through numerous conditional grants, often with support from a range of development partners.

While there are many good practices and country examples to draw from, it is the way that these are tailored to and implemented in the national context that is most important to consider. The perfect allocation formula will not be accepted if it does not support the government's agenda. And even a comprehensive legal arrangement with transparent principles for assigning conditional allocations can be managed in an inconsistent or ad hoc manner, with important implications.

Nonetheless, there will be ways that World Bank operations can help to shape the conditional grant system to support better outcomes. Inadequate funding for specific services can be relieved by increasing the value of existing grants or creating new ones. Inequities can be addressed through careful measures to change the allocation process for existing funding arrangements, by revising formulae or through other means. Performance incentives are more difficult to change, but conditional grants can play a role here too. Supporting with the overall grant framework, strengthening the institutions for intergovernmental coordination, building financial management capacity and working through country systems can all contribute to a stronger system of financing for subnational services.

Box 15: Key references – political economy of the fiscal transfer system

Most of the fundamental challenges with conditional grants and the conditional grant system are tied to the political economy of intergovernmental fiscal relations. A number of resources can provide a general introduction and framework for understanding these issues:

- **Conditioning Intergovernmental Transfers and Modes of Interagency Cooperation for Greater Effectiveness of Multilevel Government in OECD Countries** (P. Spahn, 2012)
- **An Intergovernmental Perspective on Managing Public Finances for Service Delivery: Assessing Neglected Challenges in the Health Sector** (P. Smoke et al., 2021)
- **Politics, systems and domains: a conceptual framework for the African Cities Research Consortium** (T. Kelsall et al. 2021)
5 Implications for World Bank engagement

This section looks more specifically at how World Bank technical assistance and lending operations can be used to finance or strengthen conditional grants in partner countries.

5.1 Why are conditional grants important in World Bank engagements and operations?

Conditional grants are a key means to support efficient subnational spending, but are also critical for bridging national and subnational policy preferences. In most low- and middle-income countries (but also in many OECD countries) there is a large and persistent gap between the taxes a subnational government can collect and the expenditure assignments that it must deliver. Fiscal transfers will be needed to make up the difference. Even in countries with large unconditional grant funding for basic services, conditional grants will be used to either fund services where there are spill-overs and issues with capacity, or help incentivise better spending and/or management by local governments.

Strengthening the overall framework for conditional grants, or improving the management of a particular (set of) transfers, has the potential to improve services. When conditional grants are poorly designed or managed, they can result in inadequate and inequitable funding. Incentives to improve governance, service delivery or even collect subnational revenues can be undermined. Fragmented funding streams and administrative requirements add to the burden on subnational governments, which may already face significant capacity gaps. These issues have been discussed in sections 2-4 above, and are illustrated in the context of Uganda in Box 16, below.
More generally, it is important to recognise that the World Bank is already financing conditional transfers to subnational government services via its operations. A background review of projects under the World Bank’s Governance Practice conducted for this note found that 190 out of 200 were expecting to make payments directly to subnational governments. Transfers to local governments are effectively conditional allocations, whether they are delivered through the grant system or not. They may be earmarked for a specific purpose and will certainly have process conditions, such has planning, budgeting and reporting requirements.

Delivering support to local governments outside the grant system can have negative consequences for the funding of public services. It is often the case that donor funding, including World Bank operations, bypass the intergovernmental fiscal transfer system. Indeed, many central government ministries would prefer to maintain more direct control over these additional resources. As a result, projects may fund central government to perform the functions of local government. In other cases, the projects may create parallel systems and contribute to the fragmentation of funding flows and administration. Ministries may again seek to retain more ad hoc controls over how the funds are allocated to subnational governments. There may also be misalignment between international grant financing with the routines of the budget cycle making it harder for national and subnational governments to plan effectively for the year ahead.

Where possible these challenges should be avoided. It is important that World Bank operations use the transfer system and legitimise it, where possible. Where appropriate, operations should encourage objective, adequate and equitable intergovernmental fiscal transfers for financing service delivery. And there should always be a primary aim to support unified and coherent transfers designed within a common framework, rather than risking further fragmenting the financing system and its governing institutions.

Box 16: Water sector infrastructure grants in Uganda

In Uganda, earmarked conditional grants have been used to finance basic service delivery infrastructure from the late 1990s. Most notable of these were a school facilities grant that was created following the introduction of Universal Primary Education, and a grant for rural water and sanitation. These grants contributed to significant increases in service delivery infrastructure, constructing thousands of classrooms and boreholes. The water grant is notable for the way it combined funds for infrastructure with capacity building support:

“A system of conditional grants was established whereby local governments receive grants from central government to implement rural water service delivery. This is called the District Water and Sanitation Development Conditional Grant (DWSDCG). It is worth noting that the guidelines for this are discussed and agreed between the Ministry of Water and Environment (MWE) and the Local Government Finance Commission (LGFC), which is a constitutional body that advises central government on fiscal transfers to local governments. Local governments are represented on the LGFC and thus the agreed guidelines are not seen as top-down impositions from the centre to the local level but as negotiated positions. Before this grant system was operationalised, ‘systems and capacity in local governments were either weak or non-existent’ (Williamson and Kizilbash Agha, 2008). The grant has supported the recruitment of qualified staff, and the fact that funds were transferred for service delivery, while building capacity, meant there were incentives to attract and retain qualified personnel ...Moreover, MWE shifted focus from implementing projects to supporting local governments, establishing regional Technical Support Units to support district planning and delivery. Levels of capacity – financial, technical and human – have, as such, improved in many districts in Uganda ....

Improved resource transfer contributed to the construction of new water points in rural areas. The grant guidelines specified that the bulk of the resources had to be spent on new construction. In 2009/10, for example, a total of 3,392 new water points were constructed through the DWSDCG (MWE, 2010: 146). Further, ‘the incentive framework to which the grant

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28. Though not focused on World Bank investments, on average, official development assistance (ODA) has a much higher degree of conditionality than domestic allocations to local government in most countries (Adugna and Ford, 2010).
Identifying bottlenecks and opportunities for reform

The specific challenges affecting service delivery in any given country will be varied and the causes highly context specific. There are no simple tools which will identify and prioritise the bottlenecks in the fiscal transfer system which are affecting service delivery in a specific context. A range of standard diagnostics and research will provide useful context and potentially identify important issues. The result of these will often be a long list of challenges with no guarantee that they focus on the most important problems or issues that have salience with the Government and its influential stakeholders. Refining priority areas for reform will involve a consultative process that develops a shared understanding of priority problems and brokers agreement over how those problems could be addressed in a way that fits the local context. Indeed, one general lesson from conducting diagnostics in the field of governance is that the process for implementing an analytical tool is as important as the tool itself (Hadley, Hart and Welham, 2020).

Box 17: Diagnostics examining intergovernmental fiscal transfers, including conditional grants

Common types of diagnostics. Public expenditure reviews may consider financing challenges in specific sectors or in the fiscal transfer system more generally. Public expenditure tracking surveys can explore budget execution across levels of government. PFM diagnostics such as PEFA can give insights into the overall budget process at national or subnational levels. Dedicated evaluations and research studies on fiscal transfer systems and specific conditional grants can be tailored to programming needs.

Public expenditure reviews:

- Indonesia. The 2020 Public Expenditure Review on “Spending for Better Results” includes a dedicated analysis (Chapter 3) of intergovernmental fiscal transfers. The analysis was conducted collaboratively between the World Bank and the Ministry of Finance between 2016 and 2019. Critically, even the preliminary findings began to feed into budget decisions and administrative reforms well before the publication of the final report. Further analysis is being prepared to look at options to strengthen the allocation and management of Indonesia’s main conditional capital grant (forthcoming DAK Fisik Implementation Review). In the past, there have also been high-quality evaluations of the impact of performance-based grants for local infrastructure and water as well as more general in-depth research on incentives in the grant system.

Sources: O’Meally (2011:7,14)

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29. PFM diagnostics, for example, such as PEFA can give insights into the overall budget process at national or subnational levels. Public expenditure reviews may consider financing challenges in specific sectors or in the fiscal transfer system more generally. There will also be research studies on fiscal transfer systems and specific conditional grants.
Nonetheless, fiscal transfers can be a useful entry point for World Bank teams working to strengthen decentralised service delivery. Section 4 noted that there are common bottlenecks related to the adequacy and equity of financing, the performance incentives in the grant system, the fragmentation of financing and accountability and weaknesses in basic administrative systems and financial management. Easing financing constraints, building a stronger framework for

financing local services and using this as a basis for improving local level governance has the potential to improve devolved services in different countries.

**Strengthening the overall system of conditional grants** may help address some of these common problems. This is particularly true for the challenges with fragmentation of financing and accountability where broader rules or principles
for guiding the structure of grants, the creation of new grants and the extent of conditionality are needed to manage the incentives for different entities to approach their priorities in silos. However, it may be important for addressing other problems as well – for aligning incentives for administrative or service delivery performance across different financing sources, for example. Box 18 provides a generic list of elements that make up the conditional grant framework. This may need to be accompanied by support for the organisations that regulate the conditional framework and how it is used.

Box 18: Generic components of a conditional grant framework

The conditional grants framework sets the broad institutional arrangements for the use of conditional grants in the intergovernmental fiscal transfer system. This will overlap with other institutional arrangements, whether that is for financial management, decentralisation or the use of fiscal transfers more generally. As a result each country will have a unique approach. Nonetheless, it is useful to consider the following generic components:

- The structure and purpose of different types of grants in the fiscal transfer system.
- Rules and processes for establishing or modifying a conditional grant and resolving disputes.
- Rules or principles that guide the allocation of resources vertically (between central and local governments) and horizontally (between local governments at the same level).
- Rules or principles to guide the conditionality in different types of grants.
- Grant management processes including budgeting, fund flows, accounting, reporting, auditing.
- Transparency and oversight of the conditional grant framework and its links with other financing arrangements.
- Roles and responsibilities of different organisations

Uganda’s Intergovernmental Fiscal Transfer Reform strategy and South Africa’s Division of Revenue Act offer relevant examples that describe the overall framework for conditional grants.

Designing or modifying conditional grants improve the adequacy, equity or performance incentives of specific sectors or services and help align national and local policy priorities. Regardless of the specific issue being addressed, it will also be important to consider how the conditional grant will work alongside other financing arrangements and review the basic design elements of any conditional grant (see Box 19 for a generic list). The specific presentation of these issues will vary depending on the country, as shown earlier in the guidelines for conditional grants in South Africa and Rwanda.

Box 19: Generic design elements supporting the design of an individual grant

Every country will present the core elements of a conditional grant in different ways. For example, Uganda’s conditional grant guidelines are issued annually as part of the budget process, but do not include information on the budget allocation for that year or past spending performance, unlike in South Africa where grant information is presented as an annex to the budget documents.

These differences aside, the design of a conditional grant requires consideration of at least the following element:

- Responsible ministry, department of agency
- Purpose or objectives of the grant: the strategic goal, expected outcomes, links to national or sectoral strategies; and reasons why the funding is not included in existing grants.
Linking grant financing to performance can reward improved behaviours at the level of a local government, service provider or even for individual employees, as discussed in Section 4. It can also strengthen the oversight provided by higher levels of government as they evaluate, reward and then support performance improvements. Most countries with performance-based grants will have extensive manuals that explain the many different elements that are needed, in addition to the basic grant guidelines or agreements that apply to more regular grant financing. The Government of Uganda has developed a series of interlinked performance grants covering different sectors and levels of government, with the Office of the Prime Minister setting the principles that govern the overall framework. Rwanda’s guidelines for performance-based financing in the health sector also differentiate between hospitals, health facilities and individuals. Nonetheless, these tend to incorporate a number of standard elements (described in Box 17).

Box 20: Generic design elements of performance-based grants

Performance-based grants are used most commonly to finance infrastructure at the local government level (rewarding better performers with higher grant allocations) or to pay for health services in facilities (rewarding better performers with bigger operational grants and staff bonuses). In both models there are several common design elements:

- Objectives of the performance grant
- Links to other performance systems
- Institutional arrangements
- Performance measures
- Performance assessment and verification process
- Payment processes and systems
- Integrating with the budget cycle
- Performance improvement support

Examples include Solomon Islands Provincial Capacity Development Fund (2017/18); Uganda’s Performance Assessment Manual and Grant and Budget Guidelines for the Discretionary Development Equalisation Grant and for the health and education sectors (2020/21); and Rwanda’s Ministry of Health 2018 Performance Based Financing Procedures Manual for Health Facilities (Hospitals and Health Centres).

For more detailed guidance, Steffensen (2010) offers a useful resource on the design of performance-based grants for local governments, while Fritsche et al. (2014) provides a dedicated toolkit for implementing results-based financing in the health sector.
5.3 Designing World Bank operations that use or strengthen conditional grants

The GovforResults framework offers an approach to link World Bank governance operations more closely to service delivery (Figure 5.1). As note at various points in this paper, there can be numerous governance bottlenecks that undermine service delivery. Financing may be an important bottleneck (as was the case in Uganda). In other contexts, financing may not be the most important binding constraint, or the World Bank may simply be unable to use its resources to have a significant impact on the resources available to service delivery. In these contexts, support to conditional grants may be used to address other bottlenecks, such as financing delays, inequitable allocations or poor incentives to improve service delivery performance (as with the World Bank’s support to heath services in Indonesia). These goals can be addressed while also supporting the overall framework for conditional grants – or improving institutional performance more generally. The tools available include ideas, financing, convening and facilitation.

>Figure 5.1 The GovforResults framework

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<th>Ingredients</th>
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<th>A Generic Theory of Change</th>
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<td>1. Change: specifying functional change objectives alongside results, key contributing actions and the responsible stakeholders and systems and processes to deliver change. +</td>
<td>A. Financing: Ensure adequate, equitable, efficient and reliable resources for service delivery</td>
<td>IMPROVED DELIVERY</td>
</tr>
<tr>
<td>2. Funds: the resources required for actions and the achievement of results delivered through the budget and/or supported by the operation. +</td>
<td>C. Performance: Enable improved institutional performance in managing resources and service delivery</td>
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<tr>
<td>3. Incentives: to encourage actors to change behavior and deliver. This involves designing the transition mechanisms for incentives. Incentives must be compatible with desired change. +</td>
<td>B. Bottlenecks: Address governance bottlenecks and their underlying causes</td>
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<tr>
<td>4. Technical Assistance: to facilitate and support the quality of reform implementation and build capability</td>
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</tbody>
</table>

Source: Authors

The scope of World Bank operations will affect the entry point

There are typically three types of operation that support conditional grants.

1. **Sectoral operations supporting sectoral delivery.**
   These are interventions that are seeking to improve the performance of service delivery in a specific sector. A common example in the World Bank portfolio include support to urban infrastructure (e.g. the Nepal Urban Governance and Infrastructure Project) and specific sector service delivery (e.g. Education Program for Results in Tanzania). Other schemes such as results-based financing in the health sector have the potential to be implemented in a similar way, though most examples are delivered as projects in the central government development budget and are not integrated into the fiscal transfer system (e.g. Uganda Reproductive, Maternal and Child Health Services Improvement Project).

2. **Local government capacity building and infrastructure investment.** This includes numerous operations that fund performance-based grants to local governments, most commonly for infrastructure spending. They combine performance-based grants with capacity building support to encourage a “learning by doing” approach. The Governance to Enable Service Delivery Project...
for Malawi is an example of this support, though more typical examples include the Urban Local Government Strengthening Program in Tanzania, the West Bengal Support to Institutional Strengthening of Gram Panchayat Program in India, and the Urban Local Government Development Program in Ethiopia (continued as the Urban Institutional and Infrastructure Development Program).

3. **Multi Sectoral Operations financing Service Delivery.**
   These interventions are financing and/or strengthening institutional performance across a number of sectors, typically by combining sector specific support (e.g. health sector allocation rules) and cross-cutting systems (e.g. grant management). Examples include the Protecting Basic Services Program in Ethiopia, the Municipal and Agglomerations Support Program in Senegal and the Uganda Intergovernmental Fiscal Transfer Reform project.

Each approach will have some general strengths and limitations. Sector specific concerns can provide a strong focus on tangible results but may not find salience with central government agencies that are concerned with more general aspects of governance and can come with incentives to fragment the grant system with new funding streams and administrative requirements. On the other hand, approaching general challenge with local government or supporting national reforms may focus on building new systems which are important in the long-term but may not immediately address critical bottlenecks for service delivery.

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**Box 21: Uganda Intergovernmental Fiscal Transfer Reform Program for Results (UgIFT)**

In response to concerns raised by two reports which assessed the state of financing of decentralised service delivery in Uganda in 2012 and 2013, the Government embarked on a broad reform of intergovernmental fiscal transfers, starting in FY2015/16. These two reports exposed a pronounced decline in adequacy of Local Government (LG) financing, visible inequities in horizontal distribution of resources across LGs resulting from the lack of objective allocation principles, and poor incentives for LGs to use resources efficiently.

The reforms were formalised in 2017 under the Intergovernmental Fiscal Transfer Reform Program (IGFTRP) and expanded in 2020 with four core objectives: i) improve the adequacy, equity and discretion in the financing of decentralised service delivery; ii) improve central government oversight, management and support for decentralised services; iii) improve LG management of local service delivery; and iv) improve the effectiveness and efficiency of service delivery by frontline providers.

The World Bank-funded UgIFT programme for results was approved in 2017 to support the IGFTRP objectives. It focused initially on the education and health sectors, but expanded its scope to include financing for grants in the water and agriculture sectors as well as part of the additional financing approved in 2020. UgIFT will provide nearly $500 million, much of which will be channelled through conditional grants to the respective sectors, with a focus on development grants, and this will be more than matched by rising allocations in the domestic budget. Together this financing has reversed the long-term erosion in the value of fiscal transfers to LGs, with spending rising in real per capita terms in both the health and education sectors. The UgIFT programme has also supported changes to grant management and financed an innovative performance-based grant system for local government infrastructure (see Box 11).

Given its cross-cutting nature, UgIFT requires close cooperation amongst ministries, departments and agencies to coordinate and broker decisions over policy and reform implementation which is still not fully embedded in government institutions. This includes the need to link fiscal transfer reforms to other initiatives aimed at improving systems for public financial management (e.g. IFMIS and PBS) and sector management (e.g. RBF, NHIF, school inspection). The World Bank Country offices do not always have the capacity to provide this kind of support and UgIFT has benefitted from embedded technical support from ODI, funded at various times by the World Bank, UK Government and EU. The reforms have also led to further EU financing that will, among other things, support increases in spending on the Discretionary Development Equalisation Grant that gives LGs relatively flexible resources to improve local infrastructure.
Elements of the design should link to the bottlenecks identified

Regardless of the scope, the main elements of the program design should link the nature of support that can be provided by the Bank (financing, conditionality and technical assistance) to the bottlenecks identified and agreed with stakeholders. Broadly speaking these will be:

- Addressing financing gaps for local government investments and service delivery.
- Reinforcing positive performance incentives through the design of individual grants.
- Strengthening institutional arrangements for grant management and execution.

Operations can help address financing gaps in ways which encourages more equitable or efficient spending choices. The design of the operation can facilitate agreement on the financing gaps that need to be addressed and issues related to the distribution of funding. World Bank operations can help close these gaps directly by financing existing or new conditional grants. It can use associated conditionality to encourage the Government to increase its own spending in the budget or through more reliable releases during execution, and can facilitate the use of equitable allocation formulae.

Technical assistance can support critical design issues, such as the need for service delivery standards that match the resources available and formulae that support improved equity and positive incentives to use resources effectively.

Operations can encourage institutional and delivery performance related to individual grants or the system as a whole. The results framework can focus on critical behavior changes at the national or local government level and the impact that these changes are expected to have on service delivery. Technical assistance can support the design and implementation of allocation formulae, incentive frameworks, M&E systems, or performance improvement support. Conditionality and financing can help the Government to establish these systems and maintain them over time.

Operations can also support the general improvement in grant management and execution. Again, the results framework can specify the specific behavior changes which are needed to address challenges with grant management which are affecting service delivery. Technical assistance can be used to support changes to the framework for grant management or build the capacity of local governments and/or lower-level units to manage resources more effectively. Financing can support new systems and organizational structures. Conditionality can reinforce these changes.

Box 22: Examples of World Bank projects supporting transfers to subnational governments

Earmarked sector grants (single and multi-sector)

- Municipal and Agglomerations Support Program in Senegal ($260m). This operation supports reforms to intergovernmental transfers and fiscal decentralisation needed to enable local governments to invest in infrastructure to boost local development and enhance local service delivery across a number of sectors. It also aims to incentivize selected urban local governments to improve the planning, budgeting and management of their investments, through the pilot application of a two-tiered performance-based conditional capital grant system and dedicated institutional support arrangements. The operation combines PfR and IPF financing to provide a blend of on-budget financial support through the grant system and more targeted technical assistance needed to support institutional reforms.

- Recurrent Cost and Reform Financing Project in Somalia ($68m for Phase III). The operation aims to support the Federal Government of Somalia and Eligible Federal Member States to strengthen resource management systems, the inter-governmental fiscal framework, and service delivery systems in health and education. It provides “recurrent cost financing” with the most significant share of spending going towards health and education, mainly in the form of salaries for teachers and costs for scaling up the provision of community health workers in the Eligible Member States. However, it will also provide pilot a performance-based grant providing operational costs for schools. These financing
arrangements are coupled with incentives and technical assistance that support broader intergovernmental relations and state building efforts. The operation uses IPF as the financing instrument.

- **Education Program for Results in Tanzania** ($122m and $80m additional financing). This operation aims to improve quality, equity and access in the public education system at primary and secondary level. It supports the government to finance its Fee Free Basic Education Policy and to build the capacity in the system to maintain and improve the quality of education in the context of a large influx of new students since 2015/16. The operation supports school incentives, teacher motivation, and capitation grants; extends support for teaching and learning materials; and ensures adequate financing for day-to-day school quality. World Bank financing complements significant bilateral investment from the UK and Swedish government.

**Sectoral Performance Grants**

- **Uganda Intergovernmental Fiscal Transfer Reform Program** ($788m). The operation aims to improve the level and equity of fiscal transfers and improve fiscal management of resources by local governments, with a particular emphasis on health and education services but also other sectors. The program supports an annual performance assessment of local governments which is used as an input into the formula for allocating conditional development grants for health, education and water services. Incentives in the PforR instrument are being used to ensure additionality of World Bank funding and to reinforce commitments to the Government’s reforms to the management of fiscal transfers. It is also being used as a vehicle to integrate spending in refugee hosting districts into the grant system.

- **Indonesia Supporting Primary Health Care Reform Program** ($150m). This program for results operation aims to strengthen the performance of Indonesia’s primary health care system. A key feature of this work is the aim to increase the performance incentives in the existing financing system covering both health insurance (JKN) and conditional grants (DAK) in the health sector. Regarding the latter, the program is supporting the ministries of health and finance to implement performance-based elements into DAK allocations that fund operational resources for health services. This involves the introduction of more health system and service delivery indicators to the existing performance benchmarks tied to financial reporting and financial absorption.

**Discretionary Performance Grants**

- **Local Governance Support Project for Bangladesh (Phase III)** $130m). This program has been supporting the introduction of fiscal transfers and performance-based grants at different levels of government. The objectives of the third phase of the LGSP are to institutionalize the Union Parishad (UP) fiscal transfer system, and introduce a fiscal transfer system for Pourashavas on a pilot basis. There are four components to the project: Institutionalization of UP fiscal transfers; audits and performance assessments, and management information systems; expanded block grants to pilot Pourashavas; and capacity development and project implementation support. This operation uses and IPF financing instrument.

- **Ethiopia Urban Institutional and Infrastructure Development Program** ($859.50m). This hybrid of IPF and PforR instruments aims to enhance the institutional performance of participating urban local governments to develop and sustain urban infrastructure, services, and local economic development. It builds on earlier projects (ULGDP I and II) and provides performance-based grants to 117 urban local governments while strengthening oversight capacity for managing fiscal transfers and urban services.
The choice of instruments and example operations

The main instruments are Investment Project Finance (IPF), Development Policy Finance (DPF) and Program for Results (PforR). While each can be implemented in different ways, Table 5.1 describes the main levers each has to support the grant system. These mechanisms can also be combined either through hybrid models such as an IPF with disbursement-linked indicators, or by combining two instruments (e.g. a PforR and IPF).

Table 5.1: World Bank lending instruments for financing and strengthening conditional grants

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Financing services through conditional grants</th>
<th>Incentives</th>
<th>Supporting reforms and institutional performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Project Financing</td>
<td>Direct financing specific project financed conditional grants which can be aligned to government systems</td>
<td>No specific incentives; can be designed by introducing perf-based funding within components.</td>
<td>Funding institutional strengthening and technical assistance</td>
</tr>
<tr>
<td>Investment Project Financing with Performance Based Conditions</td>
<td>Supporting existing and or new transfers as part of the grant systems as eligible expenditures, linked to achievement of performance-based conditions. Government systems must meet Bank fiduciary requirement.</td>
<td>Depending on how designed, can affect MoF or Implementing Agencies.</td>
<td>Incentivizing reforms or institutional performance through performance based conditions</td>
</tr>
<tr>
<td>Program for Results</td>
<td>Financing defined sets of existing or newly established conditional grants using government systems as part of the Program Expenditure framework.</td>
<td>Direct incentives on MoF. The transmission mechanisms for incentives for other implementing agencies can be built in design and implementation, whether bureaucratic or financial.</td>
<td>Incentivising reforms or institutional performance through disbursement-linked indicators</td>
</tr>
<tr>
<td>Development Policy Finance</td>
<td>Increasing the overall fiscal space for government financed conditional grants</td>
<td>Direct incentives focused on MoF and achievement relies on authority of MoF to secure action.</td>
<td>Incentivizing performance or reforms through prior actions</td>
</tr>
</tbody>
</table>

IPFs are the traditional modality the Bank uses to finance specific conditional grants or investing in changes to the grant management framework. It has been used widely to introduce new performance-based grants to local governments. Examples include the Protecting Basic Services Programme in Ethiopia. IPF has also been used to finance facility and school level grants, though this has not always been delivered through the grant system, as noted above. Some advantages of IPF are that it is simple and that it can be used to finance institutional capacity building, and technical assistance. This makes it a useful complement to DPF and PforR operations which have more limited scope for contracting technical assistance. These hybrid financing arrangements were deployed in both Ethiopia and Senegal (Box 22, above). The Recurrent Cost and Reform Financing project in Somalia represents an innovative use of this instrument in a fragile country context.
PforR are being used in a range of countries to support conditional grants. PforR financing supports government programs of expenditures, uses government systems and disburses against achievement of defined and verified results. The Uganda Intergovernmental Fiscal Transfer PforR uses a wide range of disbursement linked indicators to incentivise the Government to raise spending on conditional grants over the medium-term, allocate grants on the basis of agreed formulae and strengthen the routines of grant management. This PforR is also being used as a basis for harmonising Bank support for health, education and agriculture. However, PforRs can be demanding on client governments. They are also less useful when results are harder to monitor.

DPF combines prior actions with budget support and works best for supporting clear and credible policy commitments and one-off reforms to grant management. DPF support can be used to create fiscal space for increasing spending on conditional grants. Prior actions can be used to shape how the additional fiscal space is used. They may also prompt reforms to the way fiscal transfers are managed. The Second Indonesia Fiscal Reform Development Policy Loan introduced new earmarking rules for discretionary grants as subnational governments were required to allocate a minimum 25% of DAU and revenue sharing for infrastructure. New grant management conditions were introduced for the smaller capital development grant, as DAK disbursements changed to be based on reports of achievements. A follow-on operation has also required the harmonisation of central and subnational charts of accounts to facilitate coordination of spending across levels of government.

A number of issues are important to consider when using Bank operations for improving the performance of institutions or levels of service delivery. First is that the goals of the interventions need to be clear and well understood by the Government. Second priority actions and disbursement linked indicators need to be credible in order to generate stronger incentives to meet them. This includes avoiding unnecessary changes to the benchmarks and ensuring verification procedures are objective and independent. Finally, operations need to follow and reinforce national systems where possible and should avoid fragmenting the grant system and introducing projects which involve national government institutions delivering services that are the responsibility of lower levels of government.

Using Advisory Services and Analytics effectively

Advisory Services and Analytics resources can help work through the different stages of problem identification and problem solving. This can involve one or all of:

- **Analytical work** can raise issues, analyse known problems or offer options to help resolve challenges identified. It can provide an entry point for engaging with officials and other stakeholders, and a basis for supporting dialogue between different stakeholders. Analysis may feed into an existing policy process, as was the case with the report on Devolution without Disruption in Kenya, or offer a means to build interest in an issue, like the 2013 Public Expenditure Review on subnational financing in Uganda (see Box 17, Section 5.2 for examples).

- **Facilitating policy dialogue** between key stakeholders is often central to building support for change (Williamson, 2015; Andrews, Pritchett and Woolcock, 2017). The tensions inherent in any system of decentralisation mean that different stakeholders will have different views over the problems.

- **Teams working closely with the Government** can facilitate discussions and help broker agreements between different stakeholders. This is particularly important in contexts where communication across different organisations is poor. Box 23, below, offers an example of this. On-the-ground support is also likely to be needed during both the design and implementation of reforms.

5.4 Increasing coherence through fiduciary work in operations

Fiduciary work aims to identify and manage risks associated with World Bank operations, and specifically the risk of funds being used for purposes other than that which the operation is designed. One of the most common means to achieve this is to set up parallel systems or pilot projects. Another is to require countries to adopt World Bank fiduciary procedures. However, the way that fiduciary safeguards are developed can have important consequences for the coherence of intergovernmental fiscal transfer systems. This is true both in relation to specific projects, as well as to different projects implemented in the same country.

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31. DAU stands for Dana Alokasi Umum and is a general purpose, “unconditional” grant which funds most recurrent spending of provincial and local governments in Indonesia.
Although, in isolation individual donor programs and fiduciary controls may make sense, collectively they can quickly result in fragmented, inequitable, un-transparent and unsustainable financing of subnational governments. Different donors may have different approaches to service delivery and have differing reporting and accountability requirements for the subnational government. For example, donor funding may be transferred directly to local governments by donors, or via projects managed by central government institutions. As a result, it may be impossible in practice to get a comprehensive picture of resource allocation across the country; aid to local government may accidentally be included in both national ministries’ and local governments’ budgets, or in neither. This is especially important in countries where donor aid represents a significant share of local government’s sector expenditure.

While full alignment with national systems is desirable in theory, it may not be possible in practice. However, it may still be possible to align planning, reporting and other processes between the Bank operation and the government systems. For example, South Sudan has established a system of allocations to local government, in which donors and national government coordinate funding for services through a single mechanism. The government and donors worked together to design a new capitation grant to primary and secondary schools. The Government financed primary schools, while the UK supported the provision of the secondary schools, using the same guidelines, but channelling the funds separately to local governments.

It is also important to harmonise processes across World Bank operations in the same country. This is particularly important if the aim is to support improvements in the grant management framework and how it is implemented. Harmonising guidelines and principles for earmarking, allocating and disbursing grants will help build a more coherent and predictable system of fiscal transfers. Harmonising procurement rules, banking arrangements, auditing procedures and other aspects of financial management will ensure that limited capacity is strengthened over time and not overloaded by the need to navigate numerous systems and procedures. Again, where possible, World Bank operations should aim to align with existing country systems.

Box 23: Facilitating a new set of conditional grants for local services in South Sudan

After nearly two decades of civil war, the Comprehensive Peace Agreement of 2005 created the basis for an independent South Sudan. The CPA also established a quasi-federal system. Below the Government of Southern Sudan, existed ten States, and beneath the ten states, seventy-nine local governments. Large transfers to State governments quickly became a core feature of the new governance arrangements, and averaged nearly 20% of the government budget between 2006 and 2011. Moreover, this was one of the few parts of the budget to be transferred reliably. Between 2007 and 2011, the lowest rate of execution was 94%, in all other years it was above 95%.

However, the framework to guide the use of fiscal transfers to rebuild services decimated by years of conflict was weak. The functions and responsibilities of each level of governments was not set out except in schedules to the 2005 Constitution, and the 2009 Local Government Act. These provided broad, and often conflicting definitions. There was no clear policy process to more closely define responsibilities. Moreover, transfers were mostly being used to finance State wage bills that had absorbed large numbers of demobilised forces and militia. It left little for operational costs and meant that the majority of basic services were delivered with donor support using parallel systems.

While the government was determined to secure budget support as an alternative means to strengthen services with aid, donors were weary of the fiduciary and programmatic risks involved and believed that project support would be the more appropriate modality to transition away from humanitarian aid. To bridge this disconnect between government and donors, ODI advisers worked with government to develop innovate aid instruments that could meet the government objective of aid
using government systems, and could also meet donor concerns about the weakness of those systems. The result was the “Local Services Support Aid Instrument” accompanied by plans to develop a county PFM system and transfer system, as none existed and counties were, in principle, responsible for local service delivery.

Alongside government’s efforts to further develop the LSSAI, donors had ongoing planning process for projects supporting service delivery. The Director of Aid Coordination met with the Ministries, with BSI advisors facilitating these discussions, to ensure that options for progress towards the LSSAI was kept on the agenda in the design on these projects. However, support within government varied. The ministry of education was keen to decentralise and saw the LSSAI as a means to implement capitation grants and advance its policy in the face of donor fragmentation. The ministry of health was less keen and had set up a relatively well coordinated system of donor delivered services. Ultimately it was donors who saw the LSSAI as an opportunity to increase the interest in the ministry for financing basic health services.

As the LSSAI agenda had advanced it had become clear that no sector had thought systematically about how to improve basic service delivery, and that there was little communication or coordination across sectors, even when they were dealing with similar challenges. To address this ODI developed the concept of “Service Delivery Frameworks” to encourage sectors to think through various aspects of service delivery and the potential challenges or “blockages” preventing improvement. The process of formulating the SDFs provided an opportunity for the Ministry of Finance, Ministry of Labour & Public Service, the Local Government Board and the Ministries responsible for service delivery (Education, Health, Water) to build relationships and a common understanding of the challenges involved in improving service delivery. This resulted in a “Joint Plan of Action” signed off by six Undersecretaries, the inclusion of over $100 million of new financing for basic service delivery in the 2013/14 budget, and the implementation of these transfers in the first half of 2014.

Source: Hart and Williamson (unpublished)
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References


References


References


References


References


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Annexes

A1: Good practice principles for allocation formulae

1. Formulae should be simple and transparent
   - Formulae should have no more than 5 criteria for allocation
   - Formulae should be presented simply and accompanied by a written explanation of how it works and why it has been designed this way
   - Data used in the formulae and the formulae themselves should be publicly available

2. Allocations should be equitable within the resources available
   - Allocations should match resources to the target population and capture any major differences in need and cost, and ensure a balance between these factors.
   - Formulae should not use input criteria as these reinforce existing disparities in allocations,
   - Formulae should be used to distribute a predetermined pool of resources
   - A grant should be country-wide and be distributed to all local governments where there is a need for services, unless it is funding a pilot initiative, or services provided spill over to specific jurisdictions

3. Variables should be exogenous to influence from local governments and not provide a disincentive to improve service delivery
   - Incentive effects should be explicitly considered in the design process
   - Variables should be linked to overall objectives of the grant and service delivery mandates of local governments
   - Variables should be ‘exogenous’ to influence from local governments, and it should not be possible to influence/manipulate them.
   - Formulae should not undermine incentives to improve services. Therefore existing service levels/infrastructure stock must not be used.

4. Variables should support predictable and politically viable allocations
   - Variables should not vary significantly from year to year
   - Variables should be measured regularly to avoid large changes upon revision
   - Variables should be available for all local governments (or at least regionally)
   - Variables should use official data sources only and use the most up-dated validated public statistics.

Source: Authors, adapted from Steffensen (2010)
A2: Grant Guidelines in Uganda

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  1.2 Mission
  1.3 Goal
  1.4 Health Sector Policy Priorities FY 2016/17
  1.5 Purpose of the Guidelines
  1.6 Proposed LG approaches to improve Health Service Delivery
  1.7 Reform on Consolidation of Local Government Fiscal Transfers

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  2.1 Mandates of Local Governments
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  6.1 Guidelines on Medicine Procurement, supply and Management
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7.0 Direct Transfers of PHC Grants to Health Facilities (Public and Private)
  7.1 The Planning and Budgeting process
  7.2 The New Grant Payment Procedures for PHC Grants
  7.3 Release of Funds
  7.4 Signatories to Health Bank Accounts
  7.5 Disbursement Procedures
  7.6 Transfer of Funds
  7.7 Condition for Release to Beneficiary Health Facilities
  7.8 Handling of Unpaid Grants
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  7.10 Roles and Responsibilities of Officers/ Involved in the Grants Release and Payment Processes
  7.11 Critical Success Factors
  7.12 Possible Consequences of Not Meeting Direct Transfer Guidelines
7.13 Conclusion

8.0 ANNEXES
Annex I. Copy of the MOU Between the GoU and PNFP Health Service Providers
Annex II. Copy of The Memorandum of Understanding Between the DLG and PNFP Health Service Providers for FY 2016/17
Annex III: Planning and Budget Calendar for LG Institutions
Annex IV. Primary Health Care Grants - Indicative Planning Figures for FY 2016/17
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### A3: Bottlenecks in the fiscal transfer system in Kenya

<table>
<thead>
<tr>
<th>Issue/Challenge</th>
<th>Underlying Reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budgeting for Conditional Grants</strong></td>
<td></td>
</tr>
<tr>
<td>There are challenges to inclusion of conditional grants in the CARA and DORA and ensuring consistent allocations in the national budget</td>
<td>The National treasury includes in CARA only projects that have a signed financing agreement. This means that project budgets are included in the next CARA process following signing of the financing agreement, which can lead to significant implementation delays. Inclusion of performance grants in the CARA and DORA is challenging, as in the current formulation annual allocations must be locked in early in the budget process. It is a challenge to subsequently change allocations based on performance. Allocations to conditional grants in MDA budgets are sometimes inconsistent with the CARA, which means they cannot be executed. Combined MDA ceilings which included conditional grants give an artificially high impression of MDA allocations and may provide an incentive for MDAs to under budget for conditional grants.</td>
</tr>
<tr>
<td>There is inconsistent and mixed quality of budgeting for conditional grants at the county level.</td>
<td>Conditional transfers are reflected in county revenue and expenditure budgets in inconsistent ways, often with single-line expenditure budgets without clear breakdown of how the funds are to be spent on projects and/or services. This undermines both transparency in resource allocation, reporting, and compilation of information. There is no consistent communication of the purpose of conditional grants, the conditions and guidance how to budget for grants and adhere to conditions. Counties receive information on likely allocations for conditional grants late in the budget process. The funds are not therefore included in the budget process.</td>
</tr>
<tr>
<td>Allocation of funds away from conditional grant funded sectors.</td>
<td>Some counties are reducing budget allocations from other sources to sectors which are receiving (World Bank Financed) conditional grants. For Bank funded projects, this has led to conflicts between county project implementing units and chief officers (COs)/County executive committee members (CECMs) as they find a need to support non-project activities.</td>
</tr>
<tr>
<td>Complexity and delays to in-year Budget Adjustments</td>
<td>It has proved challenging to adjust CARA and DORA allocations during the FY to include Bank Projects. Once CARA is amended, a supplementary budget has to be prepared to appropriate monies to votes. Counties take a long to passing the first supplementary budgets when there are in year budget adjustments, delaying absorption of funds further. Frequent government restructuring both at the National and county affects programme implementation. Consequently the budgets have to be reconfigured when government structure is changed.</td>
</tr>
<tr>
<td>Delays in the flow of funds to and within the counties</td>
<td>There are delays by ministries in uploading cash and procurement plans in the system in the first quarter of the FY which delays transfer of funds to counties. Parent ministries delay to requests conditional grant funds to be disbursed to the counties. DP funds delay in the designated account at the National Treasury. Reasons include MDAs lacking knowledge on the process and weak incentives to disburse on time. Conditional grant amounts released are unpredictable and be based on expenditure not the schedule. Disbursing performance grants may be based on statements of expenditure not performance undermines incentives. Overall transfer amounts released to counties are also not predictable because equitable share releases at the NT take into account balances on the CRF which may not take into account that balances are made up of conditional allocations. This is attributed to Treasury balancing the cash flow needs of the Nation in an environment of competing needs.</td>
</tr>
</tbody>
</table>

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| counties delays in approving budgets and opening the new FY on IFMIS | Some counties delay in approving their budgets, which delays conditional grant related expenditure in those counties, including those funded by DPs. Conditional grant funds must be appropriated by each county assembly, as part of the overall county budget. Delays to year end closure on IFMIS and uploading of the budget resulting in loss of up to 2 months at the end of one financial year and opening of the next financial year. |
| Delays in withdrawal of conditional grant funds from the CRF, which can be diverted to other activities | There is an absence of control in the CRF based on the source of funds and there is inadequate communication of grant transfers to counties. Conditional grant funds can be withdrawn from the CRF for expenditures other than those they are intended by counties. This can result in significant delays at the counties in transferring project funds from the CRF to special purpose accounts and service facilities. |
| Delays in counties availing counterpart funding | There are delays in the re-appropriation of unspent conditional grants at the end of the FY in supplementary budgets (which can take up to 9 months) and the transfer back to operational accounts. As funds in the CRF are not traced by source of funds, this leaves them open for misappropriation. |
| Delays in opening project bank accounts | There are delays in opening project bank accounts. These delays have been attributed to This has been attributed to lack of understanding on the requirements for a county to open a project account and the fact that National Treasury has no obligation for this. Leadership/ supremacy challenges amongst county officers has also led to this delay. |
| Payment Delays at the County Level | On average it took 19 days with a maximum of 32 days to process an imprest payment after a voucher has been prepared by the PIU where the county treasury is involved in the approval process. This is mainly due to various approval levels and at times inaction from the concerned officials. Conversely, where the project account is managed directly by the PIU with exclusion of county treasury officials it took an average of 2 days. |
| Delays in payment of vendors (on average 12 days up to 39) | Payment delays in paying suppliers/vendors. On average it took 12 days to process a payment to a vendor with a minimum of 1 day and a maximum of 37 days. Conversely, where the project account is managed directly by the PIU with exclusion of county treasury officials, it takes on average 16 days to process a payment at the county level. |
| Institutional Arrangements at the County Level | Devolved projects contributing to similar objectives operate independently from each other (silos) even when in the same department hence lacking complementarity. Project implementation units largely rely on mainstream county treasury department for approval of transactions and funds flow. There is duplication of technical resources and activities mainly fiduciary staff while Counties have limitation in these technical skills both in knowledge and numbers. Lack of project acceptance by county management. There were noted instances where the political leadership felt that the project was a challenge to their exercising of political power which caused delays in approval of project activities. |
### Accounting and reporting outside IFMIS.

Project funds are budgeted as a single line in the parent ministries at the National Government and at the Counties. This means that expenditure is also posted on a single line or as part of the many other expenses by the county. It is therefore not possible to generate project reports from IFMIS.

### Inadequate technical accounting capacity at the Counties leading to delays in accounting for funds.

There are no-dedicated project accountants. Project accountants are mainly County/National Government ministry accountants with other responsibilities. Accountants working on projects at times lack adequate IFMIS system access rights especially when they are consultants and not civil servants. This challenge is worsened by regular reshuffles of trained and experienced accountants.

### Grant Design and Readiness for Implementation

#### There are inconsistencies and inadequacies in the design of conditional grants, including those supported by the World Bank

Whilst conditional grants have different objectives and conditions and there are inconsistencies in the design of bank financed grants in the way objectives and conditions are applied and guidelines take different forms. This makes it challenging for counties to adhere to such conditions. For example

- Similar types of grants having different names and ways of linking allocations to performance – e.g. investment and Capacity Building Grants having (Level 1 and 2 under KDSP and UIG and UDG under KUSP).
- There may be differing conditions for accessing and release of funds and differing requirements and instruments may vary.
- Some grants requiring counterpart contributions, whilst other do not and counties allocate funds away from sectors funded by conditional grant.

There is a lack of specificity as well as consistency in guidance on how to budget for, access and report on conditional grants which results in conditional grant funded expenditures being reflected as a single line in expenditure budgets, not specifying how the source of funds, administrative and economic segments of the standard chart of accounts.

Inadequate consideration for unique and specific circumstances of a geographical area and culture causing project implementation delays.

#### There may be a lack of preparedness for implementation

Incomplete designs and other pre-implementation processes. These include incomplete plans and engineering designs at commencement hence taking long to be developed causing project implementation delays.

It takes considerable time for pre-implementation agreements to be signed with the counties. This delay has been as high as 2.5 years.

#### There is a lack of awareness of conditional grant financed programmes

There is inadequate and inconsistent communication of the purpose of conditional grants, the conditions and how to access, budget and utilize the funds. Further, there is inadequate involvement of some key officials within the county hierarchy. For example the technical department and ministry officials participate in project design without involving fiduciary staff. This brings a challenge in carrying out fiduciary activities for the project.