POLICY BRIEF

Financial and Fiscal Commission (2022)

Repurposing and realigning the system of provincial conditional grants

Executive Summary

South Africa's system of conditional grants has been in place for over 25 years, with the aim of financing some of the crucial national expenditure priorities. The system is beset by several fundamental weaknesses, which undermine its overall efficacy. This study therefore seeks to conduct a 25-year review of provincial conditional grants with a specific focus on the following:

- The number and quantum of funding, including a proportional share of grants to the equitable share
- The number of conditional grants introduced, terminated, rationalised or reclassified and incorporated into the provincial equitable share
- The alignment between grant design and policy objectives
- Grant performance and accountability
- Fairness of the allocation criteria on selected conditional transfers

Envisaged recommendations from this study will provide guidance on how to repurpose and realign provincial conditional grants to the basic principle of intergovernmental fiscal transfer design, as outlined in the Constitution.

Background

Conditional grants in South Africa date back as far as 1994 when the Primary School Nutrition Grant (now called the National School Nutrition Programme) was introduced with the help and support of the Department of Helath to address health deficiencies among schoolgoing children and to improve learners' dietary allowance (FFC, 2006)[1]. The nutrition programme was introduced as a temporary school-level poverty relief measure that was to be replaced by the fruits of a broader reconstruction and development programme.

[1] Financial and Fiscal Commission. 2006. *Review of Transfers in the Intergovernmental Relations of South Africa in South Africa – Research reports in support of FFC Submission for the Division of Revenue 2007/08*. Financial and Fiscal Commission, Midrand.

FINANCIAL AND FISCAL COMMISSION

THE FINANCIAL AND FISCAL COMMISSION

The Financial and Fiscal Commission is a body that makes recommendations and gives advice to organs of state on financial and fiscal matters. As an institution created in the Constitution of the Republic of South Africa, it is an independent juristic person subject only to the Constitution itself, the Financial and Fiscal Commission Act, 1997 (Act No. 99 of 1997) (as amended) and relevant legislative prescripts. It may perform its functions on its own initiative or at the request of an organ of state.

The vision of the Commission is to provide influential advice for equitable, efficient and sustainable intergovernmental fiscal relations between national, provincial and local spheres of government. This relates to the equitable division of government revenue among three spheres of government and to the related service delivery of public services to South Africans.

Through focused research, the Commission aims to provide proactive, expert and independent advice on promoting the intergovernmental fiscal relations system using evidence-based policy analysis to ensure the realisation of constitutional values. The Commission reports directly to both Parliament and the provincial legislatures, who hold government institutions to account. Government must respond to the Commission's recommendations and the extent to which they will be implemented at the tabling of the annual national budget in February each year.

The Commission consists of commissioners appointed by the President: the Chairperson and Deputy Chairperson, three representatives of provinces, two representatives of organised local government and two other persons. The Commission pledges its commitment to the betterment of South Africa and South Africans in the execution of its duties.

Over 26 years of existence, this grant underwent numerous iterations and evaluations, but remains an integral part of provincial conditional grant allocation. Whereas the grant facilitates the implementation of a national priority – as one of the fundamental objectives of conditional grants – its permanency and inefficacy violates some of the crucial principles of conditional grants. These weaknesses are not unique to the School Nutrition Programme or Grant, but permeates across the entire system of provincial conditional grant transfers.

The study has found that the nature of intergovernmental fiscal relations in South Africa, particularly revenue and expenditure assignments, and the resulting vertical and horizontal imbalances, as well as interjurisdictional disparities, calls for re-distributional transfers to achieve equity objectives with respect to the funding, access and delivery of services. Special-purpose grants have emerged as a preferred instrument by national government to finance what are regarded as national priorities (or the incentivised provision of specific services), rather than addressing overall equity goals. As a result, the system of conditional grants is fragmented, disconnected from unconditional transfers and fails to meet the intended delivery outcomes and correct lingering fiscal and delivery imbalances (Ter-Minassian, 1997)[2], despite more than 20 years of implementation.

Government has paid little attention to the design of individual conditional grants or the system as a whole. Grants can be matching and non-matching. However, the research found that, while matching grants promote local ownership of the funded programme, they tend to disadvantage and create a fiscal burden for the receiving jurisdiction with limited fiscal capacity, and therefore impinge on the overall outcomes (Boadway and Shah, 2007)[3]. Government continues to allocate more funds to long-existing grants and create new grants without proper due diligence. Allocations to some conditional grants are based on the historical baselines, which are devoid of relevant expenditure needs indicators.

The study sought to identify the changes in the number of conditional grants over the past 25 years, looking at reasons for the constant and abrupt introduction, reclassification and termination of grants, including the reluctance to incorporate long-existing grants into the provincial equitable share.

Research findings

1. Constitutional basis for conditional grants legislation

Section 214(1)(c) of the Constitution of South Africa provides for conditional transfers to provinces and local government from the national government's share of revenue. There are no specific directives as to which sub-national functions should be funded by conditional grants. These details are consolidated in the enabling or subordinate legislation called the Division of Revenue Act. Each conditional grant has a specific objective and conditions. The overarching aims of the South African conditional grants, as per the annexure to the Division of Revenue Act of 1999, are to provide a detailed allocation of provincial conditional grants.

This was outlined as follows:

- Enable the implementation of national expenditure priorities through the budgets of other spheres of government
- Promote the implementation of national norms and standards
- Compensate provinces for cross-border flows and the provision of specialised services that benefit other regions, such as the training of medical professionals
- Recognise that other spheres of government implement concurrent functions, such as the provision of housing (National Treasury, 1999)[4]

[2] Ter-Minnasian, T. 1997. *Fiscal Federalism in Theory and Practice*. International Monetary Fund. Washington.
[3] Boadway, R and Shah, A. 2007. *Intergovernmental Fiscal Transfers – Principles and Practices*. The World Bank, Washington.
[4] National Treasury, 1999. *Budget Review*. National Treasury, Pretoria, South Africa

2. Historical trajectory of provincial conditional grants

Conditional grants in South Africa were first introduced in the intergovernmental system in the health sector in 1998/99 with the intention to address spillover effects linked with the skewed distribution of specialised health facilities and the training of medical professionals. Provincial conditional grant frameworks were introduced during 2002/03 as part of the reform to address the non-transferring of funds and chronic underspending. Among other things, the frameworks sought to limit the number of conditional grants, and impose stricter and more consultative requirements for national government before introducing grants (National Treasury, 2002)[5].

With regard to grant continuity, the study found that 85 provincial conditional grants had been introduced, with an average lifespan of 5.6 years. At least 27 of these grants existed for one year only, while four existed for more than 20 years, almost becoming a permanent financing instrument. It is unclear whether the average lifespan of 5.6 years is sufficient for any of the conditional grants to achieve their intended objectives, or whether the once-off grants are temporary enough to result in the anticipated outcomes.

Turning to grant schedule or grant type, the majority (47) of the provincial conditional grants are classified as schedule 5 or non-matching grants, whereas 16 are categorised as schedule 4 or matching grants. About seven grants were introduced as schedule 6 or indirect/in-kind grants, while five are listed as schedule 7 or disaster relief grants. Broadly, the study found no discernible practical distinction between schedule 4 and schedule 5 provincial conditional grants, especially, in relation to conditions that influence sub-national fiscal decisions and induce performance incentives.

3. Grant design review (largest three conditional grants)

HIV/Aids Grant

The HIV/Aids, Tuberculosis, Malaria and Community Outreach Grant (known as the HIV/Aids Grant) evolved from a multi-sectoral approach, focused on integrated support and care to children and young people affected by the virus. The Department of Health was responsible for testing and counselling, the Department of Education took care of life skills programmes in schools and the Department of Social Development was responsible for home-based care.

With the 2004 grant reforms, the grant was introduced as part of the national comprehensive response to the HIV/Aids epidemic, first focusing on the prevention of mother-to-child transmission, and later (2010) becoming one of the biggest antiretroviral funding programmes in the world. The grant has since increased in scope to include several other components, some of which are unrelated to the HIV/Aids pandemic. The rationale for this grant can be summed up as vertical equalisation since the programme supports a national programme, which provinces may not have been able to fund from their own resources.

As such the HIV/Aids Grant is regarded as a schedule 5 (Part A) grant (meaning the functional area of exclusive provincial legislative competence) or a non-matching grant, which should ideally be transferred to a province through a general-purpose transfer (provincial equitable share). However, it appears that the HIV/Aids Grant may have been wrongly classified, since HIV/Aids treatment falls under the health function, which is a concurrent function under schedule 4 (Part A) of the Constitution.

With regard to the other design characteristics, the HIV/Aids Grant appears to have a poorly constructed outcome statement, which is misaligned to the broader national health goals, such as the eradication or reduction of HIV prevalence or improving life expectancy. The outputs are, however, clearly measurable, whereas the conditions only focus on utilisation parameters and exclude eligibility criteria.

[5] National Treasury, 2022. *Budget Review*. National Treasury, Pretoria, South Africa

Human Settlement Development Grant

The Human Settlement Development Grant dates back to 1994. It was formerly known as the Housing Subsidy, which was aimed at providing housing subsidies to low-income earning households as part of Reconstruction and Development Programme. In 2005, the Housing Subsidy and the Human Settlement Redevelopment Grant were amalgamated to form the Integrated Housing and Human Settlement Development Grant, which was changed to the Human Settlement Development Grant in 2010.

The grant is, however, classified as a schedule 5 (Part A) grant in what appears to be a recurring grant classification misstep. Proper classification of the grant is complicated by the unwillingness of provinces to devolve the housing function to municipalities, which are devoting a substantial amount of their own revenue to housing-related services (i.e. water reticulation, roads and stormwater drainage).

Whereas the 2021 Human Settlement Development Grant framework states that the programme is a long-term intervention with an unspecified termination period, the 2010 budget reported that informal settlements would have been eradicated by 2014, spelling the end of the grant. That the grant continues to exist in 2021 is a clear indication of unrealistic target setting, but numerous reviews of this grant by the Commission pointed to continuous underspending and significant under-delivery (FFC, 2016)[6].

Education Infrastructure Grant

The Education Infrastructure Grant was introduced in 2011, following the disintegration of the Infrastructure Grant for Provinces (formerly known as the Provincial Infrastructure Grant) into three sectoral infrastructure grants, including the Education Infrastructure Grant, the Health Infrastructure Grant and the Provincial Roads Maintenance Grant, overseen by National Treasury .

Whereas the establishment thrust of the Education Infrastructure Grant is unquestionable, there is no record of due diligence having been carried out prior to its commencement. Due diligence ordinarily entails estimating the need and costs, implementation capacity and risk assessments, as well as agreement on the expected delivery outputs, among other things.

The Education Infrastructure Grant scored well in respect of measurable objectives in that the grant framework clearly spelled out the expected outputs in terms of numbers, but the actual number of outputs was not set out upfront in the conditional grant frameworks.

The conditions associated with Education Infrastructure Grant were administrative in nature and generally devoid of allocation (eligibility) and spending (utilisation) conditions. They were neither input-based nor output-focused. Put differently, there were no conditions stipulating the criteria for a province to be eligible for the grant, and the inputs to be purchased or outputs to be achieved.

4. Allocation criteria assessment

Equity or fairness in allocation is one of the fundamental principles of the design of fiscal transfers and is a key constitutional requirement.

The allocation criteria for the Education Infrastructure Grant is based on the computed historical shares of the Infrastructure Grant for Provinces (the former Provincial Infrastructure Grant) that was phased out in 2010. The Infrastructure Grant for Provinces itself inherited criteria that was used to distribute the Provincial Infrastructure Grant, incorporating three main determining factors with equal (1/3 each) weightings. These factors include the equitable share formulae, education and health backlogs based on the 1998 school survey of need and the health facility condition report, and the roads component computed based on the provincial

[6] Financial and Fiscal Commission. 2006. *Submission to the 2013 Division of Revenue*. Financial and Fiscal Commission, Midrand.

share of untarred roads (National Treasury 2004)[7]. In later years, a distance factor was added to the criteria to compensate the Northern Cape for the high cost of service provision due to its size, but it is not clear how the component is incorporated into the formula.

As can be deduced the Education Infrastructure Grant's allocation formula is bereft of the school infrastructure-specific needs indicators that are necessary to improve learning outcomes, such as buildings, laboratories, equipment, the territorial distribution of learners, amenities and travel time. By way of observation, the allocation criteria show a significant redistributive bias towards the three poorest and most rural provinces. KwaZulu-Natal, the Eastern Cape and Limpopo accounted for more than 50% of the Education Infrastructure Grant allocations in 2011. The proportional distribution of the allocations continued to change with the passage of time, with funding increasingly shifting away from the rural provinces.

The allocation criteria for the HIV/Aids Grant is based on the provincial share of the population, HIV prevalence and the estimated number of Aids cases. The grant framework is, however, silent on the weightings assigned to each factor in the criteria. The respective provincial distribution of the grant tends to mimic the provincial equitable share, seemingly making the grant criteria population biased. The HIV/Aids Grant has since been expanded with multiple sub-components, each with different allocation criteria. The criteria for some of the sub-components are susceptible to manipulation and lack objectivity. For instance, the allocation criteria for the mental health service component suggest that allocations are based on an approved business plan and a combination of mental health prevalence, where provinces with the greatest need are prioritised, as well as the number of contracted health professionals and defined reduction in mental health backlogs.

According to Human Settlement Development Grant formula, Gauteng and KwaZulu-Natal account for just under half of the Human Settlement Development Grant allocation, in line with high housing in those provinces. As with the HIV/Aids Grant, the total proportional shares mirror the provincial equitable share, despite inadequate housing being weighted at 70% in the formula.

Conclusion

The system of conditional grants in South Africa has been beset by poor design considerations from its inception. Grants are seemingly introduced to manage provincial government's fiscal mismanagement rather than induce certain fiscal incentives, such as encouraging provinces to allocate funds for the maintenance of education infrastructure in the case of the Education Infrastructure Grant or improve integrated spatial planning in the case of the Human Settlement Development Grant using their general-purpose grant.

Conditional grants continue to suffer several design flaws, such as poorly formulated output and outcome statements, lack of pre-grant introductory due diligence to ascertain the size of the need and the timeframe required to address the priority, failure to promote local ownership and endanger continuous reliance on the part of provinces, and an inordinately high number of administrative conditions devoid of eligibility requirements and utilisation conditions in some instances.

[7] National Treasury, 2004. *Budget Review.* National Treasury, Pretoria, South Africa.

The Commission makes the following recommendation:

1. *National Treasury, in conjunction with the national departments responsible for conditional grants, must revise the Division of Revenue Act's system of grant scheduling as it creates no fiscal incentives for provinces to reveal their expenditure preferences or sustain expenditure previously funded by conditional grants. Instead, government must invest the capacity to improve overall grant design, taking account of all good grant design imperatives, such as types of grants and their implications, pre-grant introductory due diligence, sunset clauses, conditioning schemes and allocation methodologies.*

   This recommendation seeks to improve of grant design with the general principles of grant classification, to acknowledge that matching grants in the context of provinces are impractical given the limited revenue-raising autonomy, and to minimise the potential risk of violating the Constitution in respect of financing exclusive provincial mandates.

2. *National Treasury, in conjunction with the national departments responsible for conditional grants, should undertake three-yearly reviews of their respective grants to ensure alignment across grant objectives, conditions and grant outcomes. These reviews must be informed by an overarching conditional grants guideline, setting out the circumstances under which grants are introduced and terminated, applicable minimum and type conditions, and the applicable minimum outputs. Further, there should be a mandatory grant introduction and termination pre-assessment by the Financial and Fiscal Commission to determine suitability, impact on the fiscal framework and overall grant outcome. Grant conditions are generally administrative, while the outputs are seemingly unconnected to the long-run outcomes.*

   The aim of this recommendation is to minimise the long-run objective drift of grants, to minimise overly administrative conditions, improve alignment between output and long-run grant outcomes, and to disincentivise national government departments from itemising funding for concurrent provincial mandates.

3. *The Department of Basic Education, in conjunction with National Treasury, must update the allocation formula for the Education Infrastructure Grant to ensure the alignment of grant needs indicators with grant objectives and further streamline expected and reported grant outputs to improve focus and ease of monitoring. At the very least, the allocation criteria may include learner enrolment, learner densities by area, index of schools with access to learning infrastructure and travel time to schools. The actual formula must be published in the grant framework for transparency purposes.*

   The rationale for this recommendation is to improve allocative efficiency by directing resources where the school infrastructure needs are greatest, as determined by relevant needs indicators.

4. *The Department of health and other custodians of grants with multiple components must halt the over-compartmentalisation of provincial health responsibilities through multiple grant funding windows unrelated to the main objective of the main grant. Conditional grants must, as a matter of principle, accommodate not more than two sub-components or take the shape of a traditional block grant to allow provinces the flexibility to prioritise within the set sub-functional responsibility. Sub-components, which are unrelated to the main grant objective, must be incorporated into the provincial equitable share and be monitored through the normal budget and accountability system instead of subdividing or itemising provincial health responsibilities to be funded by grant sub-components. The formulae for the newly restructured HIV/Aids grant must be published in the grant framework for transparency purposes.*

   This recommendation intends to reinforce the original grant objective, particularly that of HIV/Aids prevention, rather than curative interventions, to foster the expenditure autonomy of the province in respect of managing the disease, to reduce the grant's administration burden and to avoid multiple allocation criteria within the same grant.

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