

# Direct or Indirect Grants? A Case Study of Selected Grants

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## **POLICY BRIEF**

FINANCIAL AND FISCAL COMMISSION 3/2015



# EXECUTIVE SUMMARY

Provincial and local government conditional grants are important for funding infrastructure provision, and can be direct or indirect grants. The share of indirect grants to direct grants is growing. Indirect grants are mostly used to fund infrastructure because, historically, municipalities have not performed well in developing infrastructure. With indirect grants, national government implements the infrastructure on behalf of municipalities that lack capacity. This may result in service delivery but carries the risks of weakened accountability and poor maintenance budgeting. To establish whether changing the form of conditional grants improves performance, the Financial and Fiscal Commission (the Commission) undertook a study to assess the funding and performance of specific education, health, sanitation and electricity-related conditional grants. The study found that provinces and municipalities appear to be better than national government at ensuring grant funding is spent. The Commission recommends that indirect grants be used only as a last resort, that clear criteria for rescheduling conditional grants (from direct to indirect and vice versa) be developed, and that comprehensive capacity-building plans be developed in cases where indirect grants are used.

## BACKGROUND

Intergovernmental fiscal transfers are a dominant feature of public finance in many countries (including South Africa) that have more than one sphere of government and where national government raises more revenue than subnational governments. Provincial and local government conditional grants are important for funding infrastructure provision, and are either direct or indirect. In the case of direct grants, funds are transferred to the subnational government to be spent for a specific purpose, whereas with respect to indirect grants, the national government department or public entity performs a function on behalf of the subnational government. Thus the province or municipality concerned receives no funds but will be responsible for the maintenance and operations of any infrastructure developed.

Over the past five years, the share of indirect grants to direct grants has increased at a phenomenal rate, from 3.9% in 2011/12 to 6.4% in 2013/14, and is projected to reach 8.9% in 2016/17. Indirect grants are mostly used to fund infrastructure because, historically, municipalities and provinces have not performed well in developing infrastructure. This practice – of national government implementing the infrastructure on behalf of municipalities that lack capacity – may result in service delivery but carries risks. These include weakened accountability and poor maintenance budgeting and planning. To establish whether changing the form of conditional grants improves performance, the Financial and Fiscal Commission (the Commission) undertook a study to assess the funding and performance of specific education, health, sanitation and electricity-related conditional grants.

# RESEARCH FINDINGS

The research found that provinces and municipalities appear to be better than national government at ensuring grant funding is spent. In some instances, determining the actual performance is difficult because the data relating to targets and actual delivery is either not available or incomplete. However, the available data revealed the following:

- The indirect education grant partially achieved its targets.
- Reporting on the health grant outcomes was not aligned to targets.
- The electrification indirect grant performed better than the direct grant. This could be because this grant is implemented by a specialised agency (Eskom), not a national sector department. The direct grant was used by municipalities to achieve 83% of household connection targets in seven years. This good performance could be because municipalities have been implementing these projects for a number of years.
- The sanitation indirect grant performance improved. It is too early to determine the performance of the direct component.

**Table 1. Financial and non-financial performance of selected infrastructure grants**

Sector	Grant category	Financial performance	Non-financial performance	Recent developments
<b>Education</b>	Direct (EIG)	Good	Cannot be directly determined	
	Indirect (SIBG)	Poor	Poor	Reduced in 2015 Medium Term Expenditure Framework because of poor performance
<b>Health</b>	Direct (NHG)	Good	Cannot be directly determined – non-alignment of targets and delivery	
	Indirect (HFRG)	Poor	Cannot be directly determined –non-alignment of targets and delivery	In 2013/14, R167-million was converted to direct grants to KwaZulu-Natal and Northern Cape provincial health departments. In 2014/15, R262-million shifted to the direct grant.
<b>Electrification</b>	Direct (INEP)	Good	Good	
	Indirect (INEP)	Good	Good	
<b>Sanitation</b>	Direct (RHIG)	Cannot be determined (2013/14)	Cannot be determined (2013/14)	Direct component introduced in 2013/14.
	Indirect (RHIG)	Poor (but improving)	Poor (but improving)	

Reasons for the poor performance of indirect conditional grants include a lack of capacity at municipal, provincial and even national level, and poor planning processes.

# CONCLUSION

Provincial and local government conditional grants are key for funding infrastructure provision and reducing infrastructure backlogs in various sectors, including education, health, sanitation and electrification. Indirect grants to provincial and local governments are increasing at a faster rate than direct grants, but direct grants financially outperform indirect grants (except for the electrification indirect grant, which is implemented by an agency and not a national sector department). Part of the problem is that no principles exist to guide the classification or reclassification of grants from direct to indirect (and vice versa). The Commission therefore recommends that:

- National Treasury and line departments use indirect grants only as a last resort, while continuing to build capacity in provinces and municipalities.
- Clear criteria are developed for rescheduling conditional grants (from direct to indirect and vice versa) that take into account the historical financial and non-financial performance. The responsible government sphere should be given at least three years to administer a direct grant before conversion to an indirect grant is considered.
- Where indirect grants are used, comprehensive plans to build capacity within the province or municipality are developed, with clearly determined targets and time-frames.



Provinces and municipalities appear to be better than national government at ensuring grant funding is spent.

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