



A Report on the Third Tranche Action – C iii

**REVIEW REPORT ON THE CONDITIONAL GRANT SYSTEM
WITH SUGGESTIONS FOR IMPROVEMENT AND INSTITUTIONALIZATION**

November 2006

Provincial Finance Commission
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PREFACE

It gives me immense pleasure to state that recently the Provincial Finance Commission (PFC) had announced its new distributional formula for the conditional grant under Sindh Devolved Social Services Program (SDSSP). The announcement of new formula and subsequent distribution of the grant under it, shows that PFC now stands on a sound footing and that the Government of Sindh is committed to achieve the Millennium Development Goals (MDGs).

This report reviews the conditional grant mechanism and new distribution formula and gives suggestions for their improvement and institutionalization. This review would enable the PFC to further align its approach towards addressing the needs and targeting the priority areas. I hope that Government of Sindh with the active support of local governments and development partners would be able to institutionalize just and equitable grants distribution mechanism to improve the living standard of people of Sindh.



M. A. Jalil
Advisor to Chief Minister on Finance/
Chairman PFC

PSU - SDSSP
Finance Department, Govt. of Sindh
Diary No. 4806
Forward Date 19/08/06



Program Support Unit
Sindh Devolved Social Services Program
Finance Department, Government of Sindh




NOTE FOR ADVISOR TO CHIEF MINISTER ON FINANCE

Provincial Finance Commission (PFC) has reviewed conditional grant mechanism and has prepared a report (Flag-A). The report gives suggestions for its improvement and institutionalization. A peer review of the report by Decentralization Support Program and PFC secretariat on the suggestion of the ADB Mission in June 2006 has also been made and their suggestions have been incorporated.

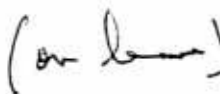
2. The report requires provisional approval of the Chairman Provincial Finance Commission for submission of the same to Asian Development Bank (ADB) as one of policy objective i.e., third tranche action 3.3 of Sindh Devolved Social Services Program (SDSSP). The report would be presented to the PFC for final approval in next session.


3. Submitted for your perusal and signature on preface please.


Abdul Kabir Kazi
Program Director

 3. / 8 / 2006

4. Special Finance Secretary (Dev/SR)

5. Secretary Finance 

6. Chairman PFC 

PSU - SDSSP
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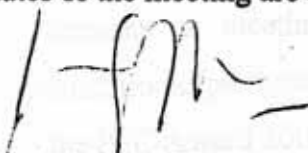


No. PSU/SDSSP P/C.G-1/01/2006
Karachi, dated 12th July 2006

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Subject: MEETING TO REVIEW PERFORMANCE GRANT SYSTEM AND SDSSP'S
CONDITIONAL GRANT MECHANISM.

A meeting was held on 12th July 2006 to discuss Performance Grant System and Provincial Finance Commission's report on the review of SDSSP's Conditional Grant Mechanism at Provincial Support Unit- Sindh Devolved Social Services Program. Minutes of the meeting are attached for kind information and necessary action please.


MUHAMMAD IQBAL MEMON
DEPUTY PROGRAM DIRECTOR

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Program Support Unit
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**MINUTES OF THE MEETING REGARDING REVIEW OF PERFORMANCE GRANT
SYSTEM AND SDSSP'S CONDITIONAL GRANT MECHANISM
HELD ON 12TH JULY 2006**

(LIST OF PARTICIPANTS ATTACHED)

A meeting was convened to discuss performance grant system and PFC's report on review of SDSSP's conditional grant mechanism on 12th July 2006 at PSU-SDSSP.

Following decisions were made in the meeting:-

1. The participants reviewed and discussed PFC's report on review of SDSSP's conditional grant mechanism.
2. PD, DSP mentioned that a four members committee comprising of PD DSSP, PD DSP, AS LF and Team leader DSSP Coordination Team, constituted by Special Finance Secretary (Dev/SR), unanimously agreed on the performance grant criteria, which would be collected by PD DSP and sent to PD DSSP for review.
3. The LF wing will move a file wherein a request will be placed to Chairman PFC to convene a meeting of PFC in order to finally approve the principles of conditional/performance grant mechanism. The decision of PFC on grant design of the PFC Award 2006-07 and SDSSP conditional grant would be final.
4. Review of SDSSP's conditional grant mechanism will incorporate the final decision of PFC.
5. PD DSP will request DSP's consultant to prepare the M&E proposal on the methodology to evaluate the TMAs and distribution mechanism of the performance grant reserved under the final grant design?



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6. It was also decided that in view of the inequalities prevalent amongst the DGs and TMAs, LGs would be categorized on the basis of their strengths and weaknesses and subsequently they would be placed in a particular category/group. The consultant DSP will propose the categories/groups of each TMA and DG and the PFC would finalized it as the purpose of having a performance grant system is to reward the best performers on one side and to assist the weaker institutions through constant monitoring and technical assistance in order to enhance their capacity and capability to perform well.
7. It was further decided that before the finalization of conditional/performance grant mechanism PFC secretariat would consult P&D, Education and Health departments.



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Program Support Unit
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Finance Department, Government of Sindh



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Review of Conditional Grant Mechanism

Introduction

To achieve Millennium Development Goals Government of Sindh has adopted a conditional grant mechanism for distribution of Sindh Devolved Social Services Program (SDSSP) funds. This report reviews this mechanism and proposes suggestions for its improvement and institutionalization. It also discusses existing types of tied / conditional grants and distribution criteria. A detailed section on monitoring and evaluation of conditional grants discusses suggestions for performance measurement. In the section on institutional analysis functioning of PFC, institutionalization of conditional grants, and its requirements are discussed. At the end there is conclusion.

A Typology of Grants

When local governments are expected to play a major role in delivering social services, they inevitably depend in large part on provincial fiscal transfers to do so. The design of intergovernmental grants (henceforth Grants) takes two different approaches on the basis of a parameter 'liberty to use that grant', These approaches are:

1. Unconditional block grants
2. Conditional grants

Unconditional Block or Discretionary Grants

Local governments determine use of these grants, provided that it is consistent with their mandated functions. These are simple lump-sum transfers with no conditionality other than the usual financial auditing (Shah 1994). Their primary objective is to ensure that all regions have adequate resources to provide services at acceptable minimum standards.

Conditional or Sector/ Purpose/Project-Specific Grants

These transfers are made only if governments have met a number of prescribed requirements e.g. provision of a certain level of service. These grants are earmarked for specific types of expenditure or services and are used for the same.

Rationale of Conditional Grants

The rationale for conditional grant funding arises from the fact that important types of investments—including social sector investments—will not be made optimally by governments (in this case local governments). It has been noted that local governments in Sindh spend more of the development funds on projects having high visibility such as construction/repair of roads. Thus, situation in Sindh makes it appropriate to use conditional grants. Bird and Fiszbein (1998) say that the risk of neglect by local governments of priority expenditure may not always be considerable. However, as a general rule, in the circumstances of most developing countries where

the agency model¹ seems applicable, some conditionality often seems desirable - particularly when the local governments provide services such as education and health. This suggests the need to impose provincial preferences and selectively introduce conditional (earmarked) financing mechanisms to address these concerns by eliminating the 'opportunity cost' (since the funds cannot be used for other purposes) in the local decision-making process. Therefore, Government of Sindh tied SDSSP Grants to poverty-related investment expenditures i.e. expenditure on education, health and water and sanitation- three most crucial sectors for poverty reduction.

Downside of the Conditional Grants

Two main arguments against conditional grant mechanisms are: i) they may undermine the local autonomy, ii) put extra strain on LGs by adding to their accounting and reporting requirements. These problems are not considerable usually but aggravate when i) there is a predominance of conditional grants in the financing of LG budgets, ii) in the planning of sector guidelines and policies LG structures are not involved and iii) policy goals are inappropriate and reflect inadequate understanding of local issues.

Degree of Tying/Earmarking

Earmarking may be very specific, with little or no discretion (e.g. for teachers' salaries), or more generic, allowing greater local discretion (for education, for example). The degree to which a government acts as an agency or plays a principal role depends on how closely such grants are earmarked.

Presently, under SDSSP, a single resource envelope is provided to local governments and it is up to their discretion to divide it among relevant sectors. Districts allocate SDSSP Grant between education and health themselves and TMA do the same for allocation between water supply, sanitation, and solid waste management. Thus, along with provincial control a good deal of independence is given to local governments.

However, there is a need of reducing the current independence levels and tying the SDSSP Grant more tightly. One important goal, which conditional grants can achieve, is of creating consistency with the provincial government's Poverty Reduction Strategy as laid in Sindh Poverty Reduction Strategy Paper (PRSP) (2002). Principles of use of SDSSP Grant can be designed in a way to achieve goals set by PRSP and Millennium Development Goals² (MDGs). For example, instead of making money available for whole of the education sector, it can be tied only to the primary education. Similarly, within health sector emphasis should be on maternal and child

¹ In a principal-agent framework, the agent (local governments) may take undue advantage of information asymmetry between him and the principal (the provincial government).

² MDGs relevant with SDSSP are (see <http://www.un.org/millenniumgoals/>):

- Goal 1: Achieve universal primary education
- Goal 3: Promote gender equality and empower women
- Goal 4: Reduce child mortality
- Goal 5: Improve maternal health
- Goal 6: Combat HIV/AIDS, malaria, and other major diseases (e.g. tuberculosis)

health and control of diseases like AIDS, malaria, and tuberculosis. TMAs may be asked to concentrate on drinking water supply.

If local discretion is not to be sacrificed at the altar of exact targeting, one way to direct allocations towards attainment of MDGs is by incentivizing local governments through performance-based transfers. The transfer of some part of the conditional grant on performance basis can be made where performance measurement considers progress towards achievement of MDGs.

The linkage of SDSSP Grant with PRSP's goals and MDGs can bear fruit if conditional grants are a considerable part of total grants. The present amount of SDSSP grant (Rs. 1.9 billion p.a.) is not sufficient enough for achieving these goals. There can be two solutions to this problem:

- 1) Increasing the amount of conditional grants.
- 2) Making conditional grants available only as a matching grant (explained below). In this case, it will be available as additionally to only those local governments that allocate a certain amount of their revenues for social sectors. Thus it will ensure enough expenditure on pro-poor sectors. However, this may exclude some poor local governments who may fail to make required allocations.

Matching Grants

Both conditional and unconditional grants can be further sub-categorized. An important one is categorization by their being lump sum or matching grants.

Bird and Smart (2001) recommend that some special purpose grants should likely have a matching component. The rationale behind matching grant is that of correction of problem of positive externality. Positive externality results if the benefits of a certain local activity spill over to other jurisdictions, which are not considered while deciding level of expenditure on that activity. In general, positive externalities will be under provided. Matching grants are a form of “Pigouvian” subsidy given for incentivizing expenditure on programs (for example public education) that are locally administered but which have positive spillovers (Oates 1999). Similarly, if a provincial government wishes to use its scarce budgetary resources to attain given standards of expenditure on certain services provided by LGs, it should pay only as much of the cost as is needed to induce each LG to provide that level of service.

Matching Rate

The correct matching rate, or the proportion of the total cost paid by the provincial government, should, principally vary across LGs by the size of the spillovers, the strength of the preferences of the provincial government and LGs for the aided activity, fiscal capacity³, need and cost differentials. An example of such a system is in Zambia, where local governments receive a transfer, which equals the difference between the estimated cost of providing a specified level of local services, and the

³ Income may be only loosely related to the level of per capita income or regional GDP. In this case other appropriate indicators should be selected.

expected revenues to be raised locally by applying a standard set of local tax rates (Bird and Smart, 2001).

As above discussion shows, the basic problem with the matching approach is that it is quite demanding in terms of information, which PFC currently lacks. Nevertheless, PFC is carrying out studies to gather this information.

Conditional Grant Distribution Mechanism

For intergovernmental transfers to fulfill their role efficiently, it is important to design them appropriately. The transfers must be formula-based to preclude ad-hocism. The formula should be simple and basing upon generally accepted indicators to make transfers transparent, credible, and free from maneuvering. Moreover, a multiple-indicator based formula is better because it would cater for the jurisdictions receiving fewer resources from a single indicator based formula.

For making such grants effective it is necessary that they be needs and performance based. For example, if education levels in some jurisdictions are desired to be increased then it is necessary to appraise the present over all situation of education facilities so that these jurisdictions can be assisted. Needs of a government are reflected by many indicators such as population, area, backwardness, poverty etc. Needs assessment can be done in a more general way by estimating per capita incomes, gross regional product (GRP), level of infrastructure, level of social service delivery, and level of consumption etc.

To ensure transparent and objective transfers to LGs, these funds are also routed through Provincial Finance Commission (PFC). As these funds were required to be transferred to the district governments and TMAs over and above the regular transfers, these were not included in the over all Provincial Consolidated Fund. Therefore, a separate multiple indicators based formula was devised by PFC. The evolution of distribution formula can be seen from table below:

SDSSP Grant Distribution Formula

Indicator	2004-05	2005-06	2006-07
	Percent (%)		
Population	50	50	50
Backwardness	30	30	40
Equal Share	20	10	0
Performance	0	10	10

Population shares are taken from Population Census 1998. The indicators of backwardness and performance are discussed below.

As the above distribution formula shows, effort has been made to cater the needs of all the local governments by using a multiple-indicator based formula. PFC has been constantly reviewing the formula. Starting from the first year’s formula PFC has made efforts to improve the formula. In the second year (2005-06) the criterion of performance was included to reward better performers and weightage of ‘equal share’ was reduced as needs levels (which SDSSP tries to target) of LGs differ markedly. In

the third year (2006-07), under demands of LGs, weightage of 'backwardness' is increased by 10 percent and 'equal share' is eliminated.

The present formula lacks one important criterion: the factor of differences in (per unit) cost of service delivery. Among other factors, cost of service provision increases in a sparsely populated area. This is particularly true in case of water supply. Therefore, such TMAs may be compensated for comparatively high costs. However, no accurate information of area is available currently. This may be a future reform avenue.

It should be noted that setting of formula is a trial and error process and the perfect formula could likely be determined only after some period after observing the results of different formulas and adjusting them to approximate more closely to the desired outcomes.

Modification of Backwardness Index Used for SDSSP Grants

Old district backwardness index, which was formulated by SPDC (2003), uses four groups of indicators viz.: Education, Housing Quality and Congestion, Residential Housing Services and Employment. While, old TMAs' backwardness index⁴, which was formulated by PFC (2003), uses indicators of Illiteracy, Semi *Pacca* Houses, *Pacca* Houses, *Kacha* Houses, Households without Water, Households without Electricity, and octroi collection.

The above indices are inappropriate for the purpose of SDSSP. Inappropriateness is used here in the sense of miss targeting with respect to the goals of SDSSP⁵. As Bird and Smart (2001) note, transfers intended to finance particular types of service are often linked to particular measures of need. As SDSSP targets only education and health at the district level and water and sanitation at the TMA level, there is a need that present system of allocation, on the basis of indices of backwardness which considers sectors outside the purview of SDSSP, is abandoned and new indices using only relevant sectors be used. The benefit of considering only SDSSP-relevant sectors is that instead of giving more money to such backward local governments that lag more in SDSSP-irrelevant sectors greater resources will be transferred to local governments that lag more in the SDSSP-relevant sectors. Thus investment will be more targeted and consistent with SDSSP's objectives.

Following methodology has been employed for the proposed indices for districts and TMAs. As no new reliable data source is available, Population Census of 1998 is used. For new districts and TMAs data of their parent district/TMA regarding backwardness have been used.

⁴ It is interesting to note that TMAs where there is low electricity provision have been getting more money despite the fact that they cannot take any remedial measures, as electricity provision is not their function. Similarly, education is a function of districts and not of TMAs.

⁵ The backwardness index of TMAs suffer from one more defect in that it considers sectors which are not the functions of TMAs i.e. electricity and education.

Backwardness Index for Districts

The new proposed Index uses information about two relevant sectors i.e. education and health only. Details about each sector are as under:

Education Index

New index also uses the same indicators for education as used in previous PFC Awards⁶ i.e. of Illiteracy Rate in percentage (10 years and above) and Out of School Children in percentage⁷ (5-9 Years). These indicators are widely used for example by UNDP in her Human Development Reports (see e.g., HDR 1997). As SPDC (2003) notes, they depict current and future levels of deprivation.

The education index is constructed by taking simple arithmetic mean of all four indicators.

Health Index

The only available health related service delivery outcome indicator in the Census is the number of immunized children below the age of 10 years. One problem with this indicator is that instead of two exclusive categories there are three different categories of the children i.e. 'vaccinated', 'not vaccinated' and 'not known'. This is problematic because 'not known' would include both 'vaccinated' and 'not vaccinated'. We assumed that there are same shares of 'vaccinated' and 'not vaccinated' in 'not known' as the shares of 'vaccinated' and 'not vaccinated' in 'known' ('vaccinated' + 'not vaccinated').

It is recognized that above is an interim solution and there is a need for better indicators of need for health spending like Maternal Mortality Rate, Infant Mortality Rate, number of infants, poverty count etc.

Engendering the Indices

The gender disparity is incorporated taking these measures separately for male and female population. Indicators using totals give different weights to each component. Using each component separately gives equal weight to each component and thus component with low share in total is benefited (women in the present case).

Backwardness Index for TMAs

In the case of TMAs, the indicator of households without water is proposed to be used. This indicator is already being used by PFC but as a member of a group of indicators. Now it is proposed to be sole indicator of backwardness of TMAs. This is desirable because most of the SDSSP Grant to TMAs goes to Water Supply Sector and because sanitation facilities correlate with water supply service delivery.

⁶ See PFC (2003, 2004,2005).

⁷ Children between the ages of 5 to 9, who never attended the school, are taken to compute out of school children at the primary level.

Formulae of the Backwardness Indices

The backwardness index of districts is constructed using the same formula as being currently used in PFC Awards. The methodology is same as used in Human Poverty Index of UNDP. The index is constructed as:

$$P(\alpha) = \left[\left(\frac{1}{2} \right) E^{\alpha} + \left(\frac{1}{2} \right) H^{\alpha} \right]^{\frac{1}{\alpha}}$$

Where E is the education deprivation index, H is the health deprivation index and α is the weight ($\alpha=1$ is used). The technical detail is provided in the UNDP Human Development Report (1997).

For TMAs, backwardness is measured by

$$\text{Backwardness Index} = \frac{\text{Percentage of households without water in a TMA}}{\text{Sum of percentages of households without water in all TMAs}}$$

Share of DGs and TMAs in DSSP Funds

Within the local tier the distribution of SDSSP funds are distributed among districts and TMAs in 70:30 ratio. It is up to the discretion of LGs to divide the amount available among different sub-sectors.

Criteria for Obtaining Sindh DSSP Grants

To ensure that the money is properly spent, recipients should satisfy pre-specified conditions. The conditional grant mechanism of SDSSP also lays down, through MOU, many conditions which are necessary to comply with for obtaining grants. These are discussed below.

Grants will be available to LGs only if they prepare Annual Sector Plans (ASPs). As the grants are conditional and can be used in only Education and Health sectors by DGs and in Water Supply, Sanitation and SWM sector by TMAs, districts, and TMAs have to submit their ASPs for their respective sectors. These ASPs must clearly indicate the plans and their source of financing prepared for the entire sector (schemes under SDSSP funding and other funding). The ASPs shall be a part of the Annual Budgets of the LGs and shall be approved by the District/TMA Council, as per the provisions of the SLGO (2001).

There are further general and sector specific restrictions on the utilization of these grants.

Conditions for DGs

- In Education, the grants can be used for covering all schools from Katchi up to Class 10 and Class 12 in few Higher Secondary Schools but not for colleges.

- In Health, the scope ranges from Community Health Facilities to District Hospitals.
- District Governments shall allocate 15% of funds in financial year 2005-06, and not less than 25% in year 2006-07, for expenditure through Community Based Organizations (CBOs).

Conditions for TMAs

- TMAs shall allocate an expenditure of not less than 10% of funds in year 2006-07 through CBOs.

General Restrictions

- LGs shall use the conditional grants in the first instance, only for rationalization / operationalization of existing services/schemes/projects and to invest in new services /schemes/projects only if there is a clear technical and financial feasibility plan of how it would be sustained.
- The recruitments should be need / facility based with preference to the locals especially females.
- LGs shall not use the conditional grants on luxury items except wherever necessary.
- LGs shall not invest more than \$100,000 (approximately Rs 5.7 million) from the funds provided under DSSP in any one scheme / project / activity.
- Local Governments shall use these funds for pro-poor, gender balancing projects, investments, schemes, and their feasibilities should clearly identify measurable benefits to for the poor and women.

There are some ambiguities in the above conditions, which need to be rectified. For example, what is considered a *new* scheme must be explained. As per Budget Rules, any scheme with no previous expenditure is a *new* scheme. While for the purposes of SDSSP, any scheme involving, for example, construction of a new facility is a *new* scheme. Moreover, the difference between scheme, project, and activity needs to be mentioned. In addition, it must be made clear that whether LGs can contribute in a scheme costing more than Rs. 5.7 million.

Flow of Sindh DSSP Funds

A proper structure of flow of funds available through SDSSP is in place. SDSSP Grants are routed to district governments' Account-IV and Local Fund Account of TMAs according to the shares of the respective districts and TMAs as prescribed by PFC. These funds are non-lapsable.

Monitoring and Evaluation

Bird and Smart (2001) note that money is fungible, so even transfers based solely on need and capacity measures do nothing to ensure that the recipient governments will in fact use these funds as per provincial government's preferences unless grant is conditioned on performance and compliance is monitored.

Therefore there is a need to measure performance of the LGs to i) monitor progress against goals of SDSSP and results of different actions and schemes, ii) enable LGs to compare with each other and over time and explore what works best; iii) integrate with other elements of the wider accountability framework (e.g. policy agreements, policy guidance, regulation and inspection).

Government of Sindh recognizes the importance of accountability of local governments to their communities and the need to develop a performance measurement system. Therefore, PFC has introduced performance-based grant system. Consequently, it has been decided to make performance based grant a component of both transfers from Provincial Allocable Fund (5%) and SDSSP Grant (10%) on the basis of same criteria.

There are many issues to consider in performance measurement, which is discussed below.

Performance Measurement

First and the foremost issue in any performance measurement system (PMS) is deciding what are the indicators to measure performance against? There are two sets of broad measures for performance measurement of local governments:

- Community measures that describe the state of a community in areas such as education and health.
- Organizational measures that describe the performance of a LG as an organization. They address the outcomes of a LG's management in areas such as financial management.

It would be ideal, however, to include both community measures and organizational measures in any PMS. There may be other mechanisms to improve performance of LGs other than monetary benefits to high performing LGs. There may be genuine problems with low-performing LGs like lack of management capacity or some unforeseen upheavals. In these cases, Govt. of Sindh must try to bring these LGs at par with others through their capacity development. Some LGs may willfully perform badly warranting suitable administrative action against them. In this regard MOU has the following provision:

“[MOU] can be terminated either by mutual agreement of the Parties or by the GOVERNMENT OF SINDH if it has demonstrable reason to believe, based on the advice and recommendation of the Provincial Program Steering

Committee, that the [LG] is not fulfilling its obligations as laid out under this MOU.”

According to Section 132 of the SLGO (2001), Provincial Local Government Commission (LGC) is responsible, inter-alia, for annual and special inspections, inquiries, special audits, annual performance report, review of development schemes, and oversight of the local governments. PFC has requested LGC to undertake monitoring and evaluation of SDSSP Grants through instruments such as Public Expenditure Tracking Surveys and Quantitative Service Delivery Surveys. PFC will also ensure through SDSSP to make Quarterly and Annual Performance Reviews as required by the MOU. SDSSP has already initiated Third Party Validation exercise, which will contribute towards such reviews.

Earlier, in year 2004-05 the PFC had decided to transfer whole share of a LG in single installment. After review in 2005-06, the PFC has decided to transfer SDSSP Grant in two equal tranches. The second tranche will depend on satisfactory utilization and performance of a LG.

Indicators for Performance

There can be different types of indicators of performance, which are described below. A good PMS must constitute a combination of these indicators. For each type of these indicators there are many different indicators, which can be used to judge better performance. Which indicator is chosen depends upon its fulfillment of conditions for a good indicator and preferences of policy makers.

1. Input Indicators: resources used to produce an output
2. Output Indicators: quantity of units produced under managerial control
3. Efficiency Indicators: inputs used per unit of output
4. Service Quality Indicators: how satisfied customers are and how accurately and timely a service is provided
5. Outcome Indicators: what are qualitative consequences associated with a program/service e.g. increased literacy, decreased MMR.

Whatever type of indicator is used, it must be SMART i.e. specific, measurable, achievable, realistic, and timed. Such an indicator should also be resistant to perverse behavior.

Indicators for Performance Measurement

I- Community Indicators

These are mostly output and outcome indicators. Separate indicators for DGs and TMAs are listed below:

1-Indicators for District Governments

Some key indicators should be identified for incentivizing within Education and Health. Following indicators from education sector may be selected:

- Overall growth in primary enrollments
- Growth in female primary enrollments
- Gap in enrollments rate of between girls and boys (to be penalized)
- Reduction in out of school children or in drop out rate
- Reeducation in Ratio of pupils to teachers
- Improvement in attendance rates

Similarly in health sector following indicators may be selected:

- Growth in number of patients treated.
- Growth in number of deliveries by trained attendants or growth in number of women registered for antenatal care.
- Growth in number of immunizations.

Moreover, it needs to be decided that what weights have to be given to performance of each of above sectors in overall performance measurement.

2- Indicators for TMAs

Some of the indicators related to water supply, sanitation and SWM are described below:

- Growth in number of water connections
- Reeducation in distance from most nearby water source
- Increase in percentage of population with access to safe drinking water
- Increase in percentage of houses with sewerage facilities
- Growth in weight of refuse collected per capita

Service delivery performance, for both DGs and TMAs, can also be measured by qualitative client surveys.

II- Organizational Indicators

These are mostly input and efficiency indicators. Below we list some of these indicators. Note that, the same type of organizational measures as in the case of DGs can be used for TMAs as well. The only difference will be that education and health will be incentivized on DG level and WSS at TMA level.

A - Expenditure Rationalization and Management

1-Timely Completion of the Development Schemes

It has been observed that often schemes are started to gain political popularity but its completion is delayed due to lack of competence or motivation. To encourage that a LG completes its schemes timely, incentive can be provided in shape of reward to the LGs who utilize higher percentage of available funds.

To prevent LGs to initiate new schemes without completing on-going schemes, it is suggested to incentivize low percentage of throw-forward.

2- Cost Efficiency

Given high level of profligacy in public sector expenditures, those LGs could be rewarded which provide services with lower cost. However these costs may be varied due to topography and/or size of a LG.

B- Fiscal Effort

1- Cost Recovery

To run the operation of services with sustainability, it is crucial to gain a satisfactory level of self-financing. To enable LGs to bill and collect charges against services efficiently, cost recovery can be used as an incentive.

C- Investment Choices

1-Priority Attached to the Social Sector

LGs attaching greater priority to expenditure in social sector (education and health for DGs and water supply, sanitation and solid waste management for TMAs) may be rewarded more. For this purpose either development social sector expenditure as a ratio of total expenditure can be taken or alternatively total social sector expenditure as a ratio of total expenditure can be compared.

2- Greater Allocation for Development Expenditure

Performance may be measured by level of development expenditure within the social sector (i.e. ratio of social sector development expenditure with total social sector expenditure) as this reflects the amount of money translating into higher flow of services to the community in future.

Non-salary expenditure may be used, but using development expenditure seems more fitting.

3- Pro-Poor Investment

Poverty is a curse, which precludes poor to enjoy bare essentials of adequate standard of living. Thus, pro-poor investment (an input indicator) must be an integral part of any PMS.

3a- General Measures

General indicators are proposed to be used for assessing pro-poor investment regardless of gender. It is proposed that primary health care, primary education and water supply may be incentivized as three fields of investments.

Following indicators may be used:

- Investment in primary health care as a percentage of development expenditure on health

- Investment in primary education as a percentage of development expenditure on education
- Investment in water supply as a percentage of development expenditure on whole of the social sector

3b- Engendered Investment

Women are worse hit by poverty and prone to discrimination in every walk of life. Concerted efforts are needed to uplift the social status of them. Incentivizing investments which benefit women (directly) will be a major consideration while deciding the grant indicators may be used:

- Investment in maternal care as a percentage of development expenditure on health
- Investment in girls education as a percentage of development expenditure on education

The aforementioned indicator “Investment in Water Supply” can also be used as an indicator showing improvement in women’s condition, as in most of the rural Sindh it’s the task of women to fetch the drinking water often from distant sources.

4. Proper financial management, compliance to rules and reporting:

To be able to sustain high levels of service delivery, it is necessary for LGs to manage their financial affairs adeptly according to Sindh Local Government Ordinance (2001) and Budget Rules (2002). MOU states,

“THE [LG] in using the conditional grant funds, shall follow all the planning, budgeting and approval processes outlined in the Sindh Local Government Ordinance, 2001 and other relevant rules including the Budget Rules”

PFC has circulated proformas given in Fiscal Transfer Rules (2004) on which LGs have to report about their finances. Moreover, they have to comply with all the reporting requirements of SDSSP like PC-I, scheme status report, scheme completion report, Statements of Expenditure,⁸ and budgetary information etc. However, all of LGs have not complied. Therefore, performance should also be measured on this front and LGs be incentivized for proper financial management and compliance to rules and reporting requirements.

Performance Based Conditional Grants

Performance based grants, given as an incentive for improving performance of the LGs, may use a combination of different criteria stated above (giving them different weights).

$$\text{Performance Formula} = X \% (\text{Criterion A}) + Y \% (\text{Criterion B}) + \dots$$

⁸ The MOU of SDSSP, requires LGs to prepare Statements of Expenditure for the DSSP funds and cause them to be audited.

Problems in Performance Measurement

If performance grants have to be given annually, ideally an annual performance measurement should be carried out. But the indicators may not be available annually. Thus some old indicators may have to be used until new surveys are carried out.

In Karachi, Water Supply and Sanitation doesn't falls under the purview of TMAs. Karachi Water and sewerage Board performs this task. TMAs of Karachi undertake solid waste management (SWM) activities only (except some repair of pipes and drains). Thus in sector specific measures, apples have to be compared with oranges or some amount may be reserved for Karachi TMAs and be distributed according to performance in SWM.

Institutional Analysis

There are a variety of practical institutional arrangements that might be engaged to facilitate the implementation of a conditional grants system. First two general issues of PFC's independence and its working approach are discussed (as they have implications for conditional grants) then we discuss issues specific with conditional grants.

Institutionalization of Conditional Grant

Conditional grants need to be a permanent feature. Building on SDSSP experience, for Gender Reform Action Program (GRAP) too, conditional grants will be released through PFC. Moreover, the amount of such grant may also be increased. In some countries, like Indonesia (Shah and Qureshi 1994), conditional grants constitute a major chunk of total grants.

Two issues, which one confronts in institutionalization, are the data requirements and legal framework of conditional grants. These are discussed below.

Data Requirements

The assessments on which PFC might recommend conditional grant distribution can be as narrow or as extensive as the available data permit. The data required are of two types—those relating to the accounts of the recipient governments, and those relating to the assessments of revenue capacities, expenditure needs and unit costs of providing services (or their acceptable proxies).

The attributes that make some data more appropriate than others are: availability of data for all LGs⁹, its comparability across all LGs, accuracy and regular collection (Ahmad and Searle, 2005).

The accounts data should be based on audited past period data if possible, as this removes the “grant design inefficiencies” which result from natural tendencies to

⁹ If not, it must be possible to use the data for one LG for others. This is sometimes possible when measuring differences in unit cost, but rarely otherwise.

underestimate revenue collections and overestimate expenses when budgeting. Presently, PFC uses no accounts data in conditional grant formula. The practice of late completion of audit and a mismatch in time of availability and requirement of data may explain this non-usage. There is a need of coordination between Accountant General Sindh, Director Local Fund Audit and PFC so as to enable PFC to know revenue and expenditure patterns and check any malpractices.

Though accounts data is not being used in conditional grant formula, a conditionality under SDSSP Loan requires LGs to maintain their social sector expenditures as a proportion of revenue at the level of fiscal year 2003-04. Data is being collected in this regard. However, information provided is not very accurate particularly in case of the TMAs. PFC intends to pace up its efforts in this regard.

For revenue assessments, estimation of base of the revenue source (e.g. value of the property in case of property tax) will be necessary. Decentralization Support Program (DSP) is presently undertaking such an exercise in Sindh. But often collection of such data is difficult and direct measures of a revenue base are not always available. In these cases, general measures of economic activity (such as GDP, household income, or value added) sometimes need to be used.

Similar lack of data is present in case of expenditure needs and cost of service delivery. DSP's study will also try to estimate costs differentials. However, the most crucial of all such data, as far as SDSSP's conditional grants are concerned, is of expenditure needs. Though there are some other latest surveys, the most acceptable source of data on service delivery/usage remains to be Population Census 1998. There is a dire need to have a more frequent database available particularly of education, health and water and sanitation. Though present efforts to assess revenue capacities and cost of service delivery are commendable, there is a need to institutionalize such efforts by assigning these tasks to Bureau of Statistics.

Legal Framework

Constitution, laws and regulations codify the formal rules of the game by which a decentralized system is supposed to function. The constitution should be used to enshrine the broad principles on which decentralization is to operate (including principles of intergovernmental transfers) and the basis on which detailed rules may be established or changed. This gives flexibility to change the specification of the implementation instruments.

Sindh Local Government Ordinance (2001) lays down the institutional details of the local government structure, procedures, accountabilities and remedies and specific parameters of the intergovernmental fiscal system. It has been provided legal cover by the constitution¹⁰.

For institutionalization, it is important to make provision for conditional grants in the related laws. For example in Australia, Section 96 of the constitution provides the

¹⁰ SLGO is given in Sixth Schedule of the constitution. Section 268 (2) says, "The laws specified in the Sixth Schedule shall not be altered, repealed or amended, expressly or impliedly, without the previous sanction of the President accorded after consultation with the Prime Minister".

legal basis for special purpose payments (conditional grants). It stipulates that ‘the (commonwealth) Parliament may grant financial assistance to any state on such terms and conditions as the parliament thinks fit.’ (Rangarajan and Srivastava). In Canada too, Section 4 and 5 of Local Government Grants Act¹¹ lay down the basis of conditional grants including purposes for which conditional grant can be made.

Feeling the need of detailed rules for working of PFC, Govt. of Sindh has made Rules of Business of PFC¹² (Draft). Section 12 of the Rules deals with conditional grants. The sub-sections are re-produced as below:

- (1) The government may, on the recommendation of the Commission and with the approval of the Governor give conditional grants from the:-
 - a. Provincial retained amount;
 - b. Loans from banks;
 - c. Donations from the donor agencies;
- (2) The conditional grants shall be for a specific purpose and a specific period.
- (3) The Local Government may appoint experts at the Taluka, District and Provincial level to monitor and report the proper utilization of conditional grants.

Conclusion

This report reviewed the conditional grant mechanism adopted by PFC and has suggested improvements and means to institutionalize it. The review shows that the conditional grant mechanism responds positively to the needs of local governments in social sector in order to reduce poverty and help Government of Sindh to achieve MDGs. It also incentivizes them for their better performance. However, conditions for grant should be made more specific like targeting only primary education to help Government of Sindh achieve MDGs. Also, rationale of conditional grant has to be established in Sindh through research and studies. It is proposed here that such a research/study be conducted under technical assistance of SDSSP. It may be pointed out that there is a communication gap between PFC and other government departments like Local Government Commission, Bureau of Statistics, Accountant General, Sindh. This gap is hampering the efforts to institutionalize the monitoring and evaluation of conditional grant mechanism. Moreover, PFC’s data collection and usage capacity needs to be strengthened in order to improve the conditional grant distribution formula.

¹¹ See: http://www.qp.gov.bc.ca/statreg/stat/L/96275_01.ht
¹² Titled ‘Sindh Finance Commission Rules of Business’, 2006.

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