Improving the Performance of Municipalities Through Performance-Based Grants

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12.1 Introduction and Statement of Problem

Since 1994, municipalities have faced service delivery challenges which are attributed to poor financial management, inadequate human and institutional capacity, overstretched infrastructure and generally weak governance systems. The service delivery challenges persist despite government channelling increasing resources (transfers) to the local government sphere. The share of total transfers to the local government sphere increased from 6.3 per cent in 2006/7 to 8.8 per cent in 2012/13. Since 1999, national transfers to local government have consistently grown faster than total government expenditure (National Treasury, 2011:51). Between 2007/8 and 2009/10 transfers to the local government sector grew by 23.7 per cent, compared to 18.1 per cent for national departments and 17.6 per cent for the provinces. During the same period, the equitable share to local government grew by 23.9 per cent, local government infrastructure support grants by 33 per cent and capacity-building grants by 16 per cent (National Treasury, 2011). The increased resources going into the local sphere have not translated into commensurate service delivery improvements in the majority of municipalities. Therefore, injecting more resources is a necessary intervention but may not be sufficient to solve all the challenges facing the sector.

The efficiency and effectiveness with which resources are used in this sphere is critical for optimal service delivery. Poor service delivery characterises many municipalities, producing outcomes such as the frequent and sometimes violent protests by residents clamouring for better services. Local government is at the coalface of service delivery, and any failure in the sector is fundamental, not only in shaping public opinion about the entire government system but also, more importantly, has the potential to undermine the overall socioeconomic development of the country. Since 1994, the South African government has instituted a number of public sector reforms to enhance the performance of municipalities. The list includes policy and legislative reforms (e.g. Municipal Finance Management Act (MFMA) of 2003), benchmarking exercises, monitoring and evaluation (M&E) systems, capacity-building initiatives, annual municipal audits, performance-based budgeting, performance appraisal schemes and performance-based contracts. However, despite all these initiatives, the performance gaps in the local government sphere remain a cause for concern. Performance gaps manifest in the high incidence of poor audit reports, under-spending/overspending, poorly maintained infrastructure, large and growing consumer debt problems, and billing challenges. Therefore, a serious rethink is needed about ways and means of achieving maximum benefits from the transfer system.

An effective transfer system is a critical lever for poverty alleviation, minimising inequalities, economic growth and overall national development. The transfers are supposed to enable the local government sphere to play a central role in countering the three major challenges facing the country: unemployment, poverty and inequality. They are designed to fund the shortfall or

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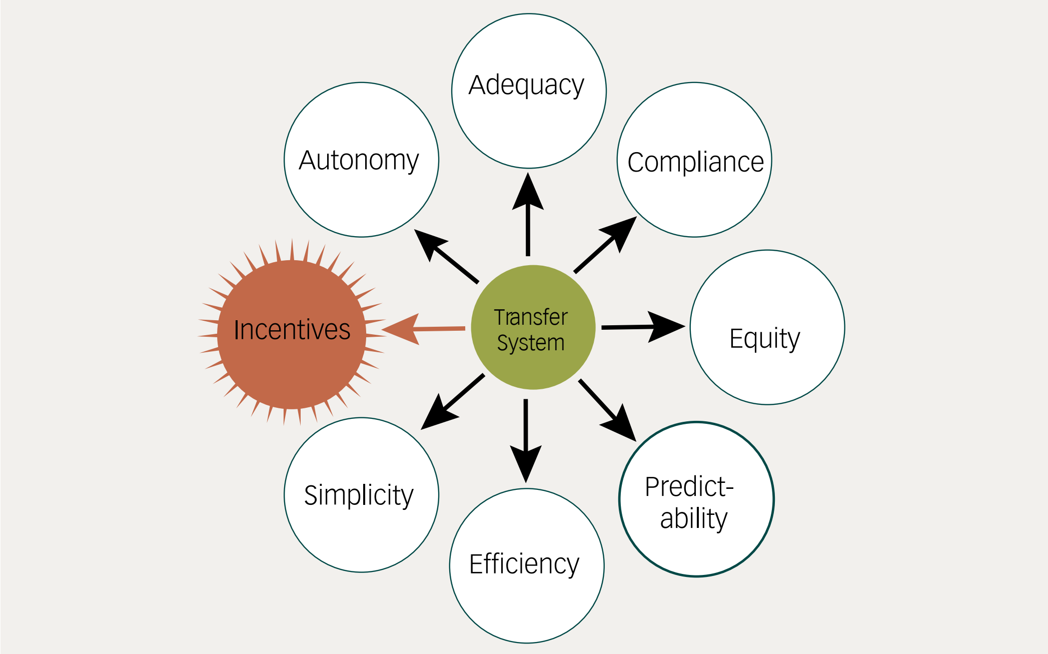
gap between resources that local governments are able to generate through their own revenue-raising capabilities and resources required to carry out the assigned responsibilities. The World Bank (2012) lists five attributes of a good transfer system:

1. Its objectives should be unambiguous and well designed.
2. It should be transparent to all stakeholders in terms of the amount of resources available (vertical pool) and distributed (horizontal distribution). The allocation criteria should be simple.
3. It should be stable, predictable and work in a timely manner, so that sub-national governments know what revenues to expect in the future and can plan strategically.
4. It should be equitable.
5. It should provide adequate incentives for sub-national governments to make the right decisions.

A good transfer mechanism should exhibit the characteristics shown in Figure 50 (Smoke and Schroeder, 2002). Value from a transfer system can also be achieved by including incentives in the system. Incentives are benefits, rewards, or costs that influence behaviour in a manner that is desirable. Incentives assume many forms and structures, which can be explicit or implicit, financial or non-financial, statutory or discretionary, and positive or negative. A transfer mechanism that includes incentives becomes performance based. In a performance-based system, municipalities' access to transfers depends on their overall performance. Central government relies on a system of rewards and sanctions to influence the behaviour of sub-national governments in negative and positive ways, attaching rewards and sanctions to influence the nature and quality of performance. In other words, such a system is designed to improve performance by linking access to (and the size of) transfers with performance in pre-determined functional areas (Steffensen, 2008). Through incentives, municipalities are influenced to improve performance (especially the cost, efficiency, quality and effectiveness of service provision), comply with central government policy imperatives and improve service delivery (Holzer and Yang, 2004; Dabla-Norris, 2006; Lin and Wong, 2010). Literature is full of evidence that performance-based transfers are effective in improving service delivery (Goddard and Mannion, 2004).

A successful performance-based transfer system depends on a set of credible performance indicators. Performance indicators are an important tool for assessing and measuring efficiency and effectiveness in generating and using resources and for holding governments accountable for performance. Indicators reveal information on how inputs are organised and used, how output is produced and, eventually, the quality of services being generated. Central government has used performance indicators, albeit to a very limited extent, to compare (benchmark), monitor and evaluate service delivery, and to ensure that sub-national governments achieve national objectives and priorities. However, performance indicators have not been systematically linked to the transfer system to improve service delivery.

Figure 50: Principles of a Good Transfer Mechanism



The purpose of this chapter is to evaluate the case for introducing incentives (explicit or implicit, financial or non-financial, statutory or discretionary, and positive or negative) into the local government fiscal transfer system. The running hypothesis is that the current system of fiscal transfers does not adequately incentivise good performance.

12.1.1 Objectives

The main objective of this chapter is to evaluate the case for introducing incentives into the South African fiscal transfer system. The second objective of this study is to isolate performance indicators that can be used to evaluate the performance of the local government sector.

12.1.2 Rationale of the Study

The Local Government Turnaround Strategy (South Africa, 2009), the New Growth Path (South Africa, 2010) and the National Development Plan (South Africa, 2011) acknowledge that the government sphere has an important role to play in addressing the three challenges of unemployment, poverty and inequality. Discussions in these documents are largely about how the sector can be turned around in order to play an effective role (South Africa, 2009). As the local government sector relies significantly on transfers, innovative ways of improving the performance of transfers need to be found. This chapter contributes to the review of the local government fiscal framework currently underway. In addition, by identifying the key performance indicators and an appropriate structure of fiscal incentives within the transfer system, this study will assist policymakers to develop policies and intervention mechanisms that enhance the performance of the local government sphere.

The study also fits well into the Commission's mandate and research strategy. The Commission is concerned about the poor performance of many municipalities, how to unlock the value and potential of the local government sector, and the levers that can be used to improve the sector's performance. It fits well into the Commission's theme of Fiscal Levers for National Development,

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as it builds a case for making transfers a sound and key lever for improving local government performance and hence national development. Thus this study will benefit the Commission's advisory inputs, especially on how to make the transfer system effective and generally improve the performance of the local government sphere. The ultimate beneficiaries of a better performing local government sector are individuals and communities at large.

12.1.3 Scope and Structure of Paper

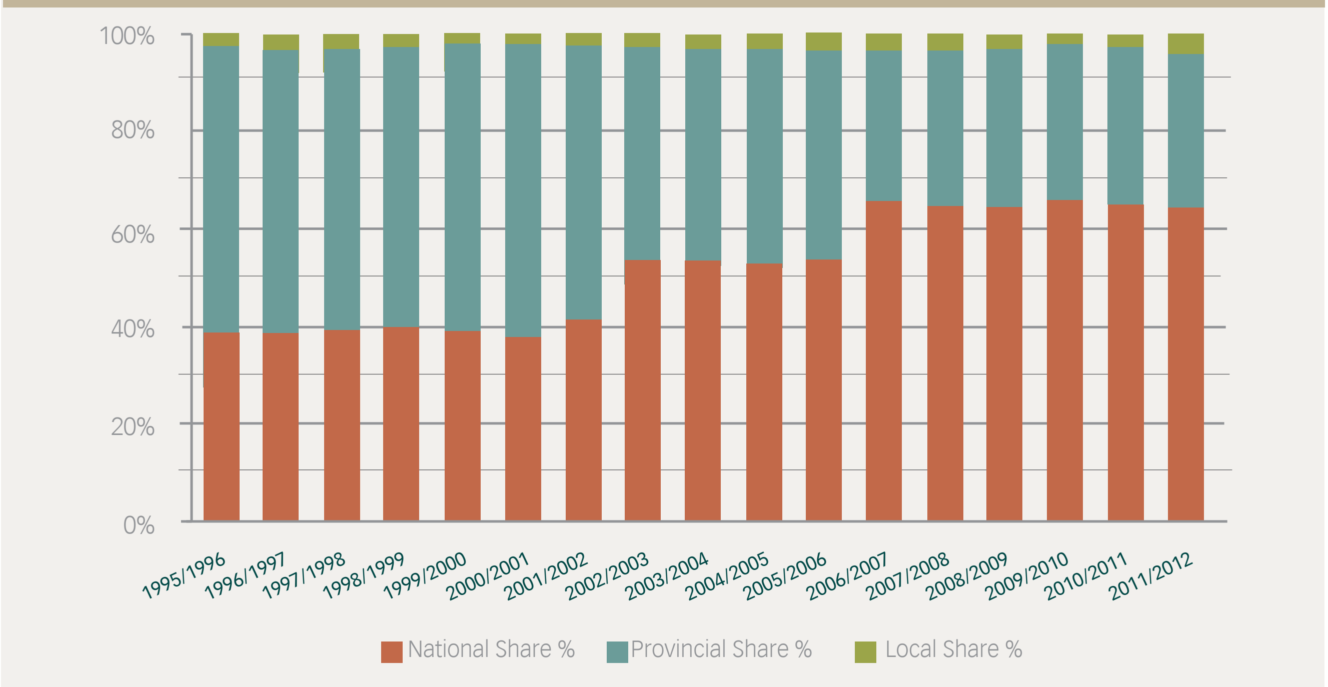
A good transfer system should have inbuilt incentive mechanisms that result in improved governance, accountability, management and ultimately service delivery (World Bank, 2012). Therefore, the focus of this chapter is on transfers from national government to local government. The transfer system comprises of the equitable share (unconditional grants) and various conditional grants. The equitable share is "needs based" and is meant to provide basic services to households deemed poor. This chapter reviews the link between the fiscal transfer system and local government performance and evaluates a case for incentives within the system of grants.

After a brief overview of the intergovernmental transfer system in Section 12.2, Section 12.3 explains the methodology and Section 12.4 provides a literature review. Section 12.5 answers the questions posed in the introduction, while Section 12.6 contains the concluding remarks and policy recommendations.

12.2 An Overview of the Intergovernmental Transfer System in South Africa

This section provides an overview of the intergovernmental transfer system in South Africa, starting with the division of revenue. The local government share is by far the smallest, while the trade-off between the national and provincial share is noticeable: between 2001/02 and 2009/10 the national share increased and the provincial share declined.

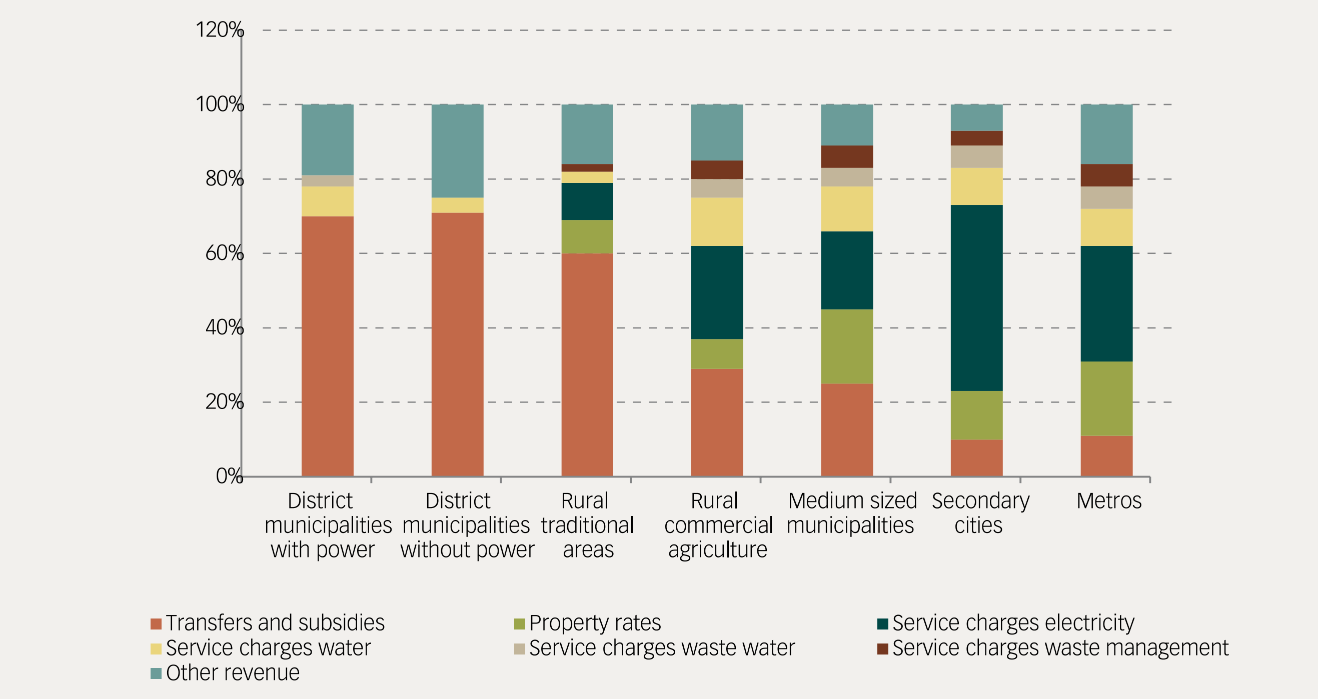
Figure 51: Vertical Division of Revenue (1995–2012)



Source National Treasury (2012)

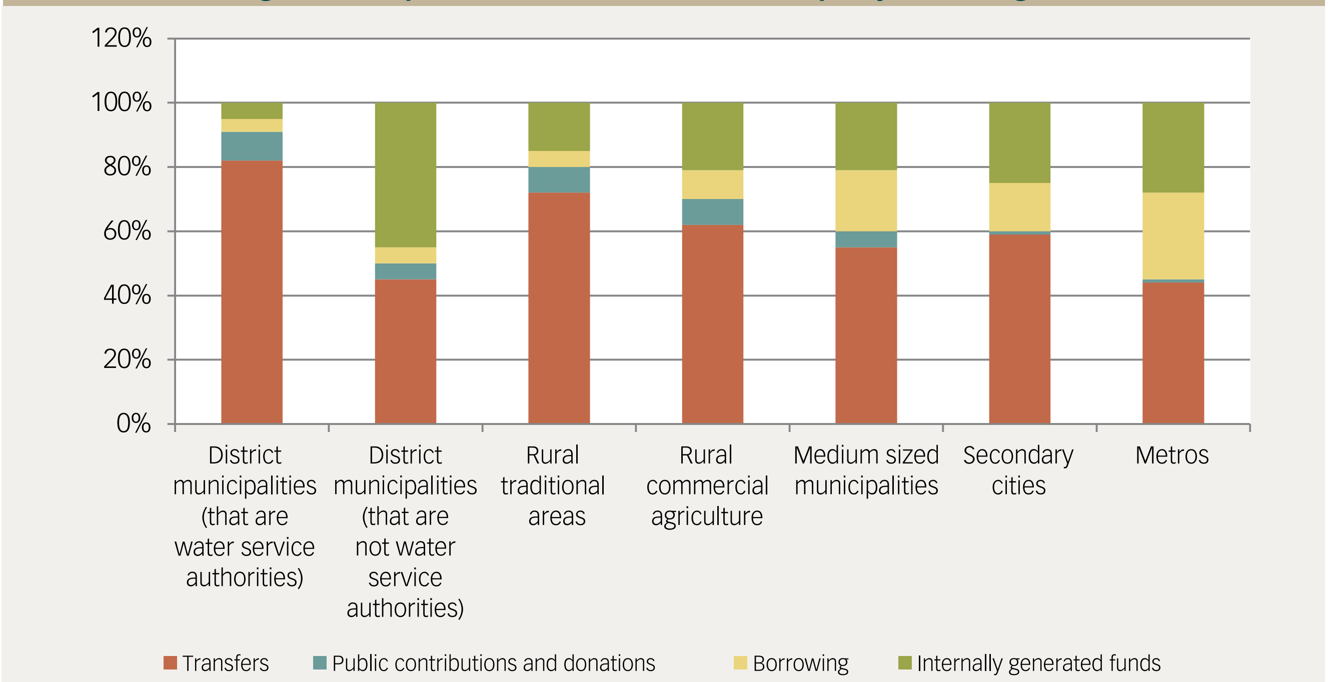
Transfers play a significant role in the budgets of many municipalities, as Figure 52 illustrates. Grant dependency is highest among district municipalities (75 per cent) and rural municipalities (65 per cent), while service charges from electricity and water, and property rates feature prominently in the revenue profiles of other municipalities. The grant dependency picture is even worse for capital expenditure, with grants representing 80 per cent of revenue for rural and 65–70 per cent for district municipalities (Figure 53). This is because of the limited revenue bases and small internally generated revenues in these two municipal categories.

Figure 52: Revenue Sources



Source: PDG (2012)

Figure 53: Capital Finance Profiles for Municipality Sub-categories



Source: Financial and Fiscal Commission (2012)

The intergovernmental transfer system consists of conditional and unconditional (equitable share) grants. The equitable share is formula driven and is allocated mainly for the provision of basic services. The focus of conditional grants is diverse, with infrastructure and capacity development being the major areas. Table 97 shows the total transfers to the local government sector.

Table 97: List of all Transfers Associated with Local Municipal (LM) and District Municipality (DM) Services (2012/13)

All figures in Rands	LMs	DMs	ALL
Equitable shares formula	28 073 584 000	5 409 319 000	33 482 903 000
Housing subsidies	15 722 317 420		15 722 317 420
Municipal Infrastructure Grant	8 428 116 000	5 453 517 000	13 881 633 000
Sharing of fuel levy	9 040 000 000		9 040 000 000
Urban Settlements Development Grant	7 392 206 000		7 392 206 000
PRAS Operating Grant	6 701 106 000		6 701 106 000
Public Transpiort Infrastructure and Systems Grant	4 988 103 000		4 988 103 000
Public Transport Operating Grant	4 317 269 000		4 317 269 000
RSC Levies Replacement		3 732 908 000	3 732 908 000
PRASA Capital Grant	3 526 799 000		3 526 799 000
RBIG ex Dora (district allocation)	1 001 028 000	1 515 613 000	2 516 641 000
Integrated National Electrification Programme (Eskom) Grant	1 879 368 000		1 879 368 000
Integrated National Electrification (Municipal) Grant	1 151 443 000		1 151 443 000
Special Support for Councillor Remuneration and Ward Committees	620 740 000	36 845 000	657 585 000
Expandable Public Works Programme Integrated Grant for Municipalities	503 737 000	95 503 000	599 240 000
Neighbourhood Development Partnership Grant (Capital Grant)	511 468 000	66 664 000	578 132 000
Water Services Operating Subsidy Grant	156 435 000	405 999 000	562 434 000
Expanded Public Works Programme Integrated Grant for Municipalities	503 737 000		503 737 000
Rural Households Infrastructure Grant	479 500 000		479 500 000
Local Government Financial Management Grant	346 753 000	56 000 000	402 753 000
Municipal Systems Improvement Grant	184 896 000	45 200 000	230 096 000
Electricity Demand Side Management Grant	200 000 000		200 000 000
Water Services Operating Subsidy	28 306 000	104 292 000	132 598 000
Neighbourhood Development Partnership Grant (In Kind)	72 000 000	8 000 000	80 000 000
Infrastructure Skills Development Grant	75 460 000		75 460 000
Rural Roads Assets Management Grant		37 295 000	37 295 000
Minicipal Disaster Grant			
Total	**95 905 371 420**	**16 967 155 000**	**112 871 526 420**

Source National Treasury (2012)

12.3 Research Methodology

The above discussion has singled out performance-based incentives as a missing element in the South African intergovernmental fiscal relations (IGFR) system and highlighted their potential role in improving the efficiency and effectiveness of service delivery by local government. The principal research questions that this chapter seeks to address are: Is there any basis for introducing performance-based grants in South Africa? If so, what principles should guide the government in designing performance-based transfers and performance indicators for the local government sector? To address these issues, this chapter draws on case studies of performance-grant systems in other countries.

12.4 Case Studies of Performance-based Grants

The literature on intergovernmental transfer design contains many studies on the implementation and effects of performance-based transfers. The case studies include the experiences of both developed and developing countries.

12.4.1 The Experiences of Developed Countries

Governments in the developed world have used incentives widely to improve service delivery, enhance revenue-raising efforts and improve spending efficiency (Mizell, 2008). Incentives assume many forms and structures, which can be explicit or implicit, financial or non-financial. In North America the incentives are built into the grant framework and are both financial and non-financial (GAO, 2008). Financial mechanisms reward performance with increased funding or one-time bonus payments, while non-financial mechanisms include altered oversight and flexibility during the grant's lifecycle. Table 98 gives examples of financial and non-financial incentives proposed for the American grant framework in 2008 (GAO, 2008).

Other OECD countries apply various other incentive systems. For example, in Italy funds are set aside for municipalities that achieve set targets in the areas of good management, modernisation of public administration, and implementation of specified reforms (Putnam et al., 1983; OECD, 2006). In the UK, financial and non-financial incentives are provided to encourage improvements in local service delivery. The national government enters into service delivery agreements with local authorities, and those that meet 60 per cent of the agreed targets after three years are rewarded with a performance grant of up to 2.5 per cent of their net annual budget (Blake, 2007). The UK also provides additional borrowing rights and relaxed administrative requirements to local authorities that have achieved set targets.

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Table 98: Incentives

Rewards/Penalties	Incentive	Definition
Reward	Praise	Public recognition of good performance, e.g. through press, websites, newsletters, hearings and award ceremonies
	Bonus	One-time cash payment
Rewards or Sanctions	Increase/decrease flexibility	An increase or decrease in the grant recipient's flexibility by ensuring administrative or financial waivers from requirements and restrictions
	Increase or decrease award term	An increase or decrease in the length or term of the grant
	Increase or decrease oversight	An increase or decrease in the degree of oversight
	Increase or decrease funding rate	An increase or decrease in the per unit reim-bursement
	Increase or decrease funding level	An increase or decrease in funding, where either the entire award or a portion of funding above an established baseline (i.e. an incentive portion) is tied to performance
	Use past performance	Past performance of grantee is used to inform selection of future recipients
Sanctions	Reproof	Public reprimand of poor performance, e.g. through press, websites, newsletters, hearings etc.
	Re-performance	Grantee must re-perform the service at its own cost to meet performance agreements
	Impose financial sanction	A one-time reduction is included in the value of the award. Also includes suspending or with-holding a payment (temporary halting grant payment); suspending or terminating the award (cancelling the current grant or temporary excluding grantee from future awards); or finally, debarment (permanently excluding grantee from future grant awards)

Source: GAO (2008).

12.4.2 South America

In Brazil the central government makes incentive payments to local municipalities based on demonstrated achievements of agreed service delivery targets (Hecht et al., 2004). The per capita transfers are based on planned increases in health-related services. Municipalities that reach targets continue to be eligible for transfers, but the transfers stop if they do not achieve targets. The Brazilian government uses performance bonuses for public hospitals, and in Costa Rica an incentive system rewards public hospitals that achieve certain performance indicators set by government (McNamara, 2005). In Nicaragua, the health ministry also provides financial incentives (equivalent to 17 per cent of hospital own revenues) to improve the performance of public hospitals.

Overall the performance-based incentive schemes in the health sectors of Brazil, Costa Rica and Nicaragua have had positive impacts on performance. Competition among hospitals in Costa Rica and Nicaragua, or municipalities in Brazil, resulted in some efficiency and accountability gains, quality and equitable service delivery (Hecht et al., 2004; McNamara 2005).

12.4.3 Asia and Pacific Region

In Asia and the Pacific region, performance-based transfers are relatively new but spreading quite rapidly across the subcontinent. Performance-based transfers have been piloted in Indonesia since 2006 and started in Nepal and Bangladesh in 2004 and 2000 respectively. In Indonesia incentives are applied mainly on grants associated with maintenance and rehabilitation of infrastructure (UNCDF, 2008). In Nepal and Bangladesh capital grants form the core of performance based grants, with such grants in Bangladesh also having a capacity-building component. In Nepal and Bangladesh independent consultants carry out performance assessments, while government officials undertake evaluations in Indonesia. In all the three countries, significant improvements have been recorded in the performance areas of financial management, planning, transparency, accountability and good governance (UNCDF, 2008; Steffenson, 2008).

12.4.4 Africa

The introduction of performance-based transfers is relatively new in Africa, and only a few countries have embraced and implemented incentive-based transfers: Uganda, Tanzania, Kenya, Ghana, Sierra Leone and Mali (Steffensen, 2008; UNCDF, 2008). The initiatives started in 1999 in Mali, 2004 in Tanzania and Sierra Leone, and 2008 in Kenya and Ghana. In Uganda and Mali, performance-based transfers were piloted in 1997 and 1999 respectively and subsequently implemented across all districts. In Tanzania, Kenya, Ghana and Sierra Leone, performance-based grants covered the entire country from the onset. The incentive system is applied mainly on capital or infrastructure grants in Uganda, Tanzania, Ghana and Kenya and also covers infrastructure repair and maintenance costs in Tanzania and Ghana. In Uganda and Tanzania, the grant incentives to local governments must have a special focus on poverty-related investment areas. In Kenya, the incentives are built into grants that focus on capital investments, service delivery and debt recovery. In Uganda, Tanzania and Ghana, the grants include a capacity-development component, as weak capacity in these countries has been singled out as a key bottleneck to the successful

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implementation of these grants. The capacity-building window in each grant enables municipalities to address capacity gaps related to grant spending. In Ghana, the capacity-building element is compulsory in each grant. In all six countries, the performance-based grants are characterised by two features: minimum access conditions and performance measures. Local governments that have fulfilled the minimum conditions are entitled to a basic grant. Examples of minimum access conditions included:

1. Putting in place development plans
2. Submission of financial statements on time
3. Functional audit committee in place
4. Capacity-building plan in place
5. Debt recovery plan
6. Citizens' participation
7. No adverse audit report
8. Procurement entities established

A municipality whose performance exceeds minimum conditions is entitled to a performance grant. Performance measures in African municipalities vary from country to country, but generally the focus is on institutional improvements, in management, planning, budgeting, financial management, participation and accountability, fiscal capacity, fiscal effort (e.g. tax collection rates) and good governance.

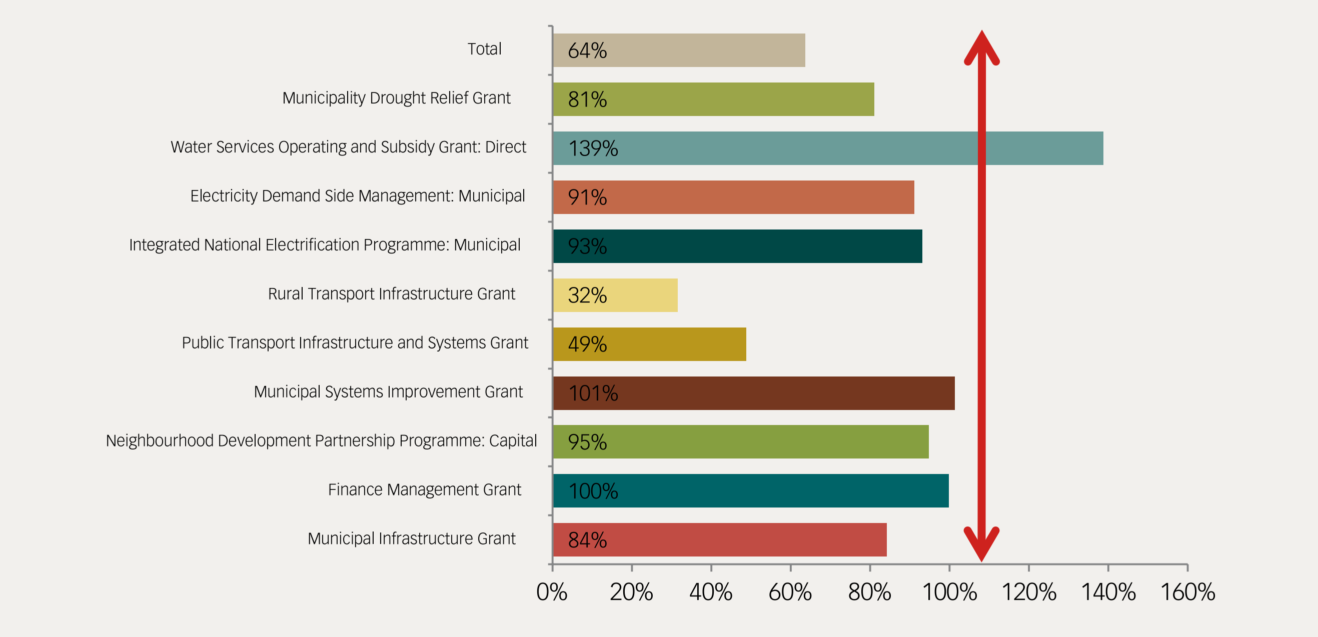
To evaluate the performance of grant recipients, five African countries use the public sector (i.e. internal evaluators), private sector evaluators or a combination of both. Uganda uses mixed teams of evaluators, internal experts and externally sourced teams. In Tanzania and Ghana, assessments are outsourced to private consultants, whereas in Sierra Leone evaluations are done by the local government finance department in the Ministry of Finance. Lastly, in Mali, central government ministers responsible for the performance area carry out the assessments; e.g. if the grant is for agriculture, then the agricultural ministry will conduct the evaluations.

The allocation of the grant varies from country to country. In Kenya, the general trend is to allocate 60 per cent of the grant based on meeting the minimum conditions and the remaining 40 per cent based on performance in key areas. In Tanzania, the allocation is based on a performance score: local governments that do well in a set of key performance areas receive 100 per cent, those classified as good receive 80 per cent, those classified as poor receive 50 per cent and those that achieve minimum conditions only receive 25 per cent of their eligible allocation. In Ghana, the allocation is in three parts: of the eligible allocation, 40 per cent is for minimum conditions compliance, 40 per cent for performance and 20 per cent for capacity building. The performance part is allocated on a scale of 0–100% in relation to the performance of other municipalities (UNCDF, 2008).

12.4.5 Performance Grants in the South African Fiscal System: Case Studies

Over the years, government's major concern has been the high incidence of under- and overspending of grants. This is a common problem with capital grants. As Figure 54 shows, as at 31 June 2012, average spending on all municipality grants was 63.4 per cent, implying a net under-spending of 36.4 per cent (or R4 billion). The casualty of such poor spending is service delivery. Reasons for under- or overspending are many and include poor and inefficient planning and budgeting, and inadequate capacity in municipalities. The capacity challenge is compounded by leadership instability, as illustrated in Table 99, which shows the number of municipal managers (MM) and chief financial officers (CFOs) in an acting capacity in the local government sector. In October 2012, 25–33 per cent of municipal managers and CFOs were in an acting capacity; a situation that does not augur well for efficient spending, planning and budgeting processes.

Figure 54: Total Expenditure as a Percentage of Revised Allocations (31 June 2012)



Source: National Treasury (2012)

Note: This data has not been audited and grants where spending is done at national level are excluded.

Table 99: Municipalities with Acting MM and CFO as of 10 October 2011

	Total no. of Municipa-lities	Acting MM		Acting CFO		Both Acting	
		No.	%	No.	%	No.	%
Eastern Cape	45	8	17.8%	5	11.1%	3	6.7%
Free State	24	5	20.8%	8	33.3%	2	8.3%
Gauteng	12	2	16.7%	1	8.3%	-	-
KwaZulu-Natal	61	17	27.9%	12	19.7%	3	4.9%
Limpopo	30	9	30.0%	11	36.7%	5	16.7%
Mpumalanga	21	10	47.6%	14	66.7%	8	38.1%
Northern Cape	32	8	25.0%	7	21.9%	4	12.5%
North West	23	13	56.5%	11	47.8%	8	34.8%
Western Cape	30	11	36.7%	6	20.0%	4	13.3%
All munici-palities	278	83	29.9%	75	27.0%	37	13.3%

Source: National Treasury (2012)

Generally, most local government grants have non-explicit and non-financial incentives. These often come in the form of withholding transfers, allowing for rollovers, public reprimand of poor grant performance, (e.g. through press, oversight and public hearings), public recognition of good grant performance, (also through the press and in public hearings). The next section reviews the performance of individual grants and evaluates the incentive features in each grant. In reviewing these grants, the incentives are viewed broadly, (i.e. explicit or implicit, financial or non-financial).

The Expanded Public Works Programme (EPWP) Grant

The EPWP incentive grant was introduced to motivate provinces and municipalities to shift from capital-intensive production methods towards labour-intensive techniques. The grant's performance-based incentive component is meant to encourage municipalities and provinces to create more jobs within their jurisdictions. The uptake of this grant has been weak, resulting in few jobs and low incentives. Reasons for the poor performance of this grant are many and include: the onerous reporting and payment procedures; municipalities not understanding clearly the performance bonus concept; provincial and municipal treasuries unsure of how to apportion the incentive; the insufficient value of the incentive, which does not tempt municipalities to participate or change their behaviour. In addition, the incentive is not reaching the contractors responsible for changing to labour-intensive production techniques, and small municipalities do not have the technical capacity to design labour-intensive delivery techniques (DPW, 2011). Table 100 shows the incentives earned against incentive allocations. The earnings in 2010/11 declined by more than 10 percentage points, an indication that many municipalities performed dismally on their targets. Thus any new incentive grant should improve on these weaknesses of the EPWP.

Table 100: Municipal Performance on the EPWP Grant (2009–2011)

MUNICIPALITIES	2009/10 Earnings			2010/11 Earnings		
	2009/10 Incentive Allocation (R'000)	2009/10 Incentive Earned (R'000)	% earned in 2009/10	2010/11 Incentive Allocation (R'000)	2010/11 Incentive Earned (R'000)	% earned in 2010/11
KwaZulu-Natal	39,974	26,102	65%	123,613	46,113	37%
Eastern Cape	53,559	7,818	15%	97,806	37,532	38%
Gauteng	35,674	60,488	170%	168,098	133,394	79%
Western Cape	7,288	1,271	17%	26,038	2,549	10%
North West	8,901	2,174	24%	32,999	17,135	52%
Limpopo	18,329	6,140	33%	55,355	23,060	42%
Free State	9,073	1,956	22%	31,400	6,071	19%
Northern Cape	15,496	5,769	37%	50,399	3,965	8%
Mpumalanga	13,454	2,453	18%	37,288	3,488	9%
Total	201,8	114,170	57%	622,996	273,307	44%

Source: DPW (2011).

The Municipal Infrastructure Grant

One of the two other grants with an incentive element is the Municipal Infrastructure Grant (MIG). The purpose of MIG is to improve access to infrastructure for basic services, roads and social infrastructure for poor households. The incentive element in the MIG is inactive and was supposed to come through the element M in the MIG allocation formula:

$$MIG = C+B+P+E+N+M,$$

where (in parenthesis are the proportions of each component except for the C component)

- The *C* component is a constant/minimum allocation made to all municipalities.
- The *B* component is for basic residential infrastructure such as water, sanitation, electricity, roads, solid waste removal and street lighting. Funding under this element covers both growth and repair and maintenance of basic residential infrastructure (54 per cent).
- The *P* component is ring fenced for municipal sport infrastructure (15 per cent).
- The *E* component caters for social and micro-enterprises infrastructure (five per cent).
- Funding under the *N* component is allocated to all nodal municipalities (five per cent).
- And *M* is the inactive incentive element.

The Urban Settlements Development Grant (USDG)

The second grant with an incentive element is the Urban Settlements Development Grant (USDG), which is a relatively new Schedule 4 grant introduced in the 2011 Medium Term Expenditure Framework. The grant is a financial instrument designed to develop sustainable metropoles. Its purpose is to supplement capital investment initiatives of metros and to enable metros to manage efficiently the built environment and respond effectively to urban growth. The USDG is performance based, with the flow of funds dependent upon the municipality satisfying minimum conditions, as specified in the grant framework. The assessment of a municipality's eligibility is based on a set of indicators agreed upon between the municipality and the grantee, i.e. the national Department of Human Settlements. The disbursing department can withhold the grant if a municipality fails to satisfy minimum conditions.

The USDG has also not performed well. Figure 55 shows spent and unspent allocations of the USDG in 2011/12 in the metros. Although the variation in spending on this grant is wide, all metros clearly under-spent, with the worst case being Buffalo Municipality, which failed to spend 69 per cent of its total allocations.

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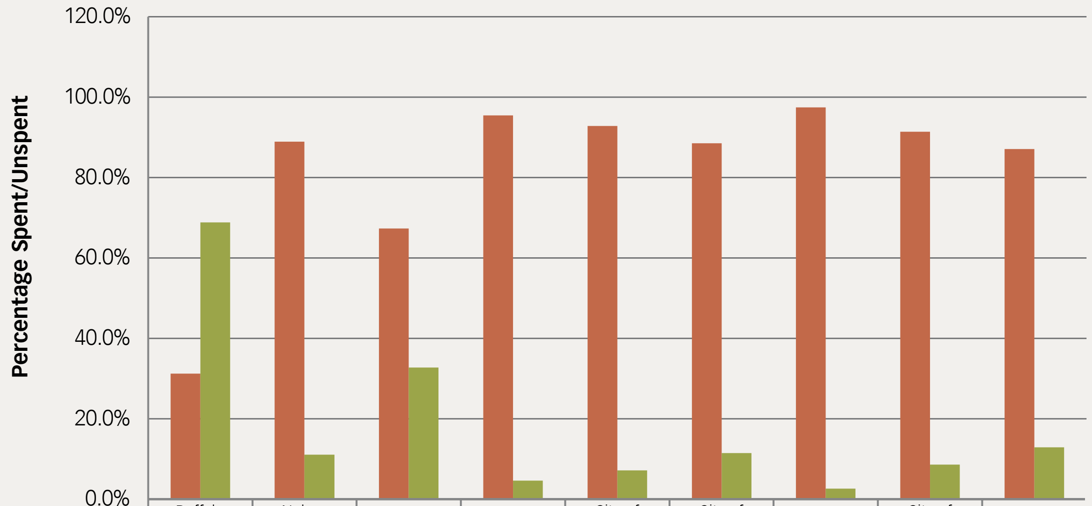
Figure 55: 2011/12 Urban Settlement Development Grant (USDG)



	Buffalo City	Nelson Mandela	Mangaung	Ekurhuleni	City of Joburg	City of Tshwane	eThekwini	City of Cape Town	Total
Spent as a % of transferred	31.2%	88.9%	67.3%	95.4%	92.8%	88.5%	97.4%	91.4%	87.1%
Unspent as a % of transferred	68.8%	11.1%	32.7%	4.6%	7.2%	11.5%	2.6%	8.6%	12.9%

Source: National Treasury (2012)

The USDG is a performance-based grant but has no separate incentive for good performance. Instead it has a negative incentive for poor performance, i.e. if performance is not adequate, the following tranche is withheld. A municipality receives the same allocation, whether it meets its targets or exceeds expectations. In addition, since the USDG is an indirect transfer, some of the causes of underperformance could possibly be traced to the parent ministry, over which the municipality has no control.

The Integrated City Development Grant (ICDG)

The ICDG is a new grant designed to incentivise metros to develop "more inclusive, liveable, productive and sustainable built environments" (South Africa, 2013). The grant provides a specific financial incentive to metros that excel in restructuring their built environments. Municipalities receive incentives for making progress on pre-specified built-environment targets. The grant has just been introduced but has some inherent design weaknesses. The ICDG only promotes a municipality's progress in one dimension i.e. spatial transformation, whereas local government performance needs to be incentivised in a number of areas in order to build a strong local government sector. The ICDG is a positive performance grant, rewarding progress, but is silent on bad performance – so what happens to municipalities that regress on spatial transformation?

Performance-based Transfers: A Critique

In countries that have introduced performance-based transfers, the performance of local governments improved (UNCDF, 2008; Steffensen, 2008), especially in the areas of financial and budget management, accountability, transparency, planning and general compliance with regulations, and other central government reporting requirements. Kenya registered significant performance improvements in financial management, community participation in planning and budgeting, and debt management. In Tanzania, adverse audit opinions decreased, while planning, budgeting and governance performance improved. In Mali, local government financial management improved significantly.

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Despite the successes recorded in the case studies, isolating the contribution of performance-based transfers to the overall performance of local governments is not easy. In each country the impact of incentives on the performance of municipalities may have been overstated, as other public sector reforms were happening at the same time. The evaluations carried out in the respective countries and many case studies also did not fully isolate the effects of incentives from a host of other public sector reforms, such as technical assistance, capacity strengthening and increases in expenditures (Eldridge and Palmer, 2008).

The other point worth noting is that well-intentioned incentives within the grant framework may yield unintended consequences or outcomes because of poor design or implementation. This incentive puzzle may arise when, at the design stage, the world is reduced to a single performance variable at the expense of a larger performance portfolio. For example, the focus may be on quantitative outcomes, at the expense of a matrix of quality variables; or cost minimisation dominates other socioeconomic considerations. Thus the design of an incentive system must be robust enough, and the set of indicators for assessing performance be comprehensive, transparent and objective, to minimise the perverse impacts of incentives. Incentives may also yield perverse outcomes when they are used as substitutes for leadership, good management, and capacity-building initiatives, etc. Therefore, to minimise unintended consequences, incentives need to be properly balanced with other initiatives and complemented by good leadership and management. Other unintended consequences, especially in the grant system, may include grants crowding out the effort by municipalities to generate their own revenues, implying poor overall economic growth and development.

In summary, despite some notable weaknesses of incentives, the following lessons can be learnt from the above case studies:

- The performance of municipalities improves as a result of the incentives. However, these incentives should be properly balanced with other performance-enhancement instruments, good leadership and management.
- Piloting the use of performance-based transfers in a few municipalities first is important.
- The use of independent evaluators is important. The Commission has also recommended the use of independent evaluators to assess government intervention mechanisms.
- Incentives are applied mainly in capital or infrastructure grants, and a capacity-building component is a key factor in the incentive structure.

12.5 Performance-based Grant Systems for South Africa: Options

The running hypothesis of this study is that local government transfers have weak incentives. The above review of local government and performance-based grants suggests that the system of grants in South Africa has weak incentives. Incentives are essential for building a strong and responsive local government sector. Evidence from both developed and developing countries demonstrates that incentives are critical in the performance of the local government sector. Literature shows that incentives, inter alia, improve accountability, budgeting, planning and governance performance.

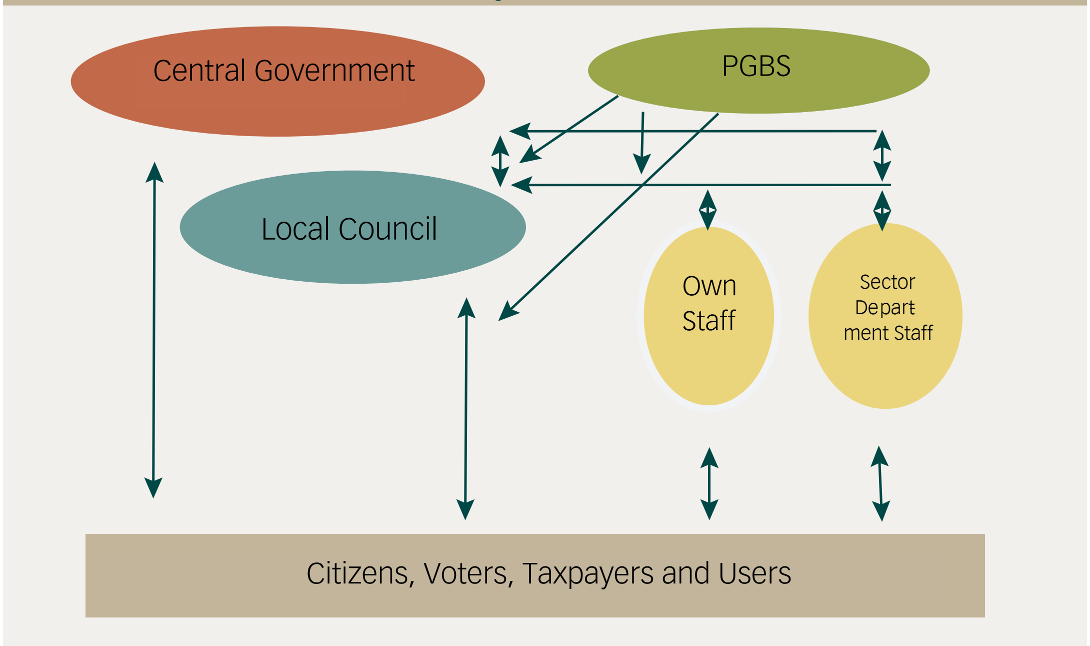
Performance-based transfers are known to complement other local government performance-enhancement mechanisms (Steffensen, 2008). As a condition for economical, efficient and effective management of public funds and sound stewardship of public assets, South Africa has instituted a number of performance-enhancement mechanisms, including:

- performance contracts for senior managers and ministers,
- benchmarking exercises,
- M&E systems,
- regular oversights, and
- Municipal audits.

In addition, all municipalities are required to have Integrated Development Plans, which link their planning (targets and priorities) and budgeting process. The government has also instituted various capacity-building initiatives to enhance service delivery and (outside government) credit ratings also influence performance in the local government. Thus, performance-based transfers can be a crucial addition to the various existing local government performance-enhancement mechanisms.

Performance-based transfers are known to improve accountability (Steffensen, 2008), both from municipalities to central government and vice versa, as well as between local and central government and citizens. How the performance-based transfers influence accountability mechanisms is shown in Figure 56. Performance-based transfers also improve the spending and targeting of funds, by ensuring that municipalities with the capacity to use the funds receive the transfers. This is critical in the South African context, where under-spending of grants in some municipalities is a perennial problem.

Figure 56: How a Performance-based Grants System (PGBS) Influences Accountability Mechanisms (2012)



Source: UNCDF (2008)

The three options for factoring in incentives into the South African transfer system are (see also Financial and Fiscal Commission, 2012):

1. Integrating the incentives into the current grant framework
2. A stand-alone incentive grant
3. A hybrid of both (a) and (b) above.

12.5.1 Integrating Incentives into the Current Framework

The option of integrating an incentive element into various grants has many advantages. The main one is that each grant includes an incentive to perform, which means possible efficiency gains, effective spending and, ultimately, better grant performance. Society is bound to benefit from such an arrangement, as service delivery is likely to improve across the board. The main drawback is that performance M&E systems, capacity and indicators have to be designed for each grant mechanism, which can be cumbersome and time consuming.

The literature reviewed suggests that likely candidates for fusing incentive elements into the grant are capital (both physical and human) and/or infrastructure grants. In many countries incentives feature strong in capital grants because the benefits of capital spending span a number of sectors. The social rates of return from better performing capital grants are much higher than from adding incentive elements into non-capital grants. As in Tanzania and Ghana, the incentive element may be applied to infrastructure repairs and maintenance.

The performance-based incentive should be above the minimum threshold, i.e. all municipalities should be awarded a basic grant provided they meet the minimum conditions. If they do not meet the minimum conditions, then sanctions are brought into effect. Sanctions should be adjusted to match the gravity of the problem. If the problem is less severe and new, then the municipality should be provided with assistance (e.g. building institutional, organisational and individual capacity) to enable it to meet the basic conditions. If the problem is severe, sanctions should include suspending or withholding a payment (temporary halting grant payment), and if the problem is deep-rooted and includes perennial non-compliance with regulations, then debarment (permanently excluding grantee from future grant awards) for the specific grant should be considered. Such funds should be channelled to other municipalities that continue to outperform their peers.

On the other hand, if a municipality performs beyond the minimum conditions, then the performance incentive should kick in, consisting of funding above an established baseline (i.e. an incentive portion). Other incentives should include public recognition of good performance, e.g. through press, websites, newsletters, hearings and award ceremonies.

12.5.2 A Stand-alone Incentive Grant

South Africa has some experience with a separate incentive grant through the EPWP. If properly designed, a stand-alone incentive grant can be used effectively to achieve government objectives. For example, the EPWP incentivises job creation, which is a government priority. A separate incentive grant is easier to design, manage and build capacity around. A single objective makes it is easier to define good and bad performance, and to draw performance indicators. A stand-alone incentive grant can be used to incentivise the performance of a municipality in many areas and based on many indicators. The same conditions for awarding incentives or applying sanctions, as described in Section 12.5.1, apply to this grant.

12.5.3 Hybrid System

A hybrid stem has incentives infused in all relevant grants and a stand-alone incentive grant. The obvious advantage of this system is that it captures the good elements of the other two options. One disadvantage is that it may result in double dipping on incentives by some municipalities. A hybrid system works well in a mature IGFR system where data and capacity issues are not major challenges.

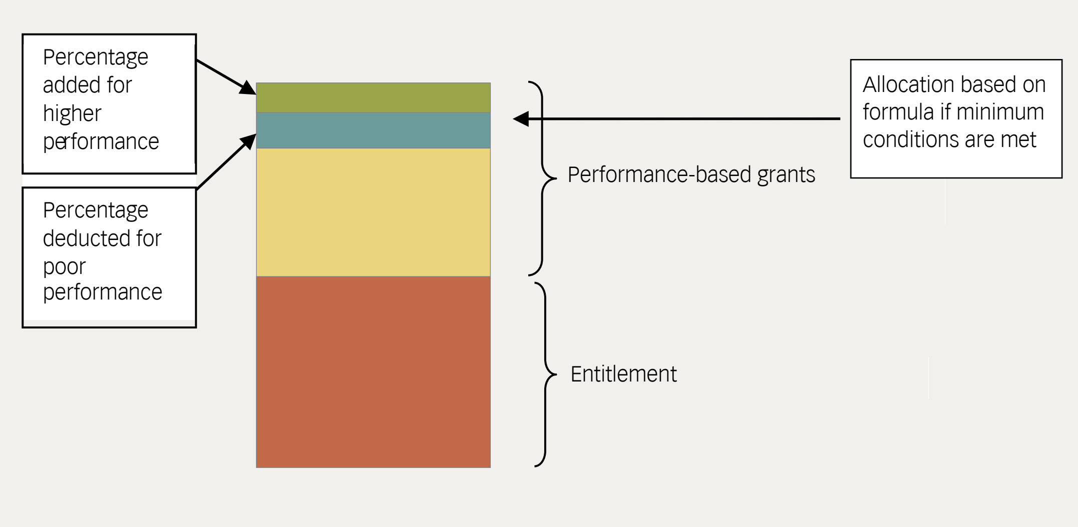
12.5.4 Proposition

This chapter supports a hybrid performance-based transfer system: i.e. a combination of a stand-alone incentive grant and the inclusion of incentives in all other grants, (especially capacity-building and infrastructure grants). Obviously, being new, the grant will require dedicated resources and administrative capacity. The stand-alone grant should focus on the non-metro municipalities, as metros are to a large extent catered for by the ICDG, although the ICDG is limited to rewarding progress on spatial transformation. The inclusion of incentives in other grants should be for all municipal categories.

12.5.5 Performance-based Grant Design

When designing a performance-based grant mechanism, a number of features should be considered. First, a clear split is needed between the entitlement and performance-based components, as shown in Figure 57. Every municipality is entitled to a minimum allocation determined through a formula that also ensures basic services (including capacity development) are provided. The performance-based component is added to this allocation. Municipalities that fulfil the minimum performance conditions are allocated a portion of the performance-based component. Municipalities that exceed expectations receive an additional allocation, while municipalities that perform poorly on the agreed measures have part of the performance grant deducted.

Figure 57: Performance-based Grant Framework



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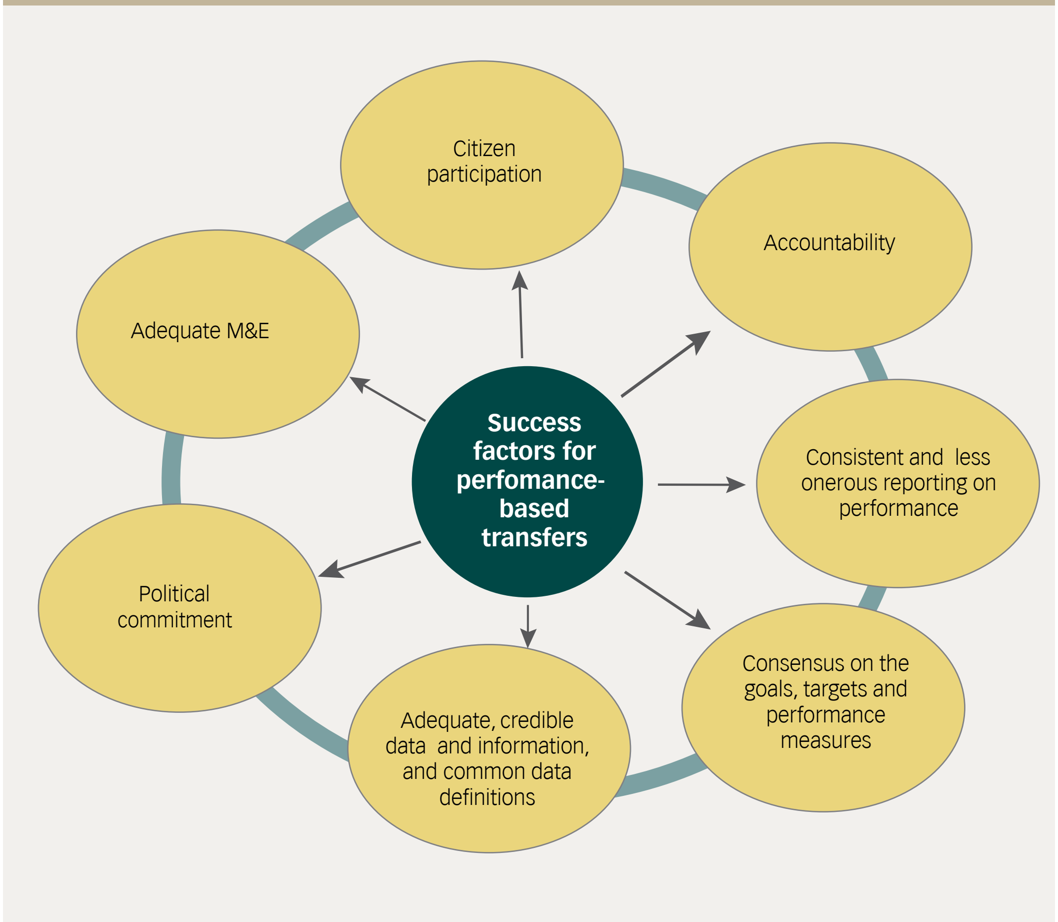
Some critical principles that should guide the design of incentives are:

- Valuable. Incentives should have sufficient value to motivate the desired behaviours and to provide meaningful return to both central government and the municipality.
- Timely. Incentive and performance indicators should be periodically revised and renegotiated between grantor and grantees. There should be sufficient flexibility to re-evaluate performance incentives and associated performance measures at regular, scheduled intervals and to allow time to learn from each cycle to improve performance.
- Attached to performance measures. These measures should capture performance unambiguously, be within the control and influence of the grantee, and be reasonably achieved and evaluated within the specified timeframe.
- Understandable. The transferring officials and the municipality should be sufficiently capacitated to understand the purpose and impact of incentives and be able to implement them effectively.
- Tailor-made. No incentive is appropriate to all situations, and so the incentive should suit specific situations.

12.5.6 Critical Success Factors for Performance-based transfers

For the performance transfer system to succeed the following factors are key (see Figure 58).

Figure 58: Success Factors for Performance-based Transfers



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Adequate M&E systems

A robust and effective M&E system provides a scientific and objective foundation and is critical for the successful implementation of a performance-based grant system. Adequate capacity to monitor and exercise oversight (and building such capacity) is a pre-condition for successfully implementing such a system.

Political commitment

Political commitment to the objectives and processes from central and local government authorities is necessary.

Less onerous reporting

Reporting on performance should be less onerous and consistent across municipalities, while processes should be unambiguously defined.

Credible performance indicators and data

Performance indicators should be credible, unambiguous and reflect the actual performance of municipalities. Performance-based mechanisms require credible and commonly defined data.

Public participation

Public participation should supplement the M&E system, embodying local democracy, accountability and transparency.

Consensus on goals, targets and performance measures

Central government and municipalities should have a common understanding of the goals, targets and performance measures, which should be negotiated and agreed to by consensus. Overall the assessment process should be highly credible.

Accountability

Individuals or entities should be accountable for not meeting targets, and sanctions/negative incentives should be imposed. Without proper accountability, persistent failures will not be minimised.

12.5.7 Performance Indicators

Performance-based transfers cannot be objectively applied, monitored or evaluated without credible performance indicators (PIs). Internationally, the use of PIs and performance incentives (rewards and penalties) to affect service delivery gained prominence in the 1980s and 1990s, with the advent of new public management reforms in the OECD countries (Mizell, 2008). Mizell (2008) found plenty of evidence that the use of PIs improves the efficiency and effectiveness of service delivery. National PIs are used by national departments, to ensure that local authorities achieve national objectives; to monitor the allocation of resources, control resources, and evaluate costs and quality; to facilitate comparison and competition among local authorities; to monitor and support local capacity to deliver services; and to monitor the decentralisation process and its impact on service delivery and citizen satisfaction.

The choice of PIs is affected by government priorities and what is going to be monitored or influenced (e.g. inputs, activities, outputs and outcomes). However, central and sub-national governments are supposed to determine jointly the PIs. This collaboration not only ensures buy-in by local governments but also enhances the quality of information shared. Mizell (2008) also points out that, when choosing PIs, the audience is important and needs information on costs, quality or availability of services.

The three options discussed above require credible and objective performance indicators. The performance indicators should be bound by the following 10 principles.

- Performance measures should be SMART (specific/simple, measurable, achievable, realistic/ result oriented, and time bound).
- Performance areas should be within the control of municipalities.
- Indicators should have theoretical validity. In other words, what is measured must resonate well with the theory behind the indicator.
- Indicators should capture performance concepts that are relevant to the government's interest.
- The data used for indicators should be available to all relevant stakeholders including the general public. This saves users the cost of collecting new data each time it is required.
- Indicators should be based on uniformly collected and defined data.
- Indicators should be based on data that is collected at regular and scheduled intervals. This allows the comparison of "apples with apples".
- Indicators should be simple, accessible and well understood by all, especially officials who evaluate them. The interpretation of indicators should not be ambiguous.
- Indicators should be resistant to manipulation.
- Indicators should be able to distinguish between "bad" and good" performance, i.e. between municipalities that are performing badly and those that are not.
- On the basis of these 10 principles, the performance measures should capture the following concepts:
- Organisational performance
- Fiscal performance (spending , revenue generation, deficits)
- Accountability and transparency (e.g. audit reports)
- Financial management (e.g. debt management)
- Cross-cutting issues (gender and child welfare, environment, employment, poverty).

12.6 Conclusion and Policy Recommendations

The local government sector has performed below expectations in delivering services. The literature reviewed suggests that performance-based transfers, if well implemented, may have tangible and positive impacts on accountability, spending and ultimately service delivery. The incentives in the transfer system supplement and reinforce other local government performance-enhancement initiatives, such as performance contracts, audit reports, oversights, credit ratings, M&E schemes and regulations.

Factors that are key for the successful implementation of performance-based transfers are: sound principles, credible data, political commitment, adequate capacity (human, institutional and organisational), adequate and effective M&E, unambiguous assessment criteria and common understanding of goals, targets and indicators.

With respect to the **impending review of the Local Government conditional grants**, the Commission recommends that:

- Performance-based grants are based on principles and guidelines. The following principles should guide the design of performance-based grants:
    - Incentives should have sufficient monetary value to motivate desired behaviours by municIpalities.
    - Incentive and performance indicators should be periodically revised and renegotiated between national government and municipalities.
    - Performance measures should capture performance unambiguously and be within the control and influence of the municipalities.
    - Performance incentives and associated performance measures should be evaluated at regular and scheduled intervals and allow time for learning from each cycle.
    - Incentives should be achievable and evaluated within the specified timeframe.
    - The transferring officials and the municipality should be sufficiently capacitated to understand the purpose and impact of incentives.
    - Incentives should be tailor-made to suit specific situations.
- The National Treasury and Department of Cooperative Government (CoGTA) ensure that there is sufficient awareness on the nature of performance-based grants, the value of incentives, relevant indicators, assessment criteria and potential benefits thereof, and how potential implementation risks could be managed.

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