CHAPTER 11

Improving the Performance of Municipalities through Incentive-Based Grants

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11.1 Introduction

Local government is at the coalface of service delivery, and any failure in the sphere is fundamental not only in shaping public opinion about the entire government system but also, more importantly, has the potential of undermining the overall socioeconomic development of the country. As noted in Chapter 10, municipalities in South Africa continue to face challenges related to service delivery and fiscal stress. These challenges have been attributed to poor financial management, inadequate human and institutional capacity, overstretched infrastructure and generally weak governance systems in some of the municipalities. Performance gaps have manifested in the high incidence of poor audit reports, under-spending/overspending, poorly maintained infrastructure, large and growing consumer debt problems, and billing challenges.

In response, Government has instituted a number of public sector reforms to enhance the performance of municipalities. The list of interventions include 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 of the local government sphere remains a cause for concern.

Government has channelled increasing amounts of resources (transfers) into the sector to improve service delivery (National Treasury, 2011):

- The share of total transfers to the local government sphere increased from 6.3 per cent in 2006/07 to 8.8 per cent in 2012/13.
- Since 1999, national transfers to the local government have consistently grown faster than total government expenditure.
- Between 2007/08 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.
- Between 2007/08 and 2009/10, the equitable share to the 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.

Transfers are supposed to fund the gap between resources that local governments are able to generate themselves (own revenues) and resources required to carry out assigned responsibilities. Yet the considerable (and increased) transfers to the local sphere have not translated into corresponding service delivery improvements in the majority of municipalities. The efficiency and effectiveness with which resources are used in this sphere is critical for optimal service delivery. Therefore, a serious rethink is needed about ways and means of achieving maximum benefits from the transfer system.

The transfers to local government 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. An effective transfer system is a critical lever for poverty alleviation, minimising inequalities, economic growth and overall national development. The World Bank (2012) lists five attributes for an effective 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.

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An effective transfer mechanism should include incentives for improving local government performance (Smoke and Schroeder, 2002). Incentives are benefits, rewards, or costs that influence the behaviour of recipient municipalities in a manner that is consistent with the objectives of the grant rather than with their own preferences. Unlike the popular use of the term incentive, which typically refers to a monetary reward for good performance, the concept used by economists is much broader. Incentives assume many forms and structures, which can be explicit or implicit, financial or non-financial, statutory or discretionary, and positive or negative (i.e. they can reward or sanction behaviour by grant recipients).

A transfer system that includes an incentive element becomes performance based. In a performance-based system, access to transfers by municipalities depends on their overall performance. Central government relies on a system of rewards and sanctions to influence the behaviour of sub-national governments in both 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 predetermined functional areas (Steffensen, 2008). The literature is full of evidence that shows the effectiveness of performance-based transfers in improving service delivery (Goddard and Mannion, 2004).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 (Lin and Wong 2010).

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

11.2 Research Methods and Findings

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 the chapter draws on case studies of performance-grant systems in other countries.

The literature on intergovernmental transfer design contains many studies on the implementation of performance-based transfers. The following lessons can be learnt from different case studies and the experiences of both developed and developing countries:

- The performance of municipalities improves when there are 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.
- Incentives are applied mainly in capital or infrastructure grants, and a capacity-building component is a key factor in the incentive structure.

Performance-based transfers have improved the performance of local governments in many countries (UNCDF, 2008; Steffenson, 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, 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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Performance-based transfers also complement other local government performance-enhancement mechanisms (Steffensen 2008). As a condition for economical, efficient and effective management of public funds, South Africa has instituted a number of performance-enhancement mechanisms, including:

- performance contracts for senior managers and ministers,
- benchmarking exercises,
- monitoring and evaluation (M&E) systems,
- regular oversights, and
- municipal audits.

Government has instituted various capacity-building initiatives to enhance service delivery, and outside government credit ratings also influence performance in local government. Thus, performance-based transfers can be a crucial addition to the various existing performance-enhancing 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 on one hand and citizens on the other. 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.

Despite the successes recorded in the case studies, isolating the contribution of performance-based transfers to the overall performance of local governments was 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 also did not fully isolate the effects of the 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 performance indicators need to 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. Incentives need therefore to be properly balanced with other initiatives and complemented with good leadership and management. Other unintended consequences, especially in the grant system, may include grants crowding out the effort by municipalities to generate own revenues, which implies poor overall economic growth and development.

11.3 Options for an Incentive-Based Grant System for South Africa

The three options for factoring in incentives into the South African transfer system are:

(a) Integrating the incentives into the current grant framework
(b) A stand-alone incentive grant
(c) A hybrid of (a) and (b).

11.3.1 Integrating Incentives into the Current Framework

The option of integrating an incentive element into many 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.

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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 strongly 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 compared to adding incentive elements to non-capital grants. As in Tanzania and Ghana the incentive element may be applied to aid infrastructure repairs and maintenance.

The performance-based incentive should be above the minimum threshold, i.e. 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 problem is 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.

11.3.2 A Stand-Alone Incentive Grant

South Africa has some experience with a separate incentive grant through the Expanded Public Works Programme (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 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 dimensions/areas.

11.3.3 Hybrid System

A hybrid system has incentives infused in all relevant grants and a stand-alone incentive grant. The obvious advantage of this system is that it captures good elements of the other two options. One disadvantage is that it may result in double dipping on incentives by some municipalities.

11.3.4 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 the metros are to a large extent catered for by the Integrated City Development Grant (ICDG), although the ICDG is limited to rewarding progress on spatial transformation. The inclusion of incentives in other grants should be directed to all municipal categories. The following sections highlight some of the design issues of performance-based grants.

11.4 Performance-Based Grant Design

A number of key features should be considered when designing a performance-based grant:

- **Valuable.** Incentives should have sufficient value to motivate desired behaviours and to provide meaningful returns 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 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.

For the performance transfer system to succeed the following factors are key:

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 is necessary from central, provincial and local government authorities to the objectives and processes.

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 supplements the M&E system and embodies 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.

11.4.1 Performance Indicators

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

1. Performance measures should be *SMART* (specific/simple, measurable, achievable, realistic/result oriented, and timebound).
2. Performance areas should be in the control of municipalities.
3. Indictors should have *theoretical validity.* In other words, what is measured must resonate well with the theory behind the indicator.
4. Indicators should capture *performance concepts* that are relevant to the government's interest

5. 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.
6. Indicators should be based on *uniformly collected and defined data.*
7. Indicators should be based on *data collected at regular and scheduled intervals.* This allows the comparison of "apples with apples".
8. Indicators should be simple, accessible and well understood by all, especially officials who evaluate them. The interpretation of indicators should not be ambiguous.
9. Indicators should be resistant to manipulation.
10. 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 the above 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).

11.5 Conclusion

The local government sector has performed below expectation in delivering services. Experiences from other countries suggest 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.

The soundness of the initial design is the key for successful implementation of performance-based transfers, and so are the following implementation factors: 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.

11.6 Recommendations

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;
    - o Incentives should have sufficient monetary value to motivate desired behaviours by municipalities.
    - o Incentive and performance indicators should be periodically revised and renegotiated between national government and municipalities.
    - o Performance measures should capture performance unambiguously and be within the control and influence of the municipalities.
    - o Performance incentives and associated performance measures should be evaluated at regular and scheduled intervals, and allow time for learning from each cycle.
    - o Incentives should be achievable and evaluated within the specified timeframe.
    - o The transferring officials and the municipality should be sufficiently capacitated to understand the purpose and impact of incentives.
    - o 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.