FINANCIAL AND FISCAL COMMISSION

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POLICY BRIEF

3/2013

Improving the Performance of Municipalities through Incentive-Based Grants

EXECUTIVE SUMMARY

Local government is at the coalface of service delivery but continues to face challenges that affect service delivery. These include poor financial management, inadequate human and institutional capacity, overstretched infrastructure and generally weak governance systems. National government has instituted policy and legislative interventions to improve municipal performance, including benchmarking exercises, monitoring and evaluation systems, capacity-building initiatives, annual municipal audits, performance-based budgeting, performance appraisal schemes, and performance-based contracts. Government has also channelled considerable (and increased) transfers to the local sphere. However, these measures have not translated into corresponding service delivery improvements in the majority of municipalities. A serious rethink is needed about how to achieve maximum benefits from the intergovernmental transfer system. An effective transfer system should include incentives for improving local government performance. Three options for factoring in incentives into the South African transfer system are: integrating incentives into the current framework, a stand-alone grant or a hybrid system. The Commission supports a hybrid, incentive-based transfer system. When designing an incentive/performance-based grant, key factors include credible data, political commitment, adequate capacity (human, institutional and organisational), robust monitoring and evaluation systems, and a common understanding of goals, targets, indicators and assessment criteria. The performance-based grants should be based on established principles and guidelines, and government departments must ensure that there is sufficient awareness of the value of incentives, assessment criteria and potential benefits.

BACKGROUND

Local government is at the coalface of service delivery, and any failure in the sphere could undermine the overall socioeconomic development of the country. Many municipalities continue to face service delivery challenges, which have been attributed to poor financial management, inadequate human and institutional capacity, overstretched infrastructure and generally weak governance systems. In response, the government has instituted a number of public sector reforms and interventions, including policy and legislation (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. Government has also channelled increasing amounts of resources (transfers) into the sector to improve service delivery. Transfers to local government are increasing as a share of total transfers. 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. 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. Yet, in the majority of municipalities, these considerable (and increased) transfers to the local sphere have not translated into corresponding service delivery improvements. A serious rethink is needed about how to achieve maximum benefits from this transfer system.

An effective transfer system is a critical lever for poverty alleviation, minimising inequalities, economic growth and overall national development. Such a system should include incentives for improving local government performance. 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. A successful performance-based transfer system depends on a set of credible performance indicators, which need to be systematically linked to the transfer system. The Financial and Fiscal Commission (the Commission) conducted research into policy options for introducing and designing incentives within the South African local government fiscal transfer system.[1]

[1] For the full study, see Ncube, M. 2013. Improving the performance of municipalities through performance-based grants, Chapter 12 in Financial and Fiscal Commission (2013). 2014/15 Submission for the Division of Revenue Technical Report, Midrand, South Africa.

FINDINGS

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

(i) Integrating incentives into the current framework

The main advantage of this option 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 literature suggests that likely candidates for fusing incentive elements into the grant are capital (both physical and human) and/or infrastructure grants. 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.

(ii) Stand-alone incentive grant

If properly designed, a stand-alone incentive grant can be used effectively to achieve government objectives. South Africa has some experience with a separate incentive grant through the Expanded Public Works Programme (EPWP), which incentivises job creation – 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.

(iii) 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.

Key features to consider

.When designing a performance-based grant, the following factors are key:

- A robust and effective M&E system.
- Political commitment from central, provincial and local government authorities to the objectives and processes.
- Less onerous reporting on performance, which should be consistent across municipalities and processes should be unambiguously defined.
- Credible and unambiguous performance indicators that reflect the actual performance of municipalities.
- A common understanding between central government and municipalities 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 of individuals or entities, with sanctions/negative incentives imposed for not meeting targets. Without proper accountability, persistent failures will not be minimised.

The performance indicators should be credible and objective, and capture organisational performance, fiscal performance (spending, revenue generation, deficits), accountability and transparency (e.g. audit reports), financial management (e.g. debt management), and cross-cutting issues (gender and child welfare, environment, employment, poverty).

CONCLUSION

The Commission 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). 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. If well implemented, performance-based transfers may have tangible and positive impacts on accountability, spending and, ultimately, service delivery.

With respect to the **impending review of the local government conditional grant system**, the Commission recommends that:

- Performance-based grants that 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 time-frame.
  - 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 (DCoG) should ensure that there is sufficient awareness of 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.

FURTHER READING

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