

## **A Differentiated Approach to the Funding of Municipalities Focus Group Notes**

### **Introduction**

Group participants introduced themselves and the organisation they are affiliated to.

Discussion began with group member giving input as to their understanding of differentiation and why it is necessary. There was agreement that differentiating municipalities can be on the basis of a number of aspects, for example, underlying circumstances or aspects that municipalities do not have control over. Differentiation can also be based on performance, focusing on aspects such as effort, output or outcomes.

*Specific individuals noted the following points:*

- Peter Smith – This participant noted that local government differentiation is implicit in the Constitution. The Constitution came up with the basic notion/categorisation of A, B and C municipalities. The need to differentiate is implicit across governments approach to favour phased implementation of legislation/policy based on the characteristics of municipalities – so even in general aspects, there are some forms of differentiation.
- Ian Palmer noted that a lot of focus is now on further categorizing B and C municipalities. These are aspects that are not underpinned by any legislation. Ian noted that within government, various classification systems have been used. For example, National Treasury have used a basic system of rating municipalities as high or low capacity municipalities. The Municipal Demarcation Board has a classification system that it subscribed to. A widely applied classification system is the B1 to B4 categorisation used by the Department of Cooperative Governance (DCoG). What we've seen recently in the system is a reorganization which has led to an expansion in the number of metropolitan municipalities. Legislation is very narrow in the sense that municipalities can only apply to be categorised as a metropolitan and not any other category.
- Karl Strauss: According to Karl, National Treasury, as part of its 2009/10 benchmarking exercises, compared the two new metros to secondary cities and with the existing metros. Relative to the secondary cities, the two new metros compared favourably. However, when looked at relative to the existing metros, they performed very poorly. This raises the questions as what criteria drives the decision to grants municipalities metro status. This group member was of the opinion, that the status awarded to these two municipalities was ill-informed as they are unlikely to meet the metro standard.

- Ian Palmer noted that there is an incentive for municipalities to get metropolitan status. The reason is that these municipalities have access to the RSC Levy Replacement Grant and you get to retain the full local government equitable share allocation. There is a downside and this lies in the greater regulatory requirements that have to be complied with.
- Emakhazeni: This participant noted that the problem is a simple one and is related to lack of recognition for well performing municipalities. The participant noted that the cost of complying to legislative/regulatory requirements (for example GRAP 17) is high and puts a significant burden on municipalities. Essentially the point made was that high performing municipalities should be rewarded. The option of ex gratia awards in cases of good performance or cases where municipalities stick to implement regulations be considered.

There was agreement that differentiation helps in understanding impact on different types of municipalities and how policy decisions play out. Differentiation assists in providing a basis for resource allocation. Differentiation can also be a basis for rewarding municipalities. This type of mechanism is not into the key formula driving the local government fiscal framework, that is, the local government equitable share formula. This aspect is becoming apparent in the local government conditional grants system. For example the Municipal Infrastructure Grant for Cities. It was acknowledged that whilst the reward aspect is largely missing from the local government system, the punitive aspect is there (for example, the revenue raising correction component in the local government equitable share formula).

We also need to be clear about what government wants to achieve through differentiation. For example if the aim is to provide every single citizen in the country with a certain level of service we need to look at per capita allocations to be similar – in this instance differentiation is not that critical as its about universal access to a certain level of service delivery.

We could pursue a differentiated approach based on the functional powers and functions of municipalities.

Commissioner Dave Savage emphasised that there is no dispute regarding the need for differentiation. The Constitution itself accepts and basically entrenches the need to differentiate. What is key is the basis for differentiation. We urgently need to explore how, in differentiating, we should blend context, whilst also recognizing performance.

The representative from Emakhazeni indicated that there is a need for a quick, short-term solution, particularly with respect to the local government equitable share allocation. In this regard, the need for a restitution grant was suggested. Going forward again, the option of a reward grant, based on fulfilling regulatory and legislative requirements, was suggested. There is a need to separate these issues.

David stressed the system for differentiation be linked to the review of roles and functions of different categories of municipalities (this is an issue which has yet to be resolved). The representative from Ekurhuleni stressed the need to focus on the core business of municipalities. When looking at the amount of activity that municipalities focus on but which is not part of its core business, the extra burden on them becomes clear. These overhead costs are significant and needs to be curbed. This is closely linked to the issue of unfunded mandates. Ian Palmer noted that this is an important point and that if a municipality is categorised as being able to take on a service there should be a clear categorisation, a clear sign of the function and the money should go with it. If you're a high performance municipality and you're doing all these things you should be rewarded.

Gerald, Emakhazeni: If this is a zero-sum game why can't we get more money from the bigger pie to the smaller local government pie?

Based on this initial discussion, Ian Palmer noted that the motivation for differentiation is clear

### **Discussion**

The second part of the discussion was related to principle – if we are going to differentiate *how* will we do it? It was noted that in the various formulae there are differentiation criteria based on poverty, need for service (public transport for example). So this is an aspect that is implicit in most formulae.

A lot of interest was expressed in the possibility of a performance based grant – the big question is if we have a performance based grant what principles would it be based on?

Gerald Emakhazeni: financial administration success should be a criteria or service delivery success

Peter Smith: what about costed norms principles to underpin differentiation. Could also use service obligations where municipalities who experience difficulty in service delivery get a bit more – e.g. harder to get electricity, water etc to a particular area. The aspect of settlement patterns is also important. You could also use FBS as a basis for differentiation.

To what extent is MIG based on redressing legacy shortages. Legacy issues could also be a base for differentiation –MIG is an attempt to address backlogs, so in a rural area where you don't have services you're supposed to get more MIG.

Ian Palmer noted that the legacy issue is an important one and not covered in formula.

There's also a cost of service component. In addition, one could also look at differentiation on the basis of development aspects.

Ian Palmer noted that the development component is not activated. D-component is not used because it's difficult to use it and estimate it. Bongani Khumalo noted that in the context of differentiation considering how the D-component can be activated may be useful in terms of the broader discussion around the fiscal framework. Ian Palmer then explained the components of the LES

The discussion then focused on whether we expand the basket of services in the D-Component thereby having an impact on the pool. What are the indicators that we can use for estimating the "D" component.

There is also the possibility of looking at quality of service delivery. We need to come up with some scientific way of measuring performance. We know we need to differentiate. We must also acknowledge it's a big challenge.

Nara from the University of Pretoria suggested introducing something based on fiscal effort and expenditure needs component. Different weight could be attributed to the different factors e.g. a weight for population density. A system of weights that can take into account the different contexts could be applied.

Peter Smith – if a token reward for good performance then it's ok but if its significant, then not so good as it depends on why municipalities are performing poorly in the first place - we need to address those root causes as well and not allocate ALL resources to good performers. If it's an incentive to motivate municipalities to do well then agree. But we need to consider that some municipalities don't have capacity etc to improve performance. The Acting Chairperson of the FFC suggested caution on the issue of rewarding performance through the grant system. Creates unnecessary distortion – devise a system that has incentives built into it. So basically this is a bad approach. We shouldn't reward somebody for doing their job. Rather reward/compensate municipalities for the cost of compliance (e.g. GRAP 17).

The issue of cost differentiation needs to be addressed.

**Grouping of the functional allocation – e.g. you want electricity because it helps you to build a more viable system**

Mixed position on costs as a differentiator – some suggest it's a good idea some think it is bad. The work that the FFC and NT are doing on costs should be taken forward.

What are the costs or implications of unfunded mandates?

D-component/grant – do we differentiate based on under-developed, non-performing. So in this instance should you get money? You can only do this in practical cases – so for example you can't get money if your management is

bad. Rather focus on historical, legacy reasons – so for example you get an allocation because you don't have systems in place.

Charl: We must be cautious. NT is looking at the D-component e.g. Dipaleseng as an underdeveloped municipality. If you use this criterion Dipaleseng will benefit. But bigger thing is to look at more than just development. We talk about performance against LES we are remiss, LES is a constitution right. If you take Dipaleseng and use underdevelopment as a criterion, you miss a critical element of the rich mining potential that it is sitting on. If you give the municipalities the right to mining it will change the status a lot. – so it's about the powers and functions allocated to municipalities.

Peter Smith: We need more research on international comparative stuff. Are there solutions out there already that we could draw on?

Ian Palmer: in the case of performance you'd want to compare similar municipalities.

Data gaps hinder what we can do. This can make a good differentiation system difficult to implement.

***The concluding points that the group agreed should be taken to plenary include:***

1. Performance reward: ambiguous view. Need good view on what this could entail and how it can be implemented
2. Differentiation based on costing: put forward as an argument without consensus. Are there rational basis to use this as a basis for differentiation?
3. D-component – almost reverse of performance aspect. Not sure that we can use management skill/or skill of politicians as basis for giving people money. Rather give people money for systems improvements – e.g. billing system, water system. More research is needed – to what extent can it be an inadequate systems grant. Or turning a deficient system into a well functioning one
4. Efficiency of spending of the whole system – so proving the need to expand the case. Are there areas of inefficiency??
5. Funding of maintenance is another critical issue – what is the best mechanism to incorporate funding for maintenance
6. Should we have a once off grant to address legacy issues?