REVIEW OF LOCAL GOVERNMENT INFRASTRUCTURE GRANTS

national treasury
Department: National Treasury
REPUBLIC OF SOUTH AFRICA

cooperative governance
Department: Cooperative Governance
REPUBLIC OF SOUTH AFRICA

SALGA
South African Local Government Association

FINANCIAL AND FISCAL COMMISSION

performance monitoring and evaluation
Department: The Presidency
REPUBLIC OF SOUTH AFRICA

In collaboration with national sector departments, municipalities and other stakeholders

Recommendations for Reform

Draft Report to Budget Forum – September 2014

***NB** This is a working document, submitted to Budget Forum in September 2014. Further edits and recommendations will follow in the coming months but comments from stakeholders are requested at this stage. Please send to grantreview@treasury.gov.za*

CONTENTS

GLOSSARY

AG	Auditor General
BEPP	Built Environment Performance Plans
BRT	Bus Rapid Transport
CMIP	Consolidated Municipal Infrastructure Programme
DCoG	Department of Cooperative Governance
DEA	Department of Environmental Affairs
DORA	Division of Revenue Act
DoT	Department of Transport
DPME	Department of Performance Monitoring and Evaluation
DWS	Department of Water and Sanitation
FFC	Financial and Fiscal Commission
HSDG	Human Settlements Development Grant
ICDG	Integrated Cities Development Grant
IDP	Integrated Development Plan
INEP	Integrated National Electrification Programme
LG	Local Government
LGES	Local Government Equitable Share
MEC	Member of the Executive Council
MIG	Municipal Infrastructure Grant
MinMEC	Ministers and MECs meeting together
MISA	Municipal Infrastructure Support Agent
MTEF	Medium Term Expenditure Framework
MuniMEC	Municipalities and MECs meeting together
MWIG	Municipal Water Infrastructure Grant
NDHS	National Department of Human Settlements
NDP	National Development Plan
NT	National Treasury
NTO	National Transferring Officer

O & M	Operations and Maintenance
PMU	Project Management Unit
PTIG	Public Transport Infrastructure Grant
RBIG	Regional Bulk Infrastructure Grant
RSC	Regional Service Council (Levies Replacement Grant)
SALGA	South African Local Government Association
SPLUMA	Spatial Planning and Land Use Management
SRSA	Department of Sports and Recreation South Africa
USDG	Urban Settlements Development Grant

CHAPTER 1 – INTRODUCTION

BACKGROUND

This 'Recommendations for Reform' paper provides a set of proposals for changes to the local government infrastructure grant system. The paper is the closing report of the first phase of the *Review of the Local Government Infrastructure Grant System* (henceforth "the Review") that was initiated by the Minister of Finance in 2013. The terms of reference for the Review were endorsed at the October 2013 Budget Forum and led to the establishment of a working group and steering committee. Officials from the following institutions were represented on these committees:

- National Treasury – the coordinating department
- Department of Cooperative Governance (DCoG)
- Financial and Fiscal Commission (FFC)
- South African Local Government Association (SALGA)
- Department of Performance Monitoring and Evaluation (DPME).

The collaborative working group and steering committee engaged in data analysis, policy and literature reviews, and widespread consultations with stakeholders at all spheres of government. This sustained research and consultative engagement over several months has allowed the Review to develop evidence-based recommendations on changes to the current system of funding municipal infrastructure. The Review's recommendations from the first phase are contained in this document.

More information on the *Review of the Local Government Infrastructure Grant System* – such as its terms of reference, structure and purpose – can be found online at: mfma.treasury.gov.za/Media_Releases/ReviewOfLGInfrastructureGrants/Pages/default_final.aspx

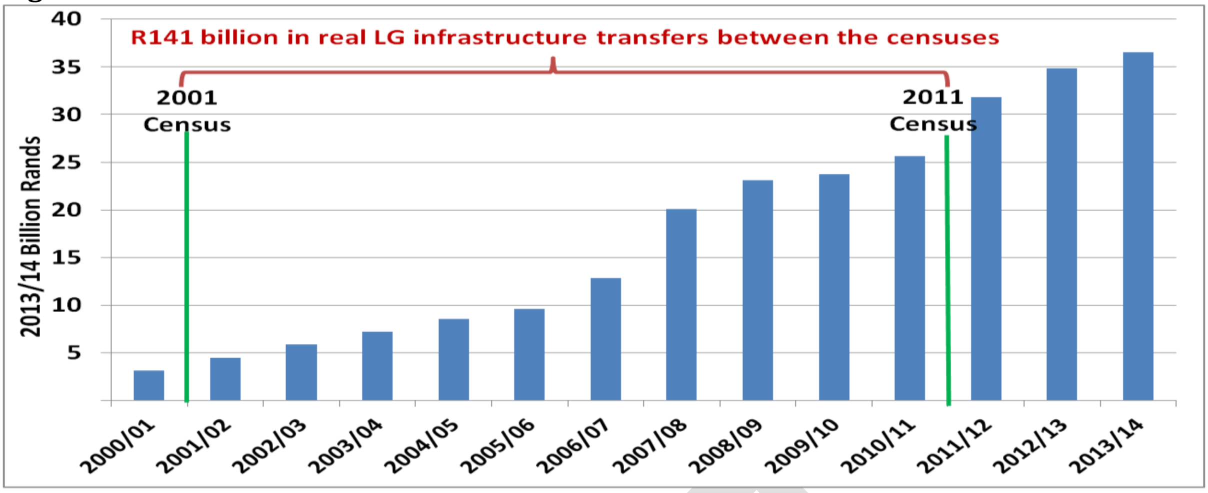
PROBLEM STATEMENT

In the calls for this Review various national, provincial and municipal stakeholders raised concerns with current infrastructure grant system. These concerns, together with further issues established via the research of the Review, form the problem statement:

Value for Money

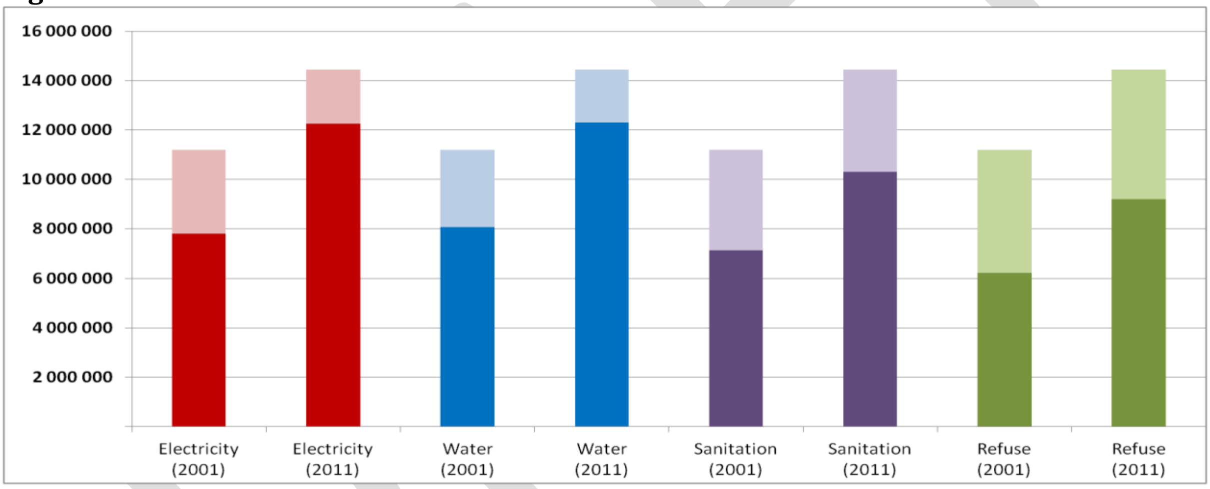
The scale of funding aimed expanding the delivery of basic municipal services – such as water, sanitation, electricity and refuse removal – has increased substantially since the establishment of current local government system. As figure 1.1 shows, R141 billion rand (in real terms) was allocated via infrastructure grants to municipalities between the 2001 and 2011 censuses, representing huge average annual growth of 20% above inflation.

Figure 1.1: Infrastructure Grants to Local Government: 2000-2013



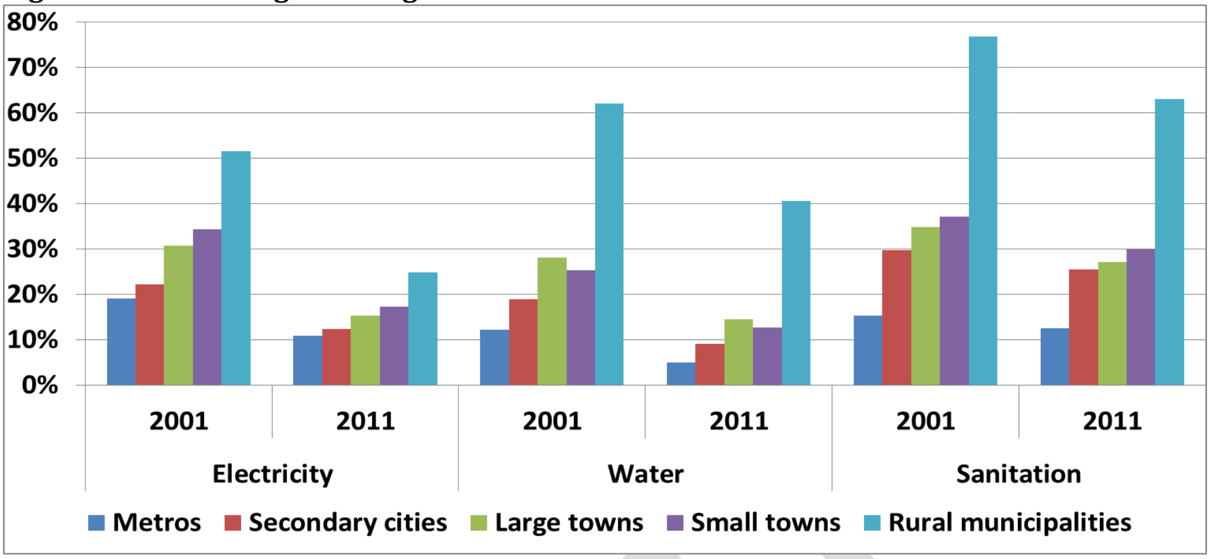
The 2011 Census revealed the extent of service delivery in several basic services delivered by municipalities such as water, sanitation, electricity and sanitation. Despite considerable progress in the roll-out of services since the 2001 Census, the level of service backlogs was still high, as indicated in figures 1.2 and 1.3.

Figure 1.2: Access to Basic Services[1]: 2001 – 2011



[1] Dark colours signify the number of households *with* access to that service in that year, the lighter colours represent the number of households *without* access – i.e. the number of backlogs

Figure 1.3: Percentage Backlogs in Access to Basic Services: 2001-2011



Given the scale of funding increases yet persistent backlogs, questions have been raised over the efficiency with which infrastructure grants to municipalities are used to achieve such backlog eradication. Previous estimates of the cost of backlog eradication have been surpassed by increased allocations, though many potential reasons exist for this and require exploration. Ensuring value for money in infrastructure grants is therefore a key part of the problem statement – not only to ensure accountability to tax-payers but also to improve roll-out of services to those citizens the allocations were designed to benefit.

Accountability

Further analysis into the value for money that infrastructure grants are delivering is hampered via the non-availability of reliable data-sets. Although monitoring of municipal budgets, including grant expenditure, has improved substantially over recent years, many key questions still remain unanswered. Financial information is complicated by different data-sets (in-year information provided by the municipality vs annual financial statements vs the national department's reports for example) and non-financial performance information is often non-existent[2]. Not only do such limitations of available data reduce the ability of government to make evidence-based policy changes to improve effectiveness and efficiency of the grant system, it reduces accountability at all spheres of government. At a national level, departments must report to parliament on the outcomes of grants appropriated for a specific purpose and be held to account. At municipal level, the local electorate should be able to hold their institutions and councillors to account and see what has been achieved with such grant allocations. Such accountability is currently largely absent from the system[3] and forms an integral part of the problem statement.

Grant proliferation

The Financial and Fiscal Commission's (FFC) annual submissions on the Division of Revenue Bill have often raised concern with the proliferation of grants. Following the consolidation of programmes into the Municipal Infrastructure Grant (MIG) in 2004, there were only two capital grants of significance as opposed to the ten infrastructure grants in the 2014 Budget, many of which also have indirect portions that further increase the total number.

[2] The quality of information is variable, depending on the service concerned, with water supply data being relatively good while roads data has serious shortcomings.
[3] As will be discussed, some grants' reporting and accountability is far higher than others

As the Evolution of Local Government Infrastructure Grants 2004-2014 paper further details, the creation of such grants were often responses to challenges in the municipal infrastructure sector (such as persistent backlogs) or new policy developments (such as the public transport grant) at the time. However, the grant system as a whole has not been managed holistically resulting in new grants that can counteract or duplicate the efforts of other grants. The result is a complex system of grants without coordinated strategy or cohesion, hampering effective planning and management of infrastructure by local government. Figure 1.4 (next page) highlights this proliferation and growth of the system since 2000.

While the creation of extra grants was an easy response to new demands, especially during South Africa's period of fiscal expansion in the mid-2000s, the phasing-out of old grants is a rare occurrence[4]. Even grants deliberately motivated as short-term and transitional – such as the Municipal Water Infrastructure Grant – have continued beyond their projected lifespan. The resistance is largely due to the political influence of national departments[5] whereby it is easy to please departments by awarding them a new grant but it takes considerable argument and potentially political capital to phase-out an old grant. This phenomenon has further contributed to the proliferation of grants. As a result of this fragmentation of grants away from the original MIG concept, the benefits to municipalities of consolidated funding with the associated primacy of local investment decisions have faded in recent years. A system that emphasises the benefits of consolidated funding therefore also requires strong and strategic leadership, including political buy-in, so that the inevitable requests for splintering consolidated funding into sector grants can be resisted. Failure to manage the system holistically and resist the political pressure for new grants is one of the key reasons the current system has experienced problems.

Sustainability

Asset Management

Though capital grants' focus is on the creation of assets, the lifespan of those assets must also be considered. A variety of stakeholders – ranging from national sector departments to municipal service delivery protestors – have drawn attention to the poor functionality of municipal infrastructure assets. Questions have therefore been raised over the ability, both in financial and organisational terms, of local government to sustainably manage such grant-funded assets after their creation.

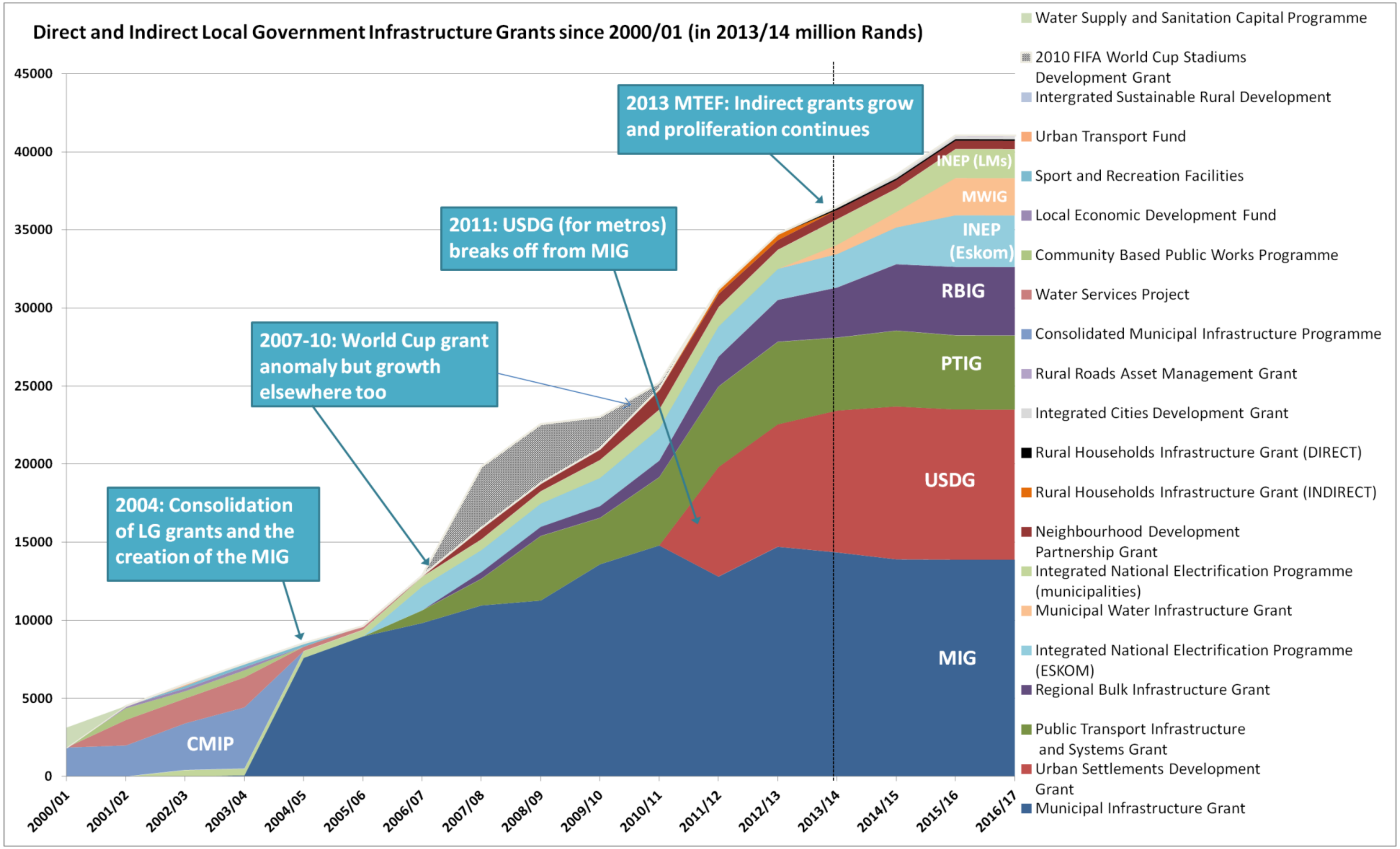
Several issues were established as undermining efficient asset management of municipal infrastructure, such as the lack of credible asset management plans[6] and non-prioritisation of renewal and maintenance expenditure. In the case of the renewal it is recognised that this relates directly to the grant system: since the establishment of the current local government system, grants have largely focused on the extension of basic services to all citizens as per the Constitution's Bill of Rights. This emphasis on backlog eradication has, with good motives, incentivised municipal investment in new infrastructure that connects previously unserviced areas to water, sanitation, electricity or roads networks. In 2014, the persistence of backlogs is concerning (see above), a key part of the problem statement and still a government priority.

[4] The 2010 FIFA World Cup Stadiums grant, which had an obvious limit to its timespan, was allocated to cities between 2007/08 and 2010/11 and is a rare example of a local government infrastructure grant being phased-out in recent years

[5] And will be explored further in the grant administration section

[6] Despite 73% of municipalities having a GRAP compliant asset register

Figure 1.4: Scale and Structure of the Grant System since 2000 (growth in real terms)



However the conditionality of many grants restricts municipal investment to building *new* infrastructure rather than make cost-effective investments in rehabilitating, upgrading or replacing *existing* infrastructure. This persistent extension of a municipal asset base can undermine sustainable asset management practices particularly if there is not also targeted investment in economic infrastructure that boosts the rate-base. Social infrastructure investment may not be matched by a corresponding increase in own revenues, via tariffs and rates[7], to fund the operations and maintenance of a new infrastructure asset.

Furthermore, over-engineering of grant-funded capital projects can also undermine the sustainability of municipal infrastructure. Such choices – whereby capital expense is higher than necessary or can increase future operational costs – can result from a poor oversight of other stakeholders (especially the national sector department), perverse incentives in the grant (such as the PTIG) or short-sighted decision-making at municipal level based on political rather than planning time-horizons.

There are concerns about the ineffective use of capital which, can be related to the following:

- Service levels being higher than necessary, driven by community demands, political motives and a propensity of engineers to prefer higher service levels.
- Unnecessary expenditure on rehabilitation of infrastructure which has failed due to inadequate maintenance.
- Weak planning particularly with regard to integrating technical and financial planning with the result that decision making on projects is overly political with too little understanding of financial constraints and long term sustainability.
- Poor oversight of contracts by municipalities often due inadequate support.
- Perverse incentives in the grant – such as the PTIG whereby national-funded capital costs are inflated to reduce future municipal-funded operational expenditure.

Unlocking Growth

A final aspect of sustainability relates to investment in economic infrastructure that can unlock growth and boost future revenues for the municipality. Municipal investment of this sort can often be seen to be diverting funds from backlog eradication or subsidising the poor, yet well targeted economic infrastructure can often do more to transform the lives of a municipality's indigent population by creating development opportunities. The Review's research has shown that the funding gap for economic investment is far greater than the funding gap for investment in backlogs or other social infrastructure that exclusively targets the poor. Although the primary focus of the grant system remains to provide a basic level of service to all South Africans by subsidising the capital cost of infrastructure to the poor, the false dichotomy of economic vs social infrastructure limits municipal investment in infrastructure that can serve both purposes. For example, a new road that connects rural villages not only provides easier access to government services and reduces a 'roads backlog' but provides villagers access to a bigger market for their wares and increases the chances of inward investment in the region. Grants in urban areas, particularly the *public transport infrastructure grant* and the *neighbourhood development partnership grant* have encouraged capital expenditures that can transform an area rather than just meet minimum access criteria, and therefore promote further investment that can improve the municipality's long-term financial prospects. Outside of the metros, such grants are rare and potential for own-revenue raising to invest in economic infrastructure is lower, so under-investment becomes likely.

[7] Since 2013, the local government equitable share formula provides a subsidy for water, sanitation, electricity and refuse regardless of if the infrastructure is in place or not

The problem statement therefore points to a lack of financial and asset sustainability in the grant system whereby a more flexible investment mix is required between:

1) new infrastructure to eradicate backlogs
2) renewal of existing infrastructure
3) and targeted economic infrastructure that can unlock growth

Capacity

It is well over 15 years since South Africa's White Paper on Local Government was published and though the intergovernmental system has matured in many ways, the development of capable local governments has lagged. Capacity challenges continue to exist within all spheres of government – and limits to the capacity of national departments is part of the problem statement – but are perhaps most stark in municipalities. Inadequate systems, insufficient qualified personnel and poor leadership at local level can undermine the best-prepared policy that fails to consider the context of implementation. The spectrum of municipalities ranges from established global cities with budgets that are bigger than some provinces, to small and rural municipalities in former homelands where budgets are almost entirely grant dependent. This diversity has led to a partially differentiated approach in funding municipalities but differentiation also relates to the capacity of municipalities to manage the infrastructure which is built using grant funds. Particularly at the rural end of the municipal spectrum where grants are often focused, the municipalities or other institutions which may support them are often the newest, the local democracy the least mature, and the costs of 'importing' external capacity the highest. As such, capacity challenges – which underpin everything in the intergovernmental system – are particularly crucial to the infrastructure grant system.

Though a critical part of the problem statement for reforms to the local government grant system, the role of capacity is not one that can be tackled head-on in this Review as is explained in the scope. Integrating the Review's outcomes with the Department of Cooperative Governance's Back to Basics approach will help overcome those areas outside the scope that are still critical to improving municipal performance. Regardless, acknowledging such varied capacities across South Africa's 278 heterogeneous municipalities is crucial to proper implementation of reforms and the grant system must, where possible, facilitate further development of local capacity rather than hinder it.

Intergovernmental Relationships

The Review's work has often returned to a central question surrounding the extent of South Africa's commitment to fiscal decentralisation. As the Literature Review highlighted, grants are used for various means but what usually determines the type of grant is whether the recipient municipality is seen as an autonomous government responsible for local affairs and priorities or rather simply a service delivery arm of national government: "Are local entities just service providers for central government policies and programmes, or shall they have the right to govern themselves?"

Though the Constitution respects the authority of municipal councils, it sets out the principle of subsidiarity subject to capacity and effectiveness of local administration. The National Development Plan (NDP) also adopts a differentiated approach to devolution, supporting the devolution of functions, such as housing and transport, to metropolitan municipalities yet still proposing regionalisation of service delivery "as a response to uneven capacity" in rural areas. In the infrastructure grant arena, municipal council approved integrated development plans (IDPs) are supposed to guide investment. Yet national grant administrators in sector departments often feel they can dictate grant investment to align with national government's plans and priorities causing tension between the primacy of planning of different spheres. The Spatial Land Use Management Act provides further clarity on the legal roles of different spheres in planning, but in practice there is likely to remain a high degree of confusion and contestation over the roles of the different spheres in determining what infrastructure is built where.

The existence of intergovernmental transfers – and a review thereof – also creates a game of political economy whereby maximising one's own institution's best interests can disrupt the efficient functioning of the system. Although the goal of efficient and sustainable municipal infrastructure is agreed to by all stakeholders, they can take very contradictory positions on the means by which to achieve it. For example, municipal stakeholders emphasise the inadequacy of allocations, despite underspending of previous years' grants, and push for minimal conditionality to increase their own discretion when spending such transfers. National sector departments however highlight the inadequate capacity of municipalities, despite their constitutional role in developing such capacity, and push for indirect or highly conditional grants that maximise their own power and budgets. Such self-maximising behaviour is neither unique to South Africa's intergovernmental system nor necessarily damaging to its performance. However, acknowledging such vested interests is crucial to ensuring fuller and more frank discussions on issues of which type of grants should exist, administered by whom and conditional upon what.

Clear guidance regarding the roles of national sector departments that are responsible for functions and services delivered at local government level is also absent. Similar guidance for the coordinating departments – such as Department of Cooperative Governance or National Treasury – on the role they are expected to play in overseeing the grant system requires clarification. The ambiguity of these roles has led to unnecessary duplication of processes, and even duplication of grants in instances such as the Municipal Water Infrastructure Grant, and distorted accountability. Clarity over the role a sector department is expected to play in overseeing and supporting grant implementation, and the role a coordinating department is expected to play in managing, allocating and evaluating grants and the grant system, could reduce intergovernmental frictions and improve the coordination of municipal infrastructure grants. One of the major obstacles to the successful consolidation of the MIG since 2004 has been the failure of national sector departments to play supporting roles in the grant and of DCoG to provide proper coordination of the relevant departments. Even though the grant does not sit on the budget of the sector (be it water, sports, roads or any other sector) the spending of MIG directly impacts on the outcomes the respective national department is seeking so careful collaboration between DCoG and the sectors is required. The original MIG Policy documents recognised this need for coordination so DCoG attempted to involve sectors via coordinating structures – such as the quarterly meetings – but these have waned in recent years. Sector departments argue there is no leverage in the MIG and often feel spending on their sector is sacrificed, even if – as is the case with roads or water – data suggests municipal spending in that sector is greater than the MIG formula allocates[8]. This failure of cooperative governance and coordination in a consolidated grant needs to be rectified moving forward in other consolidated grants, with better defined roles of national departments crucial to this. Using planning as a coordinating function rather than grant funds (similar to the Built Environment Performance Plan in metros) could be an alternative mechanism of improving cooperation between sector departments in the municipal space.

Equally, the clear identification of functions and responsibilities at municipal level, particularly the way they are shared between district and local municipalities, also hampers the effective allocation of funds and the associated provision of infrastructure. This is most obvious in the

[8] See Chapter 6

case of municipal roads but there are also on-going shifts in the way some district and local municipalities share other service provision responsibilities with water services sector being a notable example.

In sum, a clear and widely agreed upon fiscal decentralisation framework does not exist to guide reforms to the local government infrastructure grant system and many discussions surrounding the issues raised by this Review are clouded by the inherent vested interests in the intergovernmental system.

Regionally strategic municipal infrastructure

Through the stakeholder engagement process it is evident that formula based allocations of grant funds, particularly to smaller municipalities, do to not always adequately provide for large scale 'regionally strategic' infrastructure which typically results in a 'lumpy' expenditure profile and may be used by more than one municipality. Therefore one suggestion would be to have a portion of the funding allocation kept separate to fund these lumpy or regionally strategic projects in such municipalities. This could be an indirect 'Schedule 6' grant to be spent based on priorities of national departments, but the second phase of the Review will further investigate this and other options for funding regional or special infrastructure projects not catered for in the current system.

SCOPE

Given the number and breadth of concerns associated with municipal infrastructure and the associated service delivery, the Review does not aim to solve all of the problems pertaining to local government infrastructure or local government funding. Rather it is complementary to work elsewhere in government, including the following processes:

- DCoG's Back to Basics approach
- MIG policy review
- Work on development charges
- Potential for new sources of municipal own revenue
- Municipal borrowing reforms
- Procurement process
- The development of Integrated Urban Development Framework

Furthermore it is important to note that as part of the mandate given to the Review, the scope includes or excludes the following issues:

- The Review has limited itself to reviewing ways to maximise *existing* resources rather than seeking solutions that require additional funds into the grant system
- The Review will evaluate and suggest reforms to capital grants rather than operating or capacity building grants
- The Review is cognisant of the important role that infrastructure funded by own revenues has on service delivery at the municipal level (i.e. the funding of economic infrastructure or operations and maintenance of grant funded infrastructure) but it does not explicitly look at borrowing or private sector funding
- The Review does not seek to make changes to sector policies, instead it has looked at options to adjust the system to better meet the policy objectives of national government

- Changes to grant frameworks – particularly issues pertaining to conditionality or reporting requirements – are included in the scope, as is scheduling of grants to see which require more flexibility and which need greater conditionality
- Although obvious overlaps exist with provincial or national infrastructure projects, the recommendations do not explicitly go beyond local government infrastructure grants, though analysis may suggest future reforms in these areas

This narrow scope was necessary to ensure the Review could achieve its goals within the short timeframes set however the impact of the research should also prompt further reforms in areas outside the scope. The link with municipal own revenues is paramount and as highlighted the Review's recommendation should tie in with other research in that regard. Equally operating and capacity building grants can play just as crucial a role in the success of municipal infrastructure as the capital grants reviewed here so further work is needed to link the various types of grants national provides to municipalities.

PRINCIPLES

Analysis of domestic and international literature and policy experiences by the review's working group led to the drafting of principles which should guide South Africa's local government infrastructure grant system. Following widespread consultation with municipalities and national stakeholders following eight principles are the final list:

1. Respect the Constitutional Mandates of Different Spheres

- The principle of subsidiarity means municipalities are responsible for the provision of certain infrastructure, such as water and roads; **funds must follow the assignment of functions**

- Fiscal, capacity and coordination related **economies of scale may exist at district or national level**; these should be harnessed where viable but only in consultation with the affected municipalities so as to maintain subsidiarity

- The Bill of Rights means progressively providing **access to a basic level of service** is a priority, but broader socio-economic development must also be targeted while respecting budget constraints

- The constitution requires that municipalities must be afforded the right to plan and implement their functions (including infrastructure projects needed to perform these) but the national sphere also has a responsibility to support and build capacity of municipalities to perform these functions.

2. Provide for Predictability and Stability

- Encourage sound financial management and planning processes by enabling municipalities to plan infrastructure investments for future years

- Very important for infrastructure funding due to benefits which occur over a medium to long term and frequent 'lumpy' and multi-year nature of infrastructure investment

- Municipal plans can take account of the value of future grant transfers. This ensures there is no incentive to over-commit or over-spend grant funds

3. Encourage Transparency, Simplicity and Accountability

- Grants must be **simply motivated** towards achieving recognisable **outcomes** to encourage accountability to **citizens and other spheres of government**
- Allocation criteria and processes criteria will vary across grants but these criteria must be known; especially if municipalities need apply

4. Integrate a Variety of Funding Sources and Aims

- Grants cannot meet all municipal infrastructure needs; **a mix of funding sources** from own revenues and private investment should be encouraged
- Infrastructure investment must **not solely target indigent or economic** customers; grants fund basic infrastructure for those who cannot pay but must also **catalyse investment** that is recoverable via tariffs from those can pay
- Grants must also integrate with broader government aims to ensure holistic **spatial development** outcomes occur over individual sector-based outputs

5. Be Sustainable and Unlock Growth

- Infrastructure choices (by whoever the implementing agent) must be based on **longer-term** operating, maintenance and renewal costs to the municipality
- Sustainability is also premised on having **capable municipalities** able to manage infrastructure which is funded through grants and other sources of finance; investments in infrastructure must take capability into consideration
- Recognising the **multiplier effect** of economic infrastructure investment is crucial in ensuring the longer-term **fiscal viability** of a municipality and its infrastructure assets; unlocking economic growth must therefore also be a priority and principle of the grant system

6. Involve Supportive National Departments

- National transferring officers (at national departments) must be geared towards the administration and accurate monitoring of conditional grants outputs and outcomes at municipal level
- Clear **information and support** must be given to municipalities to allow them to meet the conditions of the grant and implement national policy
- National government – along with other spheres and entities of government – must lead in ensuring local government is **suitably capacitated to implement** grants and to ensure that systems are in place so that infrastructure is sustainably operated and maintained.

7. Reflect Approach of Differentiation

- Municipal infrastructure needs change over time and are different across the country: grants must **avoid a 'one size fits all'** approach

- Funding mechanisms will need to change with future realities in mind too; grants should therefore be **regularly re-evaluated** without disrupting the stability of the system

8. Reinforce practices that optimise the impact of grants and minimise negative spillover or perverse unintended effects

- Individual grants and the grant system as a whole must encourage positive behaviour and **incentivise role-players**, implicitly or explicitly, towards agreed outcomes
- The potential for perverse incentives or unintended consequences – such as 'playing the game' must be limited

CHAPTER 2 – VISION FOR THE GRANT SYSTEM

This section sets out in broad terms what it is that the reforms to the grant system seek to achieve. The details of the proposals are contained in subsequent sections, allowing this chapter to provide a high-level summary of what it is that the changes being proposed hope to achieve over the long-term.

In brief, the proposals emerging from this review seek to introduce changes to the system of local government infrastructure grants to:

1. Introduce greater differentiation in the type of grants going to different municipalities, enabling the system to better respond to the different circumstances and needs of rural and urban municipalities.
2. Pivot from focussing almost exclusively on rolling out new infrastructure to including a greater focus on the management and renewal of existing infrastructure to ensure the sustainable provision of services, while still extending infrastructure where needed.
3. Ensuring greater value-for-money is achieved from the funds spent. To achieve this, improvements are needed in planning for appropriate infrastructure solutions before construction begins and in the monitoring of progress during implementation (by municipalities, national government and local communities).
4. Ensure greater coherence in the management of the grants system by national government through improving coordination among national departments, strengthening monitoring and capacity building efforts within departments managing grants and requiring better assessments and planning before the introduction of any new grants.

Some of these changes can be implemented quickly, while other proposal will take longer to refine and implement. The intergovernmental transfer system has been constructed over many years, and the reforms proposed by this review aim to build on the aspects of the system that are working and to change those that are not working. As the National Development Plan warns us, "Government often underestimates the disruptive effect of major policy adjustments on service delivery." This review will not propose changes for the sake of making changes; it will propose incremental changes to build a grant system that can better support the rollout of sustainable municipal infrastructure.

A differentiated system

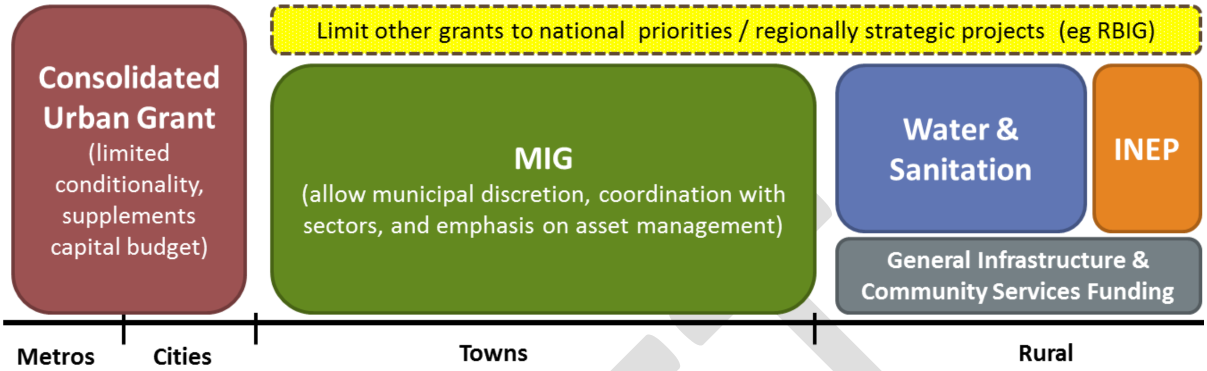
Once all of the reforms have been implemented the local government infrastructure grants system will have a differentiated structure to respond differently to the circumstances and needs of different types of municipalities.

- In metropolitan areas and predominantly urban cities it will provide an integrated package of funding to enable municipalities to extend services to expanding urban populations. Incentives and planning requirements and associated support will help to ensure municipalities direct their infrastructure investments (funded from grants and own revenues) to build more integrated cities that support economic growth.
- In rural areas with high backlogs and relatively weak municipal capacity (particularly in former-homeland areas) the grant system will provide both general funding and separate sector-based grants for water and sanitation and electricity. General grants will ensure municipalities can still respond to the priorities determined in their integrated development plans. The sector grants will be coupled with enhanced support and monitoring of municipalities by sector departments to ensure municipalities are able to

build the infrastructure needed to extend access to basic services to all households, despite their capacity challenges.

- Towns with smaller backlogs will receive a consolidated package of grant funds that they can prioritise to meet the service delivery needs specific to their circumstances.

Figure 2.1: The long term general vision for the grant structure is shown in the below



The next chapter on the structure of the grant system will outline in detail what individual grants will be targeted at each of these different groups of municipalities and what changes will be implemented in the 2015 MTEF and which will take longer to bring to fruition on the road to achieving this vision.

Promoting sustainable infrastructure management

Across all municipalities there will be a much greater emphasis on the full life-cycle of municipal infrastructure and not just on the rollout of new infrastructure. Planning for appropriate infrastructure that responds to local circumstances, maintaining infrastructure that has been built and refurbishing infrastructure that has reached the end of its design life are key to the sustainable provision of municipal services. In particular planning relating to the technical aspects of infrastructure must link to financial planning in order to ensure adequate funding for both the capital and operational activity. While the local government infrastructure grants system is not the most appropriate way to fund all of these activities, the design and management of each grant must promote good practices in planning and maintenance (with rewards for municipalities that follow best practices, and penalties for those that do not) and grant funds should be made available to support the renewal of infrastructure that has reached the end of its design life.

Supporting a sphere capable of delivering sustainable services

The design of the grant system must support building a capable developmental state at local government level. The Constitution establishes local government as a sphere with the responsibility to govern the local affairs of its community (subject to national legislation), and with a responsibility to ensure the sustainable provision of services to communities. The transfer of conditional grants from national departments must not undermine the role of elected municipal councils in deciding how to provide services to meet the needs of their constituents. At the same time, it must be acknowledged that many municipalities are organisationally weak and need support to be able to deliver on their mandates. The grant system must enable national government departments to provide this support and guidance without replacing the need for municipalities to learn and build their own capacity. At the same time the role of partnerships with the private sector and with public entities such as water boards needs to be recognised: where capacity does not exist within municipalities, partnerships can play an important role. The infrastructure grants system must work with the capacity building initiatives to promote effective and sustainable municipal service provision through the participation of a full range of institutions. .

Reporting

Each municipality will receive a small number of grants and the reporting formats and indicators will be aligned to make reporting easier for municipalities and to ensure that the information collected is comparable across municipalities. This will reduce the reporting burden for municipalities and ensure data can be used to inform analysis and decisions in national and provincial forums.

Promoting value-for-money and reducing corruption

Infrastructure projects are always susceptible to wasteful spending and inflated costs. Enhanced oversight from above and below can help reduce this. The grant reporting system must produce the data necessary for national departments to monitor the unit costs of different projects and identify projects with unreasonably high costs. Where suspicions of corruption are aroused these must be referred for further investigation. Oversight of projects by the citizens they will impact must also be promoted and enabled. Information on project plans and progress should be made available to local residents so that they can hold their municipality accountable for progress on projects.

Stemming grant proliferation

Any proposed new grant must go through a rigorous process to evaluate whether a new grant is needed and whether the purpose the proposal serves cannot be met through existing grants instead. If the need for a new grant is approved by Cabinet then a grant design process must be undertaken in line with guidelines set by National Treasury. This will prevent the ad-hoc creation of conditional grants that has resulted in the proliferation in the number of grants over the last decade without a corresponding improvement in the performance of the system. All grants must be reviewed periodically, with a view to changing or eliminating them if they are not performing. Indirect grants in particular must have a pre-determined set of criteria that must be conformed with prior to their creation. They must also be considered transitory grants that help build capacity and transfer skills rather than be seen as a permanent solution.

Co-ordination structures

National departments will have to meet regularly with each other to coordinate the grant system at national level. National Treasury will also have to take on an enhanced role in ensuring the grant system adheres to the principles set out in this review and that funds from the different grants are allocated fairly across the country's 278 municipalities.

Implementing changes

The changes needed to make a reality of this new grant system must be phased-in at a pace that does not disturb ongoing projects and commitments funded from the current grant system. Many of the changes proposed will also take significant time – and a lot of hard effort by many different stakeholders – to get right. While some changes will be introduced in the 2015 Budget, most grant allocations and structures for the 2015/16 financial year will remain as indicated in the 2014 Division of Revenue Bill. The subsequent chapters set out 'roadmaps' for how each set of proposed reforms should be phased-in and what groundwork needs to be done before proposals can be implemented. Most of the major changes should be in the process of being introduced by the time new municipal councils are elected in mid-2016.

LESSONS LEARNT

The review process included data analysis, literature reviews and extensive consultations with municipalities and departments, through which we learnt that:

- National sector departments are frustrated by MIG funds being administered by DCoG. All feel their sector – be it water, roads or sports – is under-invested in and would prefer to see grant funds flow through their own budgets rather than engage with the MIG to ensure more appropriate investment and be able to offer sector oversight.
- Roads projects have more funds invested in them compared to their share of the MIG formula, reflecting the preference for visible projects and relative ease of putting together roads projects.
- MIG spending varies considerably by region, reflecting the positive effect that a consolidated grant can have in boosting local discretion rather than imposing strict investment criteria (such as requiring a minimum of 50% must go to water).
- Municipal engineers tend to argue for 'ringfencing' in consolidated grants or stand-alone sector grants to protect the investment for their sector
- However, municipal leadership and non-engineering officials tend to prefer integrated and consolidated grant funding that enhances integrated municipal planning rather than having investment dictated by conditions of a national sector department
- International literature and practices favour consolidation for administrative ease at national and local level – a single grant is typically either administered by the ministry for local government, the ministry for finance, or by an independent grant commission
- The direction of recent urban reforms – which have emphasised integrated planning of the whole capital budget rather than strict monitoring a single grant –have been welcomed by metros and are favoured by secondary or emerging cities
- Proliferation of grants in recent years has coincided with increasing differentiation. While rationalising the number of grants to avoid duplication is necessary, a single grant for all municipal infrastructure would fail to acknowledge the variety of municipalities and not reflect the principle of differentiation.
- As the problem statement set out, there is an absence of a clear framework regarding fiscal decentralisation to guide grant reforms, however recent policy decisions and the Review's research indicate a need for increasing asymmetry

CHAPTER 3 – STRUCTURE OF GRANT SYSTEM

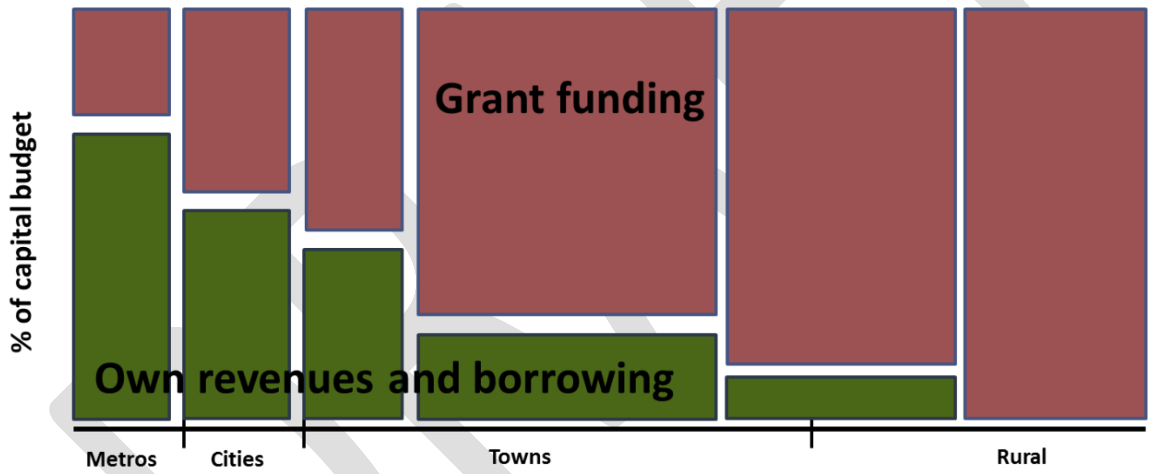
This section follows the principle of differentiation and the recommended approach of asymmetrical decentralisation via the grant system.

The Constitution and other guiding legislation and policies such as the NDP, and the Problem Statement for this review are clear that where capacity exists, functional responsibilities for local matters should be decentralised to municipalities. This leads to proposals for reforms in metros and secondary or emerging cities that emphasise the need for consolidated funding to allow integrated planning to drive investment at municipal level. In the long term, the vision for the local government infrastructure grant system includes reducing conditionality from national government as better capacitated municipalities make informed infrastructure investment decisions based on their local circumstances and priorities. However, this will not be likely to be achieved for at least another decade and would require a further review of the grant system before it could be implemented.

While consolidated funding may be an end goal, the reality facing the grant system in the short- to medium-term is very different. As such, the grant structures that are needed over the period ahead are differentiated across four municipal types – metropolitan, secondary and emerging cities, towns, and rural municipalities – with a rationalisation of funding proposed to reduce administrative burdens (especially in the water sector) but with increasing roles for sectoral oversight and monitoring in the lower capacity and rural municipalities.

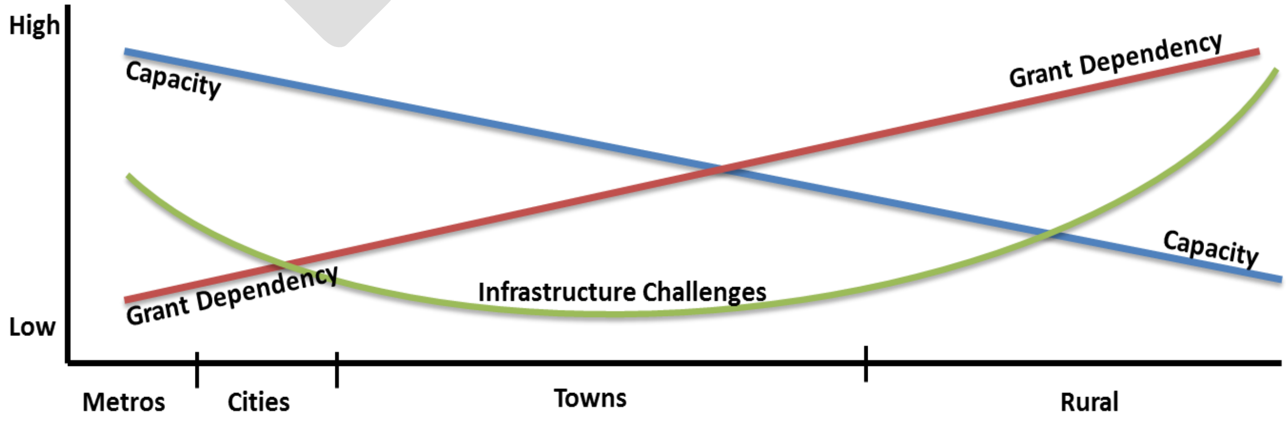
This differentiated approach also recognises the different roles that grant funding plays in different municipalities. For some, grants form almost the entire capital budget whereas for others, especially metros, grants are only 25% of the capital budget and therefore must be less conditional to ensure smoother integration with other sources of finance – adhering to principle 4. The diagram 3.1 below highlights this urban to rural spectrum of grant dependence which also implies the necessity for grants to fund both social and economic infrastructure in more rural areas:

Figure 3.1: The Urban to Rural Spectrum of Grant Dependence



The spectrum on figure 3.2 also shows the varying capacity or level of infrastructure challenges, in terms of backlogs, in-migration or national priorities.

Figure 3.2: The Urban Rural Spectrum of Capacity, Dependency and Challenges



DIFFERENT TYPES OF GRANTS

In discussing the different grants that are proposed for each type of municipality, it is useful to consider a general classification of the different types of grants that can be included in the grant system.

1. **General infrastructure grants**
    - This should be the majority of national-funding for municipal infrastructure
    - Are formula based to ensure equity in allocation
    - Stable and predictable allocations to improve planning
    - Should enhance municipal discretion with the IDP, rather than national priorities, informing where grants funds are invested
2. **Project based grants**
    - Fund projects that cannot be funded by the general infrastructure grant
    - Provide for large-scale 'lumpy' investments
    - Regionally strategic projects that cross municipal boundaries
    - Or responding to national priorities that might otherwise not be invested in by the municipality
    - Municipalities would apply for these grants and would plan and implement the projects funded through the grant
3. **Sector grants**
    - Targeted towards municipalities where the service-delivery need is apparent but the municipality is incapable of meeting that need due to capacity or institutional challenges
    - National sector departments would provide additional support and assistance to municipalities in planning and implementing projects
    - These sector grants can be implemented as direct or indirect grants (with the intention to move towards more direct allocations over time):
    a. Direct – allows extra sector oversight and support, but also include capacity building aspects so can become general funding over time
    b. Indirect – must have a short life-span, emergency in nature and build capacity so can become direct over time (must include a service delivery agreement with the municipality)

The proposals for each municipal type will be discussed in turn in further details but the below diagrams (3.3 and 3.4) highlights the various roles different grants will have in such categories compared to the status quo:

Figure 3.3: Grant Structure Status Quo

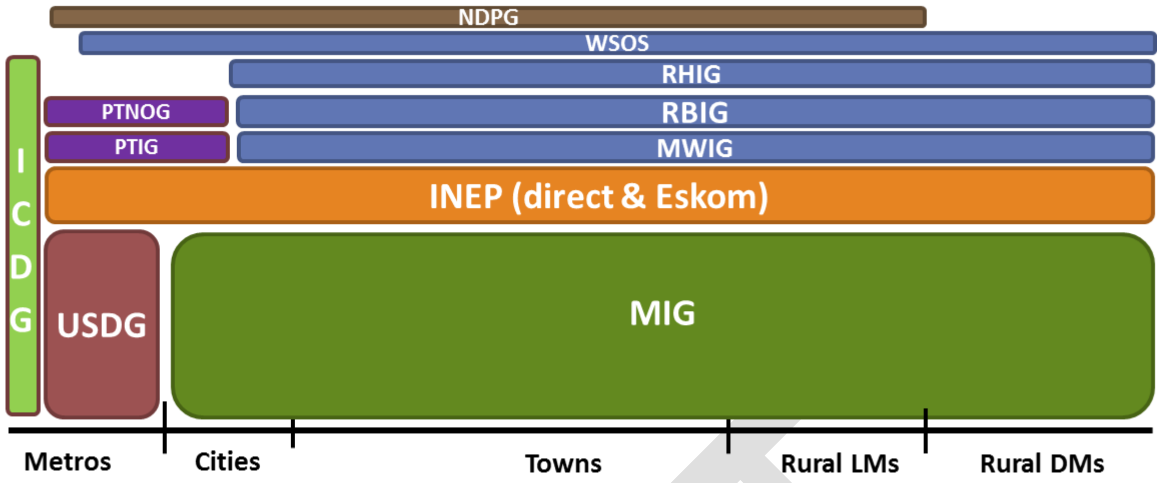
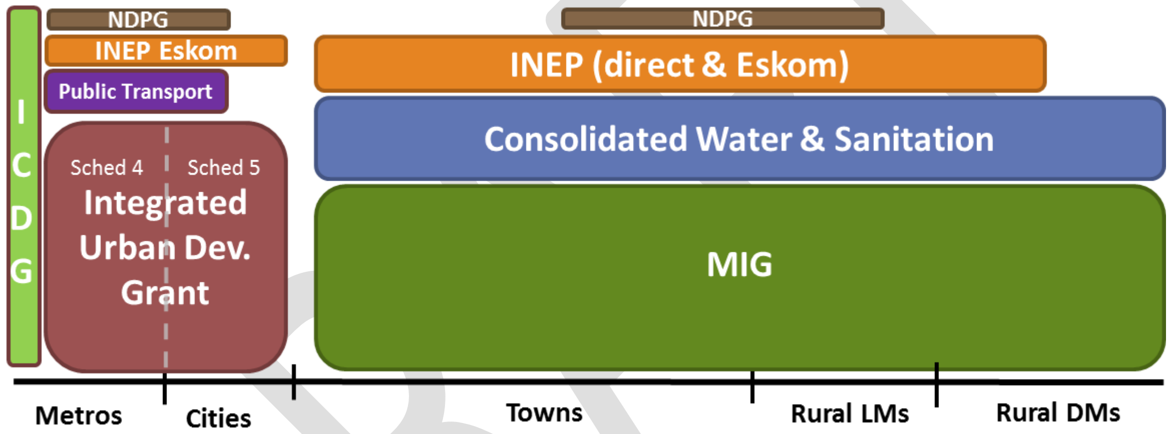


Figure 3.4: Grant Structure Proposal



Name	Characteristics	Examples
Metropolitan	Classified as category 'A' municipalities by Municipal Demarcation Board	eThekwini; City of Cape Town
Secondary/Emerging city	Category 'B' municipalities but with growth and scale that means they have many similar challenges to metros, especially in future	Rustenburg; Msunduzi
Towns	Large group ranging from significant urban towns to small towns with relatively small populations; limited rural population; authorised for the water and sanitation functions	Mossel Bay; Ga-Segonyana; Ventersdorp
Mostly rural local municipality	Limited number of towns in these municipalities; high levels of traditional land; not authorised for provision of water or sanitation	Greater Tubatse Matatiele; Umvoti;
Rural district municipality	Authorised for the water and sanitation functions; areas of significant backlogs	O.R.Tambo District; Umgungundlovu District

METROS

Road Map for Reforms

The proposals for reform in metropolitan municipalities continue the direction of grant consolidation and flexibility for municipalities established in recent years since the establishment of the USDG and its forerunner the MIG Cities. Over the longer-term, conditionality and fragmentation of urban grants will fall away as the rationale for infrastructure grants in the urban regions becomes largely to fill a fiscal gap[9]. With full planning capacity and institutional maturity at metro level especially, national government's role will diminish and a consolidated, largely unconditional grant will ensure decision-making is optimised at the local level. Some grants are advised to remain separate for the short- to medium-term but the principles of simplicity and predictability can be best served if the long term direction of the grant system for metros is to have a single formula-driven grant with limited conditionality.

The differentiated approach that acknowledges the higher capacity and greater own-revenue raising ability of South African cities is evident in the supplementary nature of the USDG schedule 4 grant[10] and the incentive-nature of the ICDG. From 2014 budgets onwards, all projects funded by grants to metros – be it USDG, PTIG, INEP or NDPG – must form part of a Built Environment Performance Plan (BEPP) that encourages municipalities to plan how the outputs funded from each of these grants will contribute to coherent outcomes for the city as a whole. Such developments in the metropolitan grant system are recommended to be continued, led by the City Support Programme, with the following proposals for reform:

Urban Settlements Development Grant (USDG)

Although the principle behind the USDG, the largest infrastructure grant to metropolitan municipalities, is widely well received, the Review's research has revealed several concerns with the grant. The supplementary nature of the grant has ensured flexibility and enhanced municipal discretion that fits in with the road-map for consolidated metropolitan funding. Though in implementation the funding can be utilised for any of the metro's capital investment priorities, from a policy perspective the grant ensures basic infrastructure is funded for the urban poor. However, the position of such a consolidated grant within a national department that has a particular emphasis on housing and informal settlements – the Department of Human Settlements (DoHS) – has led to friction: receiving officers feel under pressure to spend on the transferring department's sector rather than invest holistically guided by their IDP and BEPP, while the national department sees funds flow through their department's budget but feels restricted in its ability to maximise the impact of such funds on their sector.

The DoHS also transfers the Human Settlements Development Grant (HSDG) which was a key driver in determining the transferring officer for the consolidated urban grant, which came to be known as USDG. As per the NDP, and aligning with the road-map set out above, municipalities will ideally in-time take control of the housing function from provinces. The Review's research and engagement has repeatedly revealed the constraints to efficient

[9] This fiscal gap may also be closed in time via the introduction of new own revenue sources (i.e. taxes) in cities, as the international literature review recommended. Though such developments are beyond the scope of this Review and depend on other projects underway in government to review the suitability of own revenues.

[10] Schedule 4 grant is an allocation to municipalities to supplement funding of programmes or functions funded from municipal budgets, as opposed to most infrastructure grants to municipalities which are specific purpose Schedule 5 grants

municipal service delivery – in the areas of water, sanitation, electricity, roads and more – that can arise due to housing projects being delivered by provincial government and not aligning with the municipality's plans for development. However, due to the recent decision by DoHS that the planned accreditation of the housing function will be held "in abeyance" as a result of concerns regarding municipalities' readiness, this functional arrangement will not change in the short term. Consequently, the rationale for the USDG and HSDG being administered together by the same department falls away somewhat and the grants need to be refocused. Informal settlements funding also sits awkwardly in both grants without clear policy guidelines over which grant is for which aspect of informal settlement upgrading – as evidenced by inputs from metros.

Therefore it is proposed the USDG be changed to an Integrated Urban Development Grant (IUDG) that, rather than sit with a sector department, is administered by the coordinating department for local government and one responsible for developing the Integrated Urban Development Framework (IUDF), adopted by Cabinet on 13 August 2014: the Department of Cooperative Governance. Given its current role administering the MIG and previous responsibility administering the USDG's predecessor, MIG Cities, DCOG is well positioned to take over the administering of the IUDG and fits in with the principals of consolidating grants into more general funding streams rather than grants administered by sector departments such DoHS. The IUDG will be comprised of former USDG funds for basic and community municipal infrastructure, include the INEP funds for electricity, and can also include funds from the HSDG for land and services to ensure the grant is a consolidated funding package for all services except housing, given the delays to accreditation. Alignment with the HSDG however will still be crucial to ensuring the success of such a grant so as to overcome the problems outlined above – the role of the BEPP should aid this. The grant will be a schedule 4 supplementary grant with limited conditionality so as to give maximum discretion to local government, without ring-fencing or favour for particular sectors.

Extending the IUDG to secondary cities and therefore incorporating MIG funds too, as discussed in the next section, is another key driving force for its role at Department of Cooperative Governance.

Integrated National Electrification Programme (INEP)

The INEP grant to cities is currently a project-based grant administered by the Department of Energy (DoE) to electrify poor households. Given data analysis has shown than many metros also use USDG funding to connect households with electricity, there is an unnecessary overlap in the grant system. Furthermore the application and project-approval process required by the department does not complement the BEPP process. As such, it is proposed that the metros' share of the INEP grant be allocated along with the other basic services funding as part of a consolidated urban grant. This proposal has received backing from the affected municipalities and the transferring national officer, allowing the programme to focus their resources on ensuring efficient INEP delivery in areas of lower capacity and greater backlogs.

Part of the INEP grant is an indirect grant to service the Eskom-licenced areas of municipalities. Without changing the licencing, which is beyond the scope of the Review, these funds cannot be incorporated into a consolidated grant so remain a stand-alone grant.[11]

[11] An option proposed by SALGA for a longer term reform could be to evaluate the potential transition to having single electricity providers to enhance consolidation and municipal discretion. However more work needs to be done in this regard before such an option – or various alternatives – could be contemplated and therefore is not considered as part of this Review.

Public Transport Grant

Since the establishment of the Public Transport Infrastructure Grant *(*PTIG) in 2006 to develop *bus-rapid transit systems* (BRTs)*,* two cities – Cape Town and Johannesburg – are operational with several more in construction phase. The research of this Review has raised concerns about whether the correct incentives are in place to ensure value for money in the grant and long term sustainability of the infrastructure created. A project-based application approach was necessary at the beginning of the programme to ensure targeted investment and to overcome the large and lumpy costs of transport infrastructure. However, as the number of recipient cities has increased to a total of 13 in the 2014/15 MTEF and the limited scope for increased allocations due to fiscal ceilings, such an approach is no longer viable. Previously cities were implicitly incentivised to make investment choices that maximised capital costs – as these would be recovered in total from national government through the grant. As a result cities were incentivised to plan for BRT systems, even where these are not needed to achieve improved public transport in smaller cities.

Therefore it is proposed to retain the PTIG as a stand-alone grant but to allocate it via a formula, the variables of which will be determined jointly by the Department of Transport, National Treasury and other stakeholders. Qualifying minimum criteria – such as the timely submission of approved master plans – and grant conditions will ensure the national department is able to support and guide cities' investment in transport. However the revised grant structure will shift the onus onto municipalities to choose investment plans that fit their allocation rather than vice-versa. The BEPP process will ensure that even though remaining a standalone grant for now, public transport investment will be integrated and aligned with broader human settlements planning in cities.

Furthermore, to overcome the uncertainty of longer-term operational costs, the public transport network operations grant (PTNOG) and PTIG will be collapsed into a single Public Transport Grant that allows flexibility over whether the grant is used for operational (i.e. running a bus system) or capital (i.e. building dedicated public transport lanes) expenditures. This change echoes the IUDF's concern regarding the existing subsidy arrangements for public transport. Merging the grants is proposed to be introduced in 2015/16 with a subsequent review of transport subsidies as per the IUDF.

In keeping with the road-map set out at the start of the chapter, a formula-based transport grant would in time be well placed to form part of a larger consolidated urban funding package. However, at present the Review recommends to retain this grant as separate – as per the request of municipalities – due to its importance in driving the spatial restructuring reforms set out in the NDP.

Neighbourhood Development Partnership Grant (NDPG)

The NDPG is a unique grant in the system by virtue of its focus on regenerating township hubs and drive to leverage third-party system in its projects. Currently administered by the National Treasury, the grant was recently reviewed and refocused towards urban townships, with its portfolio of rural projects transferring in time to the Department for Rural Development. Feedback from municipal engagements showed the hands-on approach applied in its administration does not complement the hands-off approach adopted elsewhere with respect to metro grants. Given the road-map outlined above, once the spatial targeting approach and nodal hubs encouraged by the NDPG are adopted by municipalities the grant will also collapse into an all-inclusive grant like the proposed IUDF.

SECONDARY AND EMERGING CITIES

Road Map for Reforms

Metropolitan municipalities have long been recognised as the drivers of South Africa's economic growth with the emphasis in the NDP on restructuring their Apartheid-legacy inefficient spatial forms. Allocations via the USDG, PTIG and other grants, together with the incentivises for integration via the ICDG, have reflected this priority. However, the focus of these priorities has largely been determined by the status of these cities as metropolitan municipalities, however there are several other cities facing similar types of urban challenges but are not metropolitan municipalities. The growth potential in these secondary or emerging cities is considerable with urbanisation affecting them in similar ways to the metros. Yet for some the potential to generate own revenues and to harness such developments is constrained by a structure of grants better suited to smaller or more rural municipalities, despite their greater similarities to metros.

Many of the reform processes for metropolitan municipalities mentioned above were intended to eventually include a range of secondary cities too, such as Rustenburg in the North West or Msunduzi in KwaZulu-Natal. Scope for developing integrated and efficient urban environments in emerging cities is also large with early targeted investment potentially reducing the need for more government transfers at a later stage as economic growth from a more efficient city will promote increased revenues. Rather than investing early in the development of these cities, the Review's data analysis shows a significant difference in per capita allocations between the smaller metropolitan municipalities and secondary cities.

Neither the MIG Cities nor the USDG has yet delivered on the intention to reach secondary cities. Therefore the road map for this type of municipalities is:

1. Identify suitable candidates based on objective criteria;
2. Select a small number of identified municipalities to first rollout the new grant structure;
3. Introduce a consolidated infrastructure grant, like the metros' IUDG, but as a schedule 5 specific purpose grant so similar to the former MIG Cities;
4. Over time, the other identified secondary and emerging cities can be added to this group depending on the performance of the initial municipalities;
5. Once established, an incentive to improve performance can be that high performing municipalities will 'graduate' to the schedule 4 supplementary grant which will increase the municipality's own discretion and reduce the reporting requirements;
6. Such a clearly targeted grant structure for secondary and emerging cities will also help attract extra funding when fiscal space is available. Such extra funding should be linked to unlocking growth in the cities and will reduce the gap in per capita allocations between them and metropolitan municipalities.

Grant Arrangements

The present allocations from MIG will be collapsed into a new IUDG for secondary cities, together with funding from the municipal INEP direct grant as discussed for the metros. The PTIG and NDPG will also continue to operate as present to those recipient secondary cities though, like the metros, in time integration will be sought. Other grants to these cities are currently limited and will continue to be so, emphasising the need for an integrated approach that can unlock growth. The consolidated water grants including the Regional Bulk Infrastructure Grant (RBIG) will be discussed later.

TOWNS

Small town municipalities are mostly located in the Free State, Northern Cape and Western Cape but are also scattered across the country. They rarely feature in the Special Infrastructure Projects (SIPs) and typically have small populations, most of their populations are located in small urban centres with rural areas characterised by commercial farms, slow population growth and relatively low backlogs. Despite the fact that most of them are water service authorities (WSAs), allocations to these municipalities tend to be small due to prioritisation elsewhere in the lower capacitated and higher backlog rural municipalities or the growth leading cities. Yet, over 100 municipalities fall into this category and a clear grant structure is required to suit their context. However, rather than propose drastic reforms to this category of municipality, it is proposed that the current MIG structure is appropriate. Therefore the MIG in its current form will continue to account for the bulk of funding for these municipalities with the INEP, for the medium-term at least, remaining a separate grant. The social portion of regionally strategic bulk water projects will also continue to be funded by the RBIG as part of the newly configured DWS grant.

While backlogs may not be the primary concern in these municipalities, sustainable asset management – especially of older infrastructure in established settlements – is a major issue for such areas. Low allocations of MIG funding to this category of municipality is also influenced by the fact that the formula places priority on new infrastructure, ignoring the need for renewal of social infrastructure that still serves the poor. Therefore it is proposed to introduce the asset management reforms detailed later particularly to these municipalities.

These local municipalities are all authorised for the water and sanitation function so their districts municipalities' roles are primarily coordinating rather than delivering services. As such, pending changes to the institutional make-up of these district municipalities[12], or changes to the functional arrangements, most infrastructure grants will not flow to them. The only exceptions is the potential general infrastructure funding for district municipalities discussed below under the section on rural areas and grants that fund systems rather than infrastructure such as the *rural roads asset management systems grant*.

In summary, these municipalities will continue to receive allocations from the INEP, MIG and RBIG grants over the period ahead.

RURAL AREAS

Road Map for Reforms

The vision for an efficient and self-governing municipal sphere of government that can effectively respond to local priorities as well as support national goals was set out in the White Paper on Local Government and reiterated above. However, the problem statement also highlighted how many municipalities are far from this goal with little sign that national government's support – either financial or technical – will achieve the needed step-change in municipal capacity in these areas in the near future. The consolidation of grants in these areas, via the MIG since 2004, has ensured considerable municipal discretion over investment choices. Yet service backlogs in key services are still much higher than anticipated, given allocations for

[12] It is important to acknowledge that DCoG are currently undertaking a review of district municipalities with the explicit mandate or rearranging this institutional make-up. Pending the outcomes of that review, the financial and grant arrangements will be revisited to ensure alignment with the new institutional framework.

these municipalities are highest in per capita or per household terms, perhaps due to the fact that the capacity challenges are most stark. Equally, other aspects of the problem statement, such as the sustainability of the assets created or accountability over how grant funds have been invested, are major concerns in South Africa's rural municipalities – with this group particularly strongly represented in the former homeland areas of Eastern Cape, KwaZulu-Natal and Limpopo.

To account for these issues, yet also keeping the end goal of funding that enhances municipal discretion, the road map for rural areas is to first develop the capability of these municipalities through enhancing national government's oversight and support role towards such municipalities. This reflects the NDP's proposal for greater regionalisation of service delivery in low capacity areas and can be borne out by ensuring basic household services – water, sanitation and electricity – are partly delivered via specific sector grants. These grants can focus on the strategic investments identified by the national department as necessary for ensuring rollout of services. Other services – such as waste management infrastructure, roads or sports facilities – continue to be the function of local municipalities and funded via a general infrastructure grant that allows municipal discretion over which infrastructure services need prioritisation, be it community services or more basic services. This balance of (a) sector support for basic services with (b) consolidated funding for general and community services will ensure capacity continues to be built over time and the principles of consolidated funding is extended to all services.

21 Water Service Authority Districts

Currently these district municipalities receive the following grants for water and sanitation:

- MIG funds, used almost exclusively for water and sanitation
- The *rural households infrastructure grant* for on-site sanitation solutions, either via the direct or indirect grant
- The *municipal water infrastructure grant* for interim water services, either via the direct or indirect grant
- The *regional bulk infrastructure grant* for water or sanitation bulk projects
- The *water services operating subsidy* for water, both the direct and indirect grant

Therefore such a municipality can potentially receive five different streams of national funding for water and sanitation – indeed many districts such as OR Tambo and Chris Hani in the Eastern Cape, or uMzinyathi and uThukela in KwaZulu-Natal, receive all five grants in 2014/15. With the recent transfer of the sanitation function from the Department of Human Settlements to the newly named Department of Water and Sanitation, many of these grants will be administered by one department and rationalisation is therefore recommended. A recent speech by Minister for Water and Sanitation echoed this position: "It is recognized that we need to firstly, 'crowd in' and consolidate the current proliferation of grants targeted at Local Government and have a single water and sanitation grant."

The only non DWS administered funding listed above is the MIG funds. However, due to the functional arrangements these funds have also been a de facto water and sanitation grant to district municipalities authorised for the water and sanitation functions as the current MIG rules have only allowed them to spend on water and sanitation projects. This is despite the rationale for the original MIG programme being that it allows more municipal discretion.

The proposal is that these district municipalities should receive two infrastructure grants, one from the Department of Water and Sanitation that focuses on the strategic investments needed to rollout water services to areas that do not currently have access to clean water and a second, administered by DCoG to provide general infrastructure funding (inclusive of local water and sanitation priorities). The Water and Sanitation grant would include windows for large-scale bulk projects, refurbishment of schemes (if asset management best practices have been complied with) and reticulation schemes where greater capacity support from the sector department is needed. Allocations for any of these windows can be implemented through a direct or indirect allocation, though the use of indirect allocations must be carefully managed to ensure that capacity is built in benefiting municipalities to be able to operate and maintain any infrastructure developed. The general infrastructure grant administered by DCoG will include funding for water and sanitation (as per the current MIG) and for general infrastructure such as district roads. This will ensure these district municipalities have greater discretion to initiate and implement grant funded projects in line with their IDPs. The general funding allocation is subject to more detailed work that clearly outlines the legislative mandate, the service delivery needs and the current fiscal levers (i.e. the RSC Levy replacement grant) available in district municipalities.

The overlaps between the general grant funding and the water and sanitation grant will be dealt with through structures reporting to the Inter Ministerial Committee on Basic Services chaired by the Minister of Cooperative Governance. This may mean that where a weak capacity district receives an allocation for reticulation through the water and sanitation grant they would receive a smaller allocation for their general infrastructure grant.

Non water and sanitation district functions requiring infrastructure investment, like regional waste facilities or district roads for example, can also be funded via the general infrastructure grant. This grant funding for general infrastructure at district level should be potentially available to all district municipalities as the type of infrastructure it funds are functions assigned to all districts and not just the 21 WSAs. However, district municipalities also have other resources available to them through the Regional Service Council Levies Replacement Grant that can be used to fund infrastructure. To avoid providing additional funding to relatively well-resourced municipalities, more detail work (outlined above) is required to determine the legislative mandate and functional arrangements in each district[13], the service delivery need in that district and also the suitability of current allocations and finances. One option is to use per-household Regional Service Council Levies Replacement Grant allocations to evaluate how much should be allocated to each district. Details of the proposed grant will be finalised before the 2016 Budget and subject to this above work; as a rough guideline the top third of districts, in terms of per household RSC Levies Replacement Grant allocations will receive no allocation, the middle third will receive some allocations and the bottom third (which includes most WSAs) will receive the largest allocations.

The only other funding to these districts is the *rural roads asset management systems grant* which is not a strict infrastructure grant but rather an effort to generate systems that help municipalities identify maintenance and renewal needs in their road network.

In sum, this recommended grant structure arrangement for the 21 WSA district municipalities will improve ease of administration at both national and municipal level, will increase capacity support – via the national departments – to the most challenged municipalities, and will ensure better value for money in a sector of national importance within areas suffering the highest access backlogs.

[13] As noted previously, this work on the institutional framework is being led by DCOG's review of district municipalities. Alignment will be sought between the outcomes of that review and the grant system so that the stated principles and vision are still adhered to.

Local municipalities without the water and sanitation function

In keeping with the emphasis on using national support to help overcome service backlogs in the rural districts, electricity will also be a separate sector grant and remain in the current INEP form. In most rural areas Eskom is the licenced electricity provided so most of these areas receive electricity connections through the indirect INEP Eskom grant. This leaves non-household municipal services – including waste, roads, sport facilities and other community services – to form a general *Community Services Grant,* much like the current MIG operates in these municipalities. The reason for incorporating these infrastructure sectors into a consolidated grant rather than forming more sector grants is three fold:

- The benefits of a consolidated grant and how it responds to the Constitutional mandate of municipalities to plan and implement their own infrastructure is clear. Integrated funding allows synergies between different investments rather than being ring-fenced and silo-ed by national government. For example, in its discussion on the role of sport, the NDP says "local authorities can also promote exercise by ensuring that urban roads have proper pavements, developing cycle lanes and installing traffic-calming measures." For such synergies to occur however a certain scale is required and therefore keeping the non-household basic services (such as roads and waste) and the community services together in one capital grant is required.
- There are concerns regarding the ability and capacity of the respective national departments to administer individual sector grants to all of these municipalities.
- Though sector departments such as DOT, SRSA and DEA have engaged with the Review, none have provided a strategic motive for a standalone sector grant that cannot be accommodated via a consolidated grant. Though they request more control over municipal infrastructure spending in their sector, they do not currently exercise all the controls at their disposal via the MIG. For example, the sectors' participation in MIG forums or in approving or supporting MIG projects is very limited.

In sum, this is similar to maintaining the status quo as these municipalities did not receive water and sanitation funding previously. However, the use of this community services funding can be improved by re-establishing the relationships between relevant sector departments and DCoG to ensure allocation criteria, project approval and the reporting system are of mutual benefit. In the roads sector for example, it is crucial that the data from the RRAMS grant be used in allocating or approving roads funding and projects. Better grant management – based on the recommendations in the grant administration, allocation mechanism, incentives and asset management chapters – is therefore crucial to the improved performance of this *Community Services Grant.*

RECOMMENDATIONS

- Create an Integrated Urban Development Grant for metros *and* secondary cities using the existing USDG, INEP and MIG in these areas – with DCoG as the transferring department
- Retain similar conditions to the USDG for the metros (i.e. supplementary grant) while the conditions for secondary cities will provide more guidance to cities through a specific-purpose (schedule 5) grant, until good performance is proved
- Collapsing of different water and sanitation infrastructure programmes into one grant administered by DWS – allow direct and indirect windows, limiting the indirect to municipalities with significant capacity challenges (these municipalities must be provided with capacity development support together with the indirect grant)

- District municipalities also receive general infrastructure funding
- Non-water service authority municipalities to receive a general funding similar to present MIG without water and sanitation allocations (Community Services Grant)

CHAPTER 4 – PLANNING AND ASSET MANAGEMENT

LESSONS LEARNT

The review process included data analysis, literature reviews and consultations with municipalities and departments, through which we learnt that:

- The grants' emphasis on creating new infrastructure assets to target backlogs often comes at the expense of more sustainable investment in existing assets
- Data suggests the rough split between the need for new infrastructure and renewal of existing infrastructure is 60:40 (new:renewal)
- In recent years municipal capital budgets have increasingly moved towards such a split (60:40) and prioritised more renewal, but grant rules and conditions often restrict this
- Despite more priority for asset management being budgeted for, in-year underspending on renewal and maintenance plan is still rife
- Municipal officials – particularly engineers – are often unaware of the funding that national government provides for the maintenance of infrastructure, via the LGES
- Service delivery protests are increasingly a result of failures in functionality rather than in provision of services – i.e. backlogs are still a priority but further emphasis must be placed on ensuring the infrastructure put in place is operating as planned
- Forward planning of infrastructure is agreed by all stakeholders to be crucial to the success of projects, yet many municipalities' (especially smaller or more rural municipalities) resource constraints restrict planning to shorter time-horizons
- The grant system's emphasis on in-year spending and results also contributes to a less-than-optimal dedication of resources towards planning for future investments

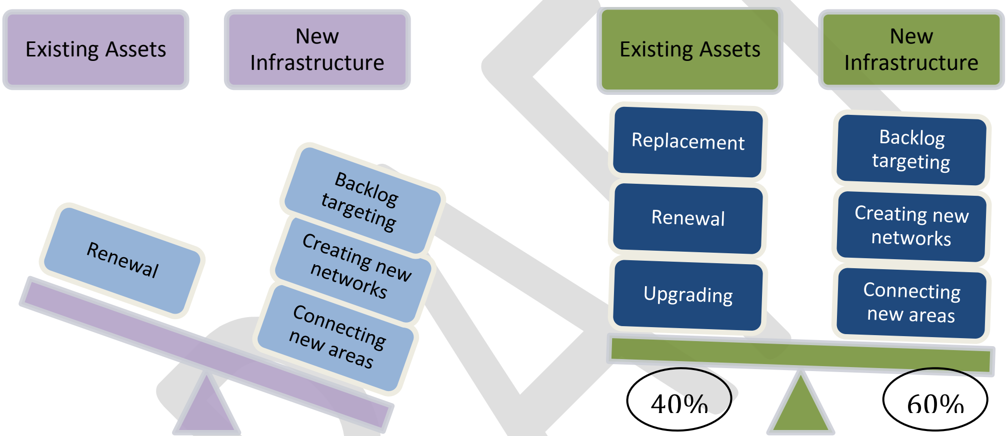
RENEWAL

Since 1994 the system of infrastructure grants to South Africa's various sub-national governments has been one of the primary mechanisms with which government has targeted the extension of services to hitherto un-serviced households. As the problem statement highlighted, the focus of the grant system – and often of local government as a whole – has been on the eradication of service delivery backlogs in certain key services, with water, sanitation and electricity often cited most prominently. Indeed the policy surrounding MIG's creation in 2004 was explicit in its targeting of backlog eradication by 2013[14] and several other programmes or grants since – such as the various Bucket Eradication Programmes , the Rural Households Infrastructure Grant, or the Municipal Water Infrastructure Grant – have had similar motivations. So much national-funded, backlog-targeting investment has led to a considerable expansion of municipal asset bases as capital is persistently used to create new infrastructure to provide electricity connections, running water and sewerage to communities that did not previously have such infrastructure. An unintended implication of these programmes however has been that existing municipal infrastructure can forego the necessary capital investment

[14] "The municipal infrastructure grant programme is aimed at providing all South Africans with at least a basic level of service by the year 2013 through the provision of grant finance aimed at covering the capital cost of basic infrastructure for the poor" (MIG Policy Framework; 2004)

required to ensure full productivity, while new infrastructure is prioritised. Finding a balance between capital spending that connects services to new households and sufficient investment in existing infrastructure is crucial and one which changes over time as municipalities edge closer towards the eradication of backlogs[15], despite the many challenges raised in this paper. The data however suggests the grant system has been getting this split wrong in recent years. Though the split between new and existing infrastructure needs varies considerably by municipality - depending on its history, demography, economy and the success of previous investments - nationwide the ratio has been shown to be roughly 60:40 (new:existing) in terms of social infrastructure[16]. Renewal[17] therefore must play a key part in the allocation and spending of municipal infrastructure grants and increasingly so as South Africa develops and progressively realises the rights set out in the Constitution. The Review responds to this maturing of the local government system and its diversity of challenges in 2014 - which differ hugely from 1994 or even 2004 - by recommending a 'pivot' in the grant system from targeting just new infrastructure to a more appropriate balance with existing assets:

Figure 4.1: Balancing Investment in Existing vs New Infrastructure

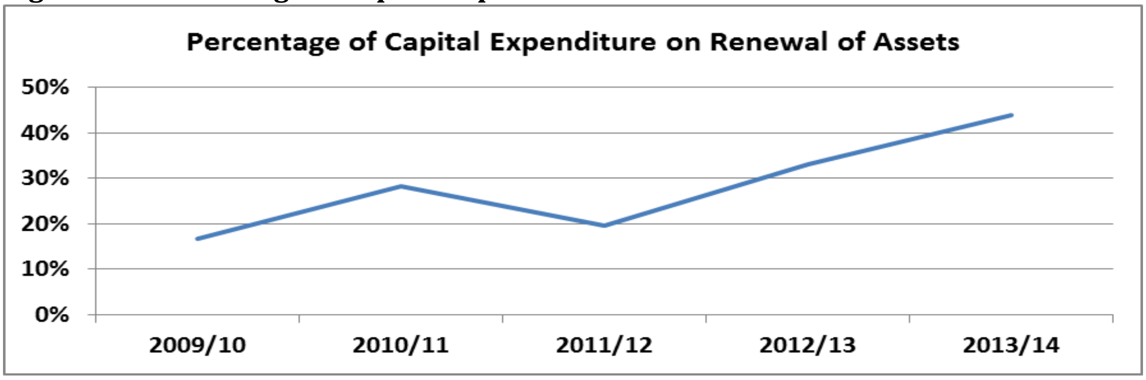


Further research by the Review has shown that:

a) Municipal capital budgets over recent years are increasingly shifting away from new infrastructure towards renewal of existing infrastructure – in 2009/10 only 16.6% of capital expenditure was on renewal of assets whereas in 2013/14, 44%[18] was budgeted to be spend on renewal

[15] And therefore can invest more in existing infrastructure or operational expenditure
[16] Infrastructure that largely serves the poor that would otherwise be unable to self-fund such investment
[17] A broad term to cover capital expenditure on rehabilitation, refurbishment, renovation, replacement or upgrading of existing infrastructure assets
[18] Note the 60:40 split refers to social infrastructure whereas municipal capital expenditures must cater for all infrastructure, hence why they spend more than 40% on renewal

Figure 4.2: Percentage of Capital Expenditure on Renewal Assets



b) Municipalities often use the infrastructure grants for capital expenditure on existing infrastructure, even if not explicitly permitted by the grant rules and conditions. This recommendation for a pivot therefore formalises the current practices of municipalities.

Certain conditionality is also recommended so that a pivot towards grant-funding for existing infrastructure fits in with the broader fiscal framework for municipalities. It is important that this funding is not seen as blank-cheque that could displace funds that should already be prioritised towards renewal. These conditions include:

Asset Management Plans

The first condition around aims to incentivise the creation of systems that will ensure renewal funding is used optimally and sustainably; to access grant funds for renewal the recipient governments must develop asset management maintenance plans. Such plans must go beyond the existing asset registers which are largely for accounting purposes and provide the municipality with comprehensive information on the state of the asset base and where funding needs to be prioritised to ensure continued functionality in the short- and long-term. Though such measures and plans are in place in some municipalities already, the Review's emphasis on sustainable asset management means all municipalities should develop these plans over the next few years. Conditions for each grant will be established separately but it is recommended that some 2016/17 grant allocations be subject to such measures and all 2017/18 allocations should include this as a condition.

Prove Maintenance

Secondly, in order to use grant allocations for existing infrastructure municipalities must show that asset has not been unduly 'run-down' or neglected by the municipality. This ensures there is no perverse incentive for municipalities to cut operational and maintenance expenditure on the asset (from their own budget), knowing the refurbishment will be nationally-funded via an infrastructure grant.

Renewal infrastructure for the poor

Finally, renewal funding must largely be used for investment in assets that are serving the poor. Economic infrastructure that mostly serves non-residential and corporate consumers, or households above the poverty line[19], should generally be funded via the municipality's own

[19] Roughly defined as the value of two old-aged pensions, which was R2300/month in 2011 prices

revenues so flexibility is required depending on municipal context and the sector involved[20]. Cost-reflective tariffs should therefore include a depreciation component that takes into account the capital costs of each unit consumed. Depreciation costs over time can then be used for the capital investment into existing infrastructure. Providing renewal funding for infrastructure used by non-poor consumers would therefore undermine the fiscal framework and disincentivise appropriate tariff setting and depreciation accounting.

The costs of consumption for indigent households are mostly subsidised via the local government equitable share. However, though the LGES covers the operational and maintenance costs, it does not include the capital cost of depreciation. Hence the reason the capital grant system can fund renewal infrastructure for the poor without danger of 'double funding' municipalities.

MAINTENANCE

Many of the issues discussed above in terms of renewal of infrastructure also relates to the maintenance of infrastructure. Though the difference between renewal (capital expenditure) and maintenance (operational expenditure) is never clear cut and may differ from sector to sector or per municipality, for policy purposes the distinction is crucial given the different ways they fit into the local government fiscal framework.

Although data in municipal budgets on maintenance is not comprehensive and has only been emphasised in recent years, analysis shows that the amount spent by municipalities on maintenance is well under 2% of the 'write down value' of their assets. Yet the amounts budgeted for maintenance are between 3% to 4%[21]. This failure to prioritise maintenance funding, in either the budgeting process or in-year spending, was echoed in the municipal engagements whereby technical officials and engineers were largely unaware of the maintenance funds (via the *local government equitable share*) provided by national government to explicitly subsidise maintenance costs on behalf of indigent households. The importance of maintenance is acknowledged by all stakeholders yet municipalities struggle to retain it as a priority during the financial year – a predicament echoed internationally and in the literature, where it's suggested that immediate budget pressures, often from politicians with short-term horizons, oust maintenance investment that has longer-term returns. Municipal officials articulated how emergency repairs are prioritised yet preventative maintenance, that would have avoided the emergency, is neglected. Further data analysis by the FFC repeats these concerns and suggests that every six years, one year's maintenance is foregone with every municipal type (from metros to rural municipalities) underspending on maintenance between 2005 and 2011.

As much of the Review's research has revealed, the theoretical local government fiscal framework that is annually developed in national policy discussions and clarified via the Division of Revenue Act can at times be very different from the reality of how grants or own revenues are treated at municipal level. This flexibility in interpretation can at times be practical – such as the use of grant funds for renewal projects listed above – but elsewhere can lead to confusion. The funding of maintenance is a good example of this and provides further motives for the infrastructure grant system not to include maintenance allocations. The local government equitable share (LGES) was reviewed in 2012 by a collaborative task team involving various national stakeholders and extensive municipal consultation. The result was a

[20] For example, generating revenues from roads is harder than electricity where tariffs can be adjusted.
[21] It should be noted that each element of infrastructure has very different maintenance requirements and therefore a flat percentage should not be used as a measure of sufficient or insufficient maintenance.

formula that equitably and transparently funded municipalities with a subsidy to provide free basic services to indigent households. Included in the cost calculations was a 10% maintenance estimate and the 2014/15 cost estimates, updated for inflation and other bulk costs, are detailed in the table below which is published annually in Annexure W1 of Division of Revenue Act and in the Budget Review document:

Table 4.1: Local Government Equitable Share Subsidies, Including Maintenance

2014/15 LGES	Allocation per household below affordability threshold (Rands)			Total allocation per service (R millions)
	Operations	Maintenance	Total	
Energy	54.20	**6.02**	60.22	6 289
Water	83.78	**9.31**	93.09	9 722
Sanitation	68.40	**7.60**	76.00	7 937
Refuse	57.34	**6.37**	63.71	6 654
Total basic services	**263.72**	**29.30**	**293.03**	**30 603**

The table shows that each poor household nationally is subsidised R29.30 per month[22]. The total allocation for the provision of free basic services is R30.6 billion meaning national government allocates R3.06 billion in maintenance funding for municipalities to recover the cost of providing free basic services to indigent households. As an unconditional grant the LGES can be utilised at the municipalities' discretion so it is unrealistic to expect exactly R3.06 billion in 2014/15 entering municipal maintenance budgets. However, it is important to note that it is the municipality's choice to use these funds for maintenance or not.

The fiscal framework expects the non-indigent households, plus non-residential consumers, to be paying tariffs and rates that have been calculated to ensure the full cost of infrastructure – including the maintenance – is recovered by the municipality. Improvements in the systems of municipalities to ensure cost-recovery via tariffs has improved in recent years but given the concerns of stakeholders at all spheres of government, this is not translating into greater prioritisation of maintenance.

As the literature review conducted for this Review suggested, under budgeting of maintenance is a common problem internationally and especially in developing countries but "a maintenance problem signals that either local democracy in terms of financial control is dysfunctional, and/or the local assignment and/or collection of local government revenues is inefficient". It is a symptom in other words of underlying inefficiencies that cannot only be resolved by further national funding. An increase in such funding would reduce the incentive for municipalities to maximise their own revenue collection and likely displace many of the funds (from the LGES or own revenues) currently funding maintenance, meaning the problem of ill-maintained municipal infrastructure will continue.

As a consequence of the underspending on budgeted maintenance funds, the relative unknowns due to lack of data, the non-prioritisation of existing maintenance allocations, and several potentially perverse incentives that could result, the Review is reluctant to investing further national-funded maintenance money in South Africa's municipalities. Instead the Review's recommendation is for better national oversight, monitoring and support regarding the importance of maintenance in order to ensure functional municipal services and create longer term efficiencies. This can be done with the following:

- Continued and enhanced monitoring of municipal maintenance budgets

[22] 10% of the R293 for all service

- Conditionality surrounding life-cycle costing of grant-funded assets
- Use of the 'renewal' reforms requiring asset management maintenance plans in every municipality which should reduce the scope for maintenance being side-lined in the municipal budget processes

MUNICIPAL PLANNING

As has been highlighted throughout the Review and this document, municipal systems are crucial success factors in the delivery of efficient municipal infrastructure. Having appropriate planning horizons and systematic planning that directs current and future investment is the first step towards sustainable infrastructure delivery, without which assets can be underutilised, poorly maintained or unnecessarily expensive. This ties in with the findings of the MIG Policy Review which recommends that Infrastructure Investment Plans be developed by municipalities which require them to engage with long term financial sustainability of their capital programmes and ensure that selected projects from their IDP fit within a sustainable capital expenditure envelope.

The status-quo is that planning is too often limited to the short-term due to the pressures of meeting in-year spending targets by grants or the political cycle. Though the grant frameworks contained in DoRA state certain planning deadlines adherence to these is not widespread. Some grants, such as the MIG, allow a 5% top-slice of a municipality's capital allocation to be used for a project management unit (PMU) however this is largely used for in-year management of projects rather that future planning. Equally for municipalities with small MIG allocations – either small municipalities or ones with few backlogs – the 5% top-slice is insufficient to fund the necessary planning of their capital investments. Larger or wealthier municipalities, such as metros and secondary cities with significant own revenue raising potential, should already be funding planning departments with own revenues rather than relying on national funding so the issue is largely restricted to smaller and poorer municipalities.

Planning funds from capital grants

To overcome the absence of future year planning, and enhance it where it does exist, the Review recommends that small percentages of capital grants can be utilised on the municipality's operational budget if those funds are ringfenced to improve planning the investment of future allocations. The Review's research cannot engage in the planning requirements per sector in the same detail the national sector departments can. As such it is proposed that each transferring national department make proposals regarding the potential need and appropriate scale and conditions surrounding the provision of planning funds via the capital grant they administer. Any diversion of capital funds away from the provision of infrastructure needs to be carefully evaluated and as such the grant administrators are best place to do this so that ultimately the grant funds that are invested in infrastructure are utilised in the most efficient manner and fit in with longer term plans of the municipality.

Road Map of Reforms

As with many previous recommendations it is proposed that the 2015 Budget be used to signal the intended direction with regard funding of municipal planning, while national stakeholders make more detailed proposals over which grants will include a top-slice of planning funds. The 2016 MTEF can then be used to implement these recommendations.

RECOMMENDATIONS

- Pivot the grant system away from its excessive focus on the creation of new infrastructure; allow grant funds to be used to renew existing assets
- Conditionalise renewal funding on the establishment of asset management maintenance plans, proof of proper maintenance and ensure projects are mainly serving poor consumers
- Avoid funding maintenance via the capital grant system due to the severe perverse incentives and disruption it could cause to the fiscal framework
- Continue to emphasise the importance of maintenance and its prioritisation within municipal budgets, in line with the DCoG Back to Basics approach
- Allow more grants to include a top-slicing of funds to municipalities to enhance the planning function at municipal level – details in 2015

CHAPTER 5 – ADMINISTRATION OF THE GRANT SYSTEM

LESSONS LEARNT

The review process included data analysis, literature reviews and consultations with municipalities and departments, through which we learnt that:

- The reporting requirements in conditional grants is uncoordinated and therefore places a unnecessary burden on municipalities, yet the information generated from this system is seldom used for analysis or to inform strategic decisions.
- Many policies and regulation related to the grant system, via the Division of Revenue Act for example, is not realised in reality; largely due to capacity and resource constraints at local, provincial *and* national government.
- Grants that would only transfer funds after project milestones have been completed (as proposed by some national stakeholders) would pose substantial risks and could create instability in municipal budgets.
- Though many grants have been created over the past 10 years, very few have been phased-out. Related to this, the trend in recent years has been to have more indirect grants rather than switching to direct grants as municipal capacity improves.
- All stakeholders agree on the benefits of regularly reviewing the structure and performance of grants to avoid the unstructured evolution of the grant system experienced in recent years.
- National departments allocate substantially different resources to the management and monitoring of the conditional grants they administer.

This chapter sets out number of recommendations for changes to the way the transfer of conditional grants is managed and monitored. These proposals can be grouped into the following objectives:

- The **reporting system** should be simplified and focus on indicators that can be used to identify areas of under-performance so that targeted support can be provided to these municipalities;
- National departments need **increased capacity** to monitor, guide and support municipal infrastructure delivery; and
- The **coherence** of the grant system as a whole must be maintained by ensuring that the design of the system agreed to in the outcomes of this Review is adhered to and not undermined by ad-hoc changes.

REPORTING

The rationalisation of the number of grants each municipality receives will substantially reduce the reporting burden on municipalities. The reduction in the number of water and sanitation grants transferred from 4 to 1, for example, will eliminate a lot of duplication in the reporting requirements.

It is important for accountability that direct reporting relationships on non-financial reporting be maintained between receiving municipalities and the departments that are responsible for transferring and managing each schedule 5 conditional grant. This means that it is not possible to have a single reporting system at this stage for non-financial reporting. However, over the longer term the system should move towards more consolidated reporting and should rely more on existing reports in the system to measure performance, as already happens in the financial reporting system and with schedule 4 (supplementary) grants where non-financial progress is measured against municipal Service Delivery and Budget Implementation Plans.

The content of the reports required by each conditional grant manager need to be re-examined to ensure there is a degree of standardisation across the different reports required. This will ensure data collected on the performance of different grants can be compared and used to evaluate standard measures of performance such as unit costs. The process of agreeing on changes to the reporting system should be coordinated through the coordination structures under the Inter Ministerial Committee on Basic Services. Provisions in the Division of Revenue Act should allow for National Treasury to approve non-financial reporting requirements so that this process can be used to ensure a minimum level of consistency is maintained across different reports.

Information from the reporting system should be regularly analysed and reported on to management and political forums at local government, provincial and national levels. This will help to keep decision makers informed of progress and allow for better oversight. It will also make sure the system derives more value from the time and energy invested in reporting on grant performance. In line with the recommendations of the Back to Basics approach led by the Department of Cooperative Governance, progress on infrastructure projects should be an item regularly reported to municipal councils.

MANAGEMENT OF GRANTS

Administering and monitoring conditional grants and providing the accompanying support needed for municipalities requires a serious investment of resources by national departments. As conditional grants are used to achieve some of the key objectives of government as a whole, it is entirely appropriate for national departments to prioritise resources towards grant administration within their own budgets. To ensure that funds for grant administration and support are not diverted to other functions within departments[23], it is proposed that these funds be ring-fenced on the budgets of national departments. It is also proposed that in future budget processes at national level, efforts are made to reprioritise more departmental funds towards grant-related administration and support.

The performance of each conditional grant against its objectives should be regularly reviewed. The conditional grant framework for each local government infrastructure grant should include the date for when the grants performance should be reviewed. Reviews should take place roughly every five years and should include consultation with recipients and other stakeholders as well as a thorough assessment of performance data. Reviews are to be conducted by departments administering the grant, but with oversight from National Treasury. The outcomes of these reviews should be used to inform appropriate changes to grant structures (if required).

MAINTAINING COHERENCE OF THE GRANT SYSTEM

In the years following the previous review of the grant system that resulted in the creation of the Municipal Infrastructure Grant in 2004 there has been a gradual fragmentation as more and more conditional grants have been added to the system, usually through ad hoc decisions, with

[23] Something the Review found to be commonplace in some national departments

little consideration for how all of these changes would impact the coherence of the grant system as a whole. This experience must not be repeated in the period ahead. In future the grant system must be managed as a system, not just a collection of individual grants and proposed changes in one grant must be considered in light of their impact on the system, not just that grant.

This will require making National Treasury accountable for monitoring and ensuring the coherence of the system as a whole. Although National Treasury is already responsible for bringing the grants together in the Division of Revenue process, the Treasury needs to be given additional tools through the Division of Revenue Act to require departments to amend draft allocations and grant frameworks if this is required to ensure coherence in the system. For example if a district municipality is allocated funds for a water project through the water and sanitation grant that it has already committed funding to from its general infrastructure grant, then National Treasury should be able to require a change in allocations. The use of this mechanism should be rare as most cases of overlaps can be resolved through improved coordination between departments, but it will be necessary to have provisions to enforce changes if agreements cannot be reached. It is proposed that the Financial and Fiscal Commission should monitor how the Treasury exercises these powers and report to Parliament on any concerns it may have with the way they are used.

Any proposal for the creation of any new infrastructure conditional grant must go through a thorough process of consideration to establish whether a new grant is needed, whether there is capacity to manage it at national government and to ensure that the grant is designed properly so as to make sure its implementation will be successful. The Division of Revenue Act should include requirements that proposals for new grants must be submitted in formats prescribed by National Treasury and must be consulted on with SALGA and the FFC before being presented to Budget Forum for endorsement. This will ensure adequate opportunities for consultation on new grants as well as providing time for officials to work through and refine the proposed structure of the grant.

This process should also apply to grants that are intended to be short term or interim in nature[24] but with fewer restrictions as it could cause unnecessary delays in the transfer of funds for urgent priorities. Examples of this need for exceptions could include funding for disaster recovery or to construct infrastructure needed for major events. Further details will need to be determined in the next phase of the Review.

The role of indirect grants in the system must be managed in a more holistic and strategic manner. Similar to the process of introducing a direct grant and the new requirements described above, a proposed indirect grant must also go through a rigorous set of checks and consultations. Of particular importance is that a credible justification must be made showing:

a) why municipalities are not capable of implementing this grant themselves (i.e. a schedule 5 grant)
b) how the national department is capable and resourced to deliver the grant
c) how plans are put in place to ensure municipalities can operate and maintain the infrastructure created
d) what capacity building measures are in place to ensure that the reasons raised for point a) are overcome if capacity related
e) that the grant is a temporary measure and there will be efforts to make the grant a direct allocation once sufficient capacity has been developed

[24] I.e. three years or less

Following a parliamentary recommendation in 2014, all indirect grant administrators must now put in place a skills transfer and capacity building plan. This initiative is welcomed by the Review and the above measures should further assist in ensuring the recent trend of increasing indirect grants is reversed.

ROLES OF SECTOR AND COORDINATING DEPARTMENTS

There needs to be a greater distinction drawn between different types of grant administrators. International literature suggests that grant systems function best when grants are administered by a single coordinating national department. In the South African context however it is acknowledged that the need to provide capacity support and also to ensure that national strategic priorities are met means that sector departments must also have a role as grant administrators in the period ahead. This is especially true in more rural contexts where the need for capacity support is greatest, in urban contexts the greater integration that can be achieved through management from a sector department is more important.

Coordinating departments (such as the Department of Cooperative Governance and National Treasury) should be responsible for transferring grants that allow a greater degree of municipal discretion over which projects are funded. In keeping with principle 1 agreed to for the grant system – to respect the constitutional mandates of different spheres - these grants should account for the bulk of the funds in the grant system.

Sector departments should be responsible for administering grants where the need for additional capacity support and guidance is greatest. For this reason, sector grants are proposed in only a limited number of areas:

- In public transport, where new networks must be designed and built in line with national norms and standards;
- In water and sanitation for large regional projects and in rural areas where new water supply systems are being developed in municipalities with limited technical capacity; and
- In electricity, where allocations must be aligned with licencing for Eskom and municipalities in different areas and where technical standards must be complied with in low-capacity rural areas.

Sector departments however must also play a supportive role with the general grants that are administered by coordinating departments. Though a grant may not sit on a sector department's budget, that department is not absolved of responsibility from the grant's implementation and must still assist municipalities in the relevant projects. For example, municipal sports infrastructure has been funded, and will continue to be funded, via a consolidated grant administered by DCoG; but SRSA must help municipalities develop credible plans and projects that meet SRSA's policy and criteria, plus evaluate and monitor performance in such projects. The coordination at national level, via a grant, has not been a success over recent years and resulted in a breakdown in relationships between sector departments and the MIG. However, coordination at the municipal level cannot continue to lapse and administrators of general (non-sector specific) grant.

RECOMMENDATIONS

- Streamline reporting and coordinate national roleplayers (sector departments, National Treasury, DCoG and DPME) in municipal data collection to ensure better & public use

- National Treasury to flag and interrogate outer-year allocation deviations
- Increase regulatory obstacles to avoid ad-hoc new grants and set regular reviews of existing grants to ensure appropriate phase-out
- Stricter regulation to limit creation of indirect grants and ensure capacity transfer when they do exist
- Better define the different roles required of coordinating departments (i.e. DCoG or National Treasury) and sector departments to improve the functioning and accountability of the grant system

CHAPTER 6 – ROLE OF INCENTIVES AND ALLOCATION TYPE

LESSONS LEARNT

The review process included data analysis, literature reviews and consultations with municipalities and departments, through which we learnt that:

- South Africa does not use grant incentives as widely as the literature or international experiences – in developed and developing countries – would recommend
- Stakeholders at all levels are wary of incentives that could further reward the richer, larger or higher capacitated municipalities because they can more easily respond to the 'carrots' whereas poorly performing municipalities will continue to underperform
- Though positive incentives are ideal, the infrastructure grant system includes various unintended 'perverse incentives' such as panic spending and grant dependency
- There are advantages to both formula-based and project-based allocations but the appropriate methodology is largely determined by the type of grant
- A lack of reliable data restricts the potential for more complex formulas or incentive allocations based on past performance
- Formulas may indicate estimate proportions to be invested in different sectors but municipal discretion will ensure local priorities dominates the choice of projects
- Transparency is lacking in many allocations, as is the required predictability and stability outlined in the principles

ROLE OF INCENTIVES

Literature

Theoretical literature and international experience considers properly aligned incentives to be crucial to the successful outcomes of grant funded programmes. South African stakeholders however often point to a lack of municipal capacity to respond to incentives as a constraint to implementing incentive grants. The Review's literature review acknowledges that not all types of municipalities can respond to incentives and notes that "any incentive scheme to promote intended outcomes in a developing country context should include capacity building measures for local councillors, local administration and local populations".

It was also found that in many grant programmes the relationship between national government and municipalities is characterised by a principle-agent dilemma wherein national government is the principle and the municipality is the agent. The dilemma exists because sometimes the municipality as the agent is motivated to act in its own best interests rather than those of the principal. In the absence of a clearly defined decentralisation framework (see problem statement discussion), incentives and regulation are ways to bring the two institutions together focusing on a common goal. Performance based systems were found by the literature review to be a good way of aligning such incentives and with the following benefits listed:

- Better compliance with legal and statutory requirements;
- Improved planning and public financial management at the local level;
- Greater attention being paid to, and improved performance in, cross-cutting areas such as environmental management, good governance and transparency;

- More focused capacity building;
- Consistent use of capital grants to finance investments in core poverty alleviation areas.

The international experience of performance based grant systems was largely found to be positive in the literature review. The problem of grant dependency or national grants 'crowding out' and displacing municipal own investment is well documented with many developed nations – such as France or Canada – using matching grants whereby recipients are required to counter-fund (or co-fund) projects with their own funds. Other examples of using incentives can be found in Germany where recipients can increase their infrastructure allocations by showing improvements in their own-revenue collection rates, or in the less-decentralised United Kingdom, where recipients are rewarded for limiting rates increases. Incentive based grant systems have found success in developing countries too with more similar contexts to some of South Africa's municipalities. Uganda, for example, piloted minimum conditions for certain local governments to access national grants from 1997, expanded the pilot in 2000 and rolled out the performance based grant system nationwide from 2003 onwards based on the successes. Municipalities had to meet certain planning standards, achieve improved audit outcomes, show compliance with procurement laws and also provide 10% co-funding, among other criteria. The percentage of recipients meeting these criteria jumped from 28% in 2002 to 78% in 2007 and the system has widely been credited both domestically and internationally as having significantly contributing to improved service delivery as well as improving local capacity. The conclusion therefore is that internationally incentives of various types can form an integral part of any grant system and not just help overcome the principal-agent dilemma but improve performance in numerous ways over the long term. However, such experience internationally does not necessarily mean incentives are suitable for South African municipalities hence the Review is not proposing immediate changes as will be discussed below.

South Africa's experience

As well as requiring municipal capacity to respond to incentives, performance or incentive grants are heavily reliant on data which, as the grant administration section highlights, is noticeably absent in the South African local government context. This lack of credible data on grant performance restricts the feasibility of introducing incentives into the grant system. The only incentive grant that exists in the infrastructure grant system at present is the Integrated Cities Development Grant, currently in its first full year and only allocated to metropolitan municipalities. The criteria for the grant are:

- no decrease in total debt to revenue ratio in 2012/13 (20 per cent)
- no Section 57 vacancies for longer than 6 months in 2013 (20 per cent)
- financially unqualified audit opinion by AG (with or without findings) for the last financial year (30 per cent)
- decrease in total value of irregular, fruitless and wasteful expenditure identified by AG (20 per cent)
- timely submission of 2014 BEPP and performance indicators (10 per cent)

Being a new grant the Review could not yet fully assess the impact the incentives had on performance but reception among the metropolitan municipalities has been positive thus far. The expanded public works programme grant for municipalities has used a formula incorporating past performance that acts as an incentive grant however allocations are small and data limited so again the Review could not fully research the success of the grant.

Provincial infrastructure grants for health and education have recently undergone reforms to incentivise better planning and performance. These reforms aim to address infrastructure planning and procurement failures in infrastructure delivery by introducing incentives which will promote good infrastructure delivery management system practices and complement existing capacity support programmes. From 2015/16, provinces will only be eligible to receive allocations for the health facility revitalisation grant and the education infrastructure grant if they meet certain planning criteria. Provinces are now required to bid for their infrastructure grant allocations two years in advance with a set of bidding prerequisites and criteria used to evaluate bids. Unsuccessful bids are not funded and those allocations are pooled in an unallocated fund, which provinces with successful bids can apply for – acting as a further incentive to plan properly and bid successfully. These reforms mirror the approach recommended by the research of the Review – that is to use incentives to align priorities and systematise better performance via processes rather than on raw performance. Once again however, the recent nature of the reforms restricts data analysis that could guide similar initiatives in the local government infrastructure system.

Perverse or unintended incentives

Prompted by discussion of 'principle 8'[25], stakeholders revealed the various behaviours encouraged by current grants that are not perversely affecting service delivery. One municipal PMU manager for example said that in the private sector he would be rewarded for completing a project under-budget, yet when dealing with municipal grants he was praised by his managers for spending the whole allocation regardless of cost. This encouragement to inflate costs or just spend allocations by the end of the financial year without the necessary planning is a perverse incentive that requires addressing.

As municipalities are responsible for most household infrastructure services but not for the delivery of housing – which is a provincial function funded largely via the human settlements development grant (HSDG) – it was found that there is frequently a lack of integrated planning between the relevant spheres and arms of government[26]. The availability of cheap land can (perversely) incentivise the province to construct houses away from the central areas that are cheaper for municipalities to service and more efficient for the economy as residents are closer to employment and services. Another perverse incentive is the under investment in the renewal of existing infrastructure[27]; many grants, including the MIG, are considered by the implementing officials to be solely for the creation of new infrastructure.

Very few grants require municipalities to co-fund infrastructure projects with their own revenues, and where it is a requirement the Review's research found it to be weakly applied. Such loose conditions can promote grant dependency and contravenes 'principle 4'[28] adopted by the Review. The literature highlights various means of structuring grants to increase

[25] Reinforce practices that optimise the impact of grants and minimise negative spillover or perverse unintended effects
[26] Discussed more in the Grant Structure chapter
[27] Discussed more in the Asset Management chapter
[28] Integrate a Variety of Funding Sources and Aims

municipal own contributions, such as the introduction of matching-grants. Depending on the priority of a project, and the ability of the municipality to raise its own revenues, a national grant could pay a percentage of the total project cost once the municipality funds the rest – this is a process used with success in France and Canada where fiscally weak municipalities get bigger match-funding incentives than the more prosperous municipalities.

Though larger reforms may be required to progressively introduce explicit positive incentives into grant frameworks, the Review has identified several perverse and unintended consequences of the current grants that require more immediate attention.

Attitudes to incentives

From the municipal and sector engagements, it was noted that many officials are cautious of incentive-based grants as they may adversely impact citizens that reside in poorly performing municipalities, whereas those responsible for the poor performance (i.e. municipal decision makers) may not experience any punishment. Such concerns have validity if not guarded against in the structure of the incentives. Equally incentives that relate more directly to individuals rather than institutions could in certain instances be very powerful, though such proposals fall outside the scope of this review. Persistent poor performance by some municipalities however means the above concerns are similar to the status-quo at present; households in poorly performing municipalities already lose out on service delivery due to misuse of grants by the institutions and officials responsible. Incentives therefore could improve such a situation if structured suitably to encourage the building blocks required for sustainable and efficient service delivery – such as embedding capacity, engaging in long-term planning and practicing asset management. Though hesitation from role-players is to be expected if it appears they have something to lose, framing the incentives in such terms and with such motives will allow the gradual introduction of implicit systematic incentives and in time explicit performance based incentives.

Road Map for Reforms

Based on the above discussion the Review's suggested reforms in the area of incentives is a gradual and progressive introduction as the intergovernmental system matures, rather than an immediate roll-out of performance based grants for example. The Review can therefore illustrate a road map of how incentives will be introduced into the system, in a gradual and differentiated manner, over the medium and long term.

Firstly, it should aim to avoid perverse incentives through:

- Introduce matched-funding for certain grants on a differentiated and sliding scale based on ability of the municipality to raise own revenue. Grant administrators will need to work such conditions into frameworks for appropriate grants, or strengthen oversight where such conditions already exist – such as the RBIG. National Treasury can provide assistance in evaluating the municipality's ability to match-fund. Such reforms should help avoid grant dependency in the longer-term and ensure larger and more urban municipalities in particular are moving towards the longer-term vision of greater fiscal decentralisation and less reliance on transfers from national government.
- Increased accountability and analysis of grant performance data (realised through some of the grant administration reforms) can avoid the reliance on expenditure as the main

performance indicator. Use of this metric can incentivise panic spending and fiscal dumping in the final months of the financial year, regardless of outcomes for service delivery.

- Aim to integrate planning between different spheres and arms of government to avoid grants not being aligned with each other. This is particularly relevant in metropolitan areas and is the logic behind the recent BEPP reforms.

Secondly the system can positively incentivise the building blocks and processes required for efficient service delivery, especially by enforcing improved planning and asset management over the life cycle of the infrastructure built by:

- Conditionalising grants on meeting pre-determined planning deadlines (like are currently in place but often ignored) and showing life-cycle costing of projects
- Further supporting from Provincial Treasuries in municipal budgeting and emphasis on ensuring full cost recovery tariffs, which should address maintenance funding issues
- Provision of renewal funds conditional on municipalities demonstrating ability to manage and maintain infrastructure (i.e. the Asset Management Maintenance Plans discussed in the Asset Management chapter)

Thirdly, once sufficient capacity and systems are in place to ensure municipalities can comply with best-practices, more explicit performance-based grants (like the ICDG for metros) will be required. Failure to meet or respond to such incentives can act as a red-flag for assistance and support from other spheres of government and equally year-on-year progress, rather than absolute performance, must be measured to avoid better performing municipalities to continually divert funds from weaker municipalities. The carrot acting as the incentive (or the stick acting as the deterrent) need not always be financial and, aligning with reforms in the other chapters, consistent high performance can also be rewarded by changes to conditionality, scheduling or reporting requirements. For example, the proposed IUDG will allow secondary cities to 'graduate', pending performance, from the schedule 5 specific purpose grant to the more loosely conditioned schedule 4 supplementary grant.

ALLOCATION TYPE

A key aspect of intergovernmental transfers is the mechanism used to determine allocation size per municipality. While many other budgetary and policy processes that are beyond the scope of this review affects the total size of the infrastructure grants system, the subsequent division of the total envelope between municipalities is crucial in achieving allocative efficiency and adhering to the principles set out earlier.

There are two main methodologies for this division:

1. Formula based allocations
2. Project/application based allocations

The Review's research and literature review details the advantages and disadvantages of both:

Table 6.1: Pros and Cons of Formula Based Grants and Project Based Grants

	FORMULA BASED	PROJECT BASED
Pros	• Stable and predictable allocations • Avoids discretionary or subjective interference (i.e. at political level) • Imposes hard budget constraint • Enhanced transparent and accountability if formula published • Can be simply run at national level • Can allow more municipal discretion	• Can promote healthy competition as municipalities compete for funds • Allocations only made to projects with the best investment returns • Encourages pre-planning by municipalities • Can overcome 'lumpiness' typical of infrastructure projects
Cons	• Requires reliable data • Not as flexible to respond to changing priorities • Can fund inefficient projects	• Can be an administrative burden • Richer or more capacitated regions may continue to get bigger allocations • Can create incentive for municipalities to bid for exorbitant allocations

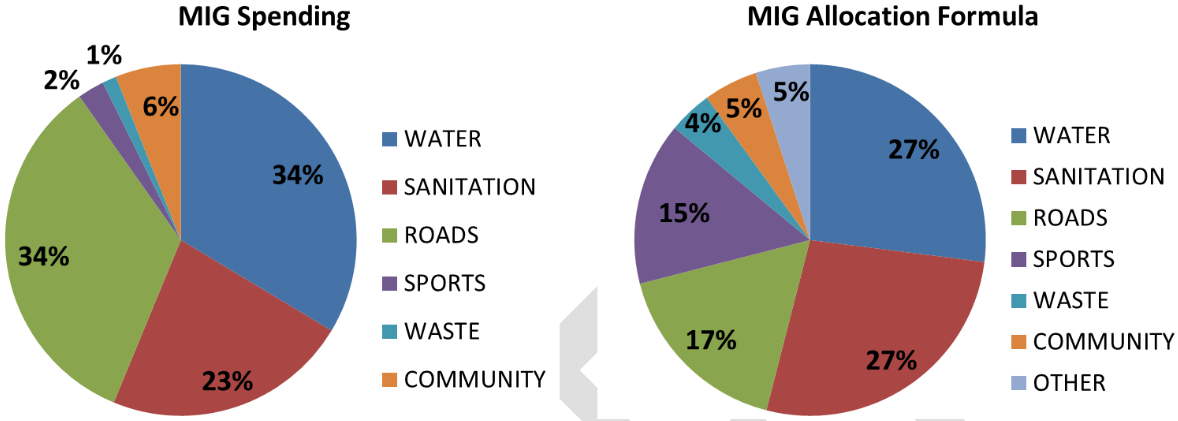
As a result of the above conclusions the Review has proposed and recommends maintaining a mix of different allocation types depending on the nature of the grant to be allocated. The current grants are not always fully transparent in how allocations are determined, despite grant frameworks including a section for allocation criteria to be details. The Review's research suggests the current grants are allocated with the following methods:

Table 6.2: Allocation Criteria for Current Infrastructure Grants

Grant Name	Method	Comments
MIG	Formula	Uses Census 2011 data, based on poverty and demographics
USDG	Formula	Based on old MIG formula, updated with allocations for informal settlements
ICDG	Formula	Allocations to metropolitan municipalities based on population and on performance against pre-determined criteria (explained above)
RRAMS	Formula	Uses a R500/km rate based on the extent of network and number of local municipalities in a district municipality
RHIG	Formula	Based on the highest number of backlogs in priority districts
MWIG	Project Based	Prioritised in the 24 priority districts; projects assessed by DWS and allocations made on the feasibility of the projects
PTIG	Project Based	Budget requests evaluated by department per project
NDPG	Project Based	Approval of projects by National Treasury; priority to township areas with high densities, poverty and connectivity
INEP	Project Based	Approval is by an annual committee chaired by the department; criteria used include backlogs, a rural bias, integration with other projects, and alignment with the IDPs
RBIG	Project Based	Projects assessed by DWS and allocations made on the feasibility of the projects

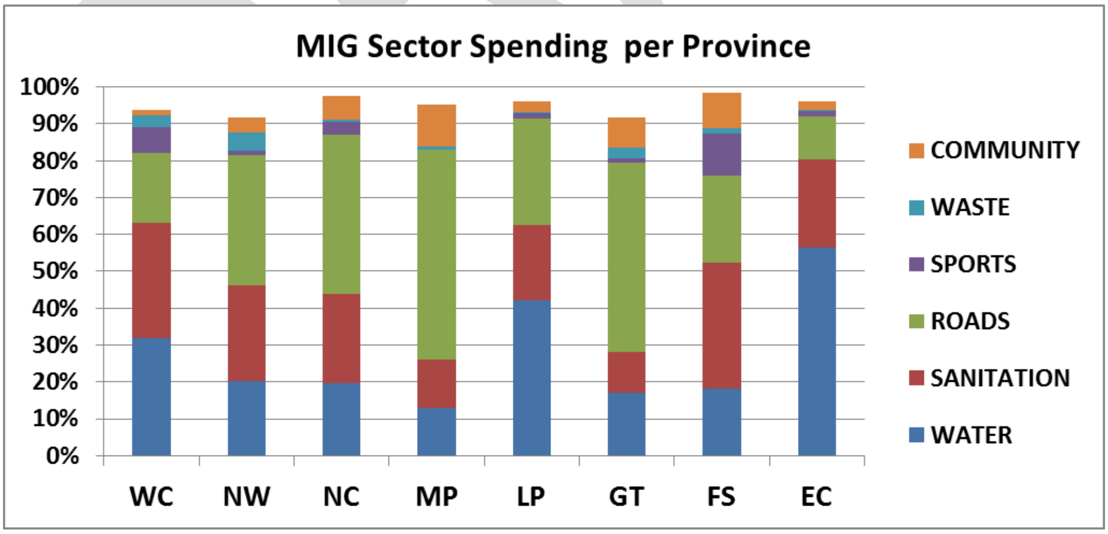
South Africa's infrastructure grants typically follow a general rule of formulas for larger grants that are allocated to every municipality for general infrastructure (i.e. MIG or UDGD) but more discretionary allocation methods for smaller or specific-purpose grants (i.e. NDPG or PTIG). As state above, formula grants align better with the need for municipal discretion whereby local rather than national government decides the location, type and scale of a project rather than having certain pots of funding ringfenced. The Review's analysis of MIG spending over recent years highlights how the municipal interpretation of a formula split can differ from the national split, in relation to what the formula provides for, and the provincial splits, is given below:

Figure 6.1: Sectoral Spending of MIG compared to the MIG Allocation Formula



Spending on roads is much higher than envisaged in the formula which could suggest an inaccurate provision in the MIG formula or that municipalities (for a variety of reasons) choose to spend more on roads than national government would recommend. The large provision for sports and recreation facilities in the current formula (15% following a 2011 parliamentary decision) – which is not the same as the original design – is clearly not being fulfilled by municipal spending patterns.

Figure 6.2: MIG Sector Spending per Province



The provincial variation of MIG spending shows that municipal discretion in the way funds are prioritised between sectors generally responds to local needs (for example responding to the large water backlogs in the Eastern Cape). This is a strong argument for large formula grants that allow municipal discretion but also points towards the need for updating the formula split which was based on municipal needs in 2004, not 2014 or the future. The Review's recommendation is therefore for grant administrators, together with other relevant stakeholders such as National Treasury and DCoG, to ensure updating of grants to match present and future realities. The concurrent MIG Policy Review will further detail the reforms envisaged for the MIG formula itself.

Road Map for Reforms

Based on the above discussion the Review is not proposing drastic or immediate reform to the allocation mechanisms of most grants. Formulas are well suited to the majority of grants however caution must be taken to ensure the main drawback highlighted in the literature – out of date or unreliable data – does not reduce the validity of the formula. Therefore three reviews of current or proposed formulas are suggested:

- The MIG formula to be updated as part of the MIG Policy Review's recommendations and in collaboration with other national stakeholders.
- The formula used to allocate the urban grants, either the USDG or proposed IUDG, needs to be revisited in order to ensure its transparent, up-to-date and equitable based on the grant's purpose.
- As per the Review's previous recommendation[29], public transport funding should be allocated via a formula to ensure the incentive is to invest in suitable, affordable transport solutions. This should be done in 2015 via collaboration between the Department of Transport, National Treasury and other stakeholders.

RECOMMENDATIONS

- Implement a progressive and differentiated introduction of incentives over the medium term
- Emphasis in short term needs to be avoiding perverse incentives and encouraging or conditionalising the setting up of systems that improve performance rather than incentives based on performance itself
- Maintain the mix of formula and project based funding currently in the system
- Develop an equitable formula for the new grants created in the Grant Structure chapter (Integrated Urban Development Grant and Public Transport Grant)

***NB* THIS IS A WORKING DOCUMENT, FURTHER EDITS AND RECOMMENDATIONS TO FOLLOW OVER COMING MONTHS. PLEASE SEND ANY COMMENTS TO: GRANTREVIEW@TREASURY.GOV.ZA**

[29] See Grant Structure chapter