



# The Capable Cities Index: Compliance

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## About the Compliance Index (ComI)

The Compliance Index (ComI) is one of three indices that together comprise the Capable Cities Index (CCI). The Capacity Index was published in early 2015 and the Performance Index will be published in due course.

The ComI presents two sets of data:

First, there is a composite ranking of all municipalities (categories A, B and C) against three measures of compliance covering the period 2010 to 2014.

Second, there is a ranking of the 27 major metropolitan municipalities (A) and secondary cities in the country (B1 local municipalities).

The ranking of a city can be compared to those of other cities, other categories of municipality, and municipal areas which do not have a major urban center.

What does *compliance* mean? Compliance has three elements:

1. There is a binding statutory obligation on municipalities,
2. The obligation relates to the effective operational management of a municipality, and
3. The obligation relates to only functions which are under the direct operational control of the municipality itself.

The measures selected thus include only a narrow range of variables and exclude variables which reflect the impact of the external environment like the broader socio-economic or political conditions.

At the most basic level compliance requires that finances are managed in accordance with statutory obligations for municipal finance management and spent only on mandated objectives. Three measures of compliance will be used, as set out in Table 1 below.

**Table 1: Indicators of compliance with the rule of law**

Indicator	Explanation
1. The audit outcome consistently obtained over a five year period	Each year the Auditor-General (AG) forms an opinion of the extent to which municipalities have complied with regulations and established procedures. The viability of an institution centers on, not compliance in a year, but its consistent conduct over time. The AG's assessments are thus aggregated for the latest five year period using the Municipal Audit Consistency Barometer ratings (the MAC-B <sup>1</sup> ), which measures the extent to which municipalities comply with regulations <sup>2</sup> in a consistent manner.

1 While it would be preferable to use consistent time periods for each of the three components the absence of key data for specific years precludes this.

2 The AG's assessment of the state of municipal finances is formed by a wide range of factors including the quality of information provided by the municipality and the level of irregular, wasteful and unauthorised expenditure. However, the AG's assessment is informed less by the quantum of irregular, wasteful and unauthorised expenditure and more by whether these levels are increasing or decreasing. The inclusion of

2. Misspending due to unlawful, irregular and wasteful expenditure	Diligence in applying financial controls would result in lower levels of waste and financial misappropriation. One measure of such diligence is thus the amount of money associated with irregular, wasteful and unauthorized expenditure as estimated by the AG. The precise measurement used in the index is the proportion of municipal budget associated with unauthorized, irregular and wasteful expenditure (UIW) for 2011/12 and 2012/13. <sup>3</sup>
3. Deviation from mandated objectives in budget appropriations	Municipal administrators' compliance with the mandate given to them by elected representatives is reflected, <i>inter alia</i> , by the deviation between actual expenditure and what was approved and budgeted. National Treasury norms and standards require that actual expenditure by local government falls between 95% and 100% of the original budget. Municipalities which exceed budgeted expenditure or spend less than 95% of that budget falls short of the stipulated standard. <sup>4</sup> The greater the mismatch between actual and budgeted expenditure the less the administration is seen to conform to its mandate. The mismatch is measured by the difference between total actual and total budgeted expenditure. The difference is expressed as a percentage of budgeted expenditure. Estimates are based on the financial years of 2010/11, 2011/12 and 2012/13.

Against each variable, municipalities are scored between 0 (lowest level observed) and 1 (highest level observed). For example, the municipality with the highest percentage of its budget associated with unauthorised, irregular and wasteful expenditure is accorded a value of 0 for the first component. Conversely, the municipality with the lowest proportion of its budget “misspent” is allocated a score of 1 in this component. Likewise, the municipality whose expenditure deviates least from the budget is allocated a score of 1 in the second component. As a rule, higher scores correspond to better/preferable situations. These two components were aggregated and combined with the MAC-B score to give a composite compliance score for each municipality. The aggregated “composite” is, in turn, reset to the 0 - 1 scale.

The audit data was sourced from the AG’s Municipal Finance Management Act reports<sup>5</sup> for each province, and financial data was obtained from the National

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the AG's assessment as well as the quantum of irregular, wasteful and unauthorised expenditure (i.e. the first sub-index) adds different dimension to measuring compliance. The combination places greater emphasis on the level of “misspending”.

- 3 In the *General report on the audit outcomes of local government MFMA 2012-13* the Auditor General defines unauthorized, irregular and wasteful expenditure as:
- Unauthorized expenditure: Expenditure that was in excess of the amount budgeted or allocated by government to the auditee, or that was not incurred in accordance with the purpose for which it was intended.
  - Irregular expenditure: Expenditure incurred without complying with applicable legislation.
  - Fruitless and wasteful expenditure: Expenditure that was made in vain and could have been avoided had reasonable care been taken. This includes penalties and interest on the late payment of creditors or statutory obligations as well as payments made for services not utilized or goods not received.

<sup>4</sup> See the National Treasury's MFMA Circular No. 71 'Uniform Financial norms and ratios' – dated 17 January 2014.

<sup>5</sup> For example the 2012/13 financial reports are available from

Treasury website for municipal finances.<sup>6</sup>

## Overall Compliance (all municipalities)

Diagram 1 below indicates how the composite indices of compliance for municipalities are distributed on the spectrum of scores. Municipalities with greater compliance levels are indicated by a higher score. The median *ComI* index score of all 278 municipalities is 0.65. Half of all municipalities get more than this value.

A wide variation in compliance can be seen, with three clear trends. These trends correspond to

- the small number of municipalities with clean audits and a near perfect compliance score,
- those municipalities that failed to achieve clean audits but received a score higher than 0.43, and
- the 40 municipalities that receive a score lower than 0.43.

Trend 1: Only five municipalities fall into group 1. Members of this group of municipalities have a compliance index of greater than 0.98. These municipalities are marked by clean audits, low levels of misspending and strong adherence to budget allocations. Given their high scores on all sub-indices there is little room for members of this group to improve compliance.

Trend 2: The vast majority (85%) of municipalities fall into group 2. This group displays a linear declining trend and moderate variation in compliance levels. Compliance levels for this group descend in a straight line from a composite score of 0.9 to 0.43. The aggregate for this group is shown by the long sloping line. Given that scores in this group fall in a continuum it seems that the current strategy of incrementally advancing the components of the index is a viable strategy for improving compliance. This strategy hinges on municipalities progressively reducing the level of UIW, improving audit outcomes and better matching expenditure to budgets.

Trend 3: The municipalities in group three have a *ComI* index of lower than 0.43 and display rapidly declining levels of compliance. The trend for this group is shown by the dashed regression line.

The *ComI* shows that better audit outcomes correspond to lower levels of UIW expenditure and smaller deviations from budget allocations. Conversely, poor audit outcomes correspond to higher levels of UIW expenditure and larger deviations from budgets. The distribution of *ComI* scores further suggests that there is a “tipping point” about a value of 0.43. This is indicated by the short dashed line on the graphic below.

Municipalities with a *ComI* below the tipping point of 0.43 show very rapid levels of deterioration. This arises from them having poor audit outcomes, high levels of

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<http://www.agsa.co.za/Documents/Auditreports/MFMA20122013.aspx>

6 See <http://mfma.treasury.gov.za>

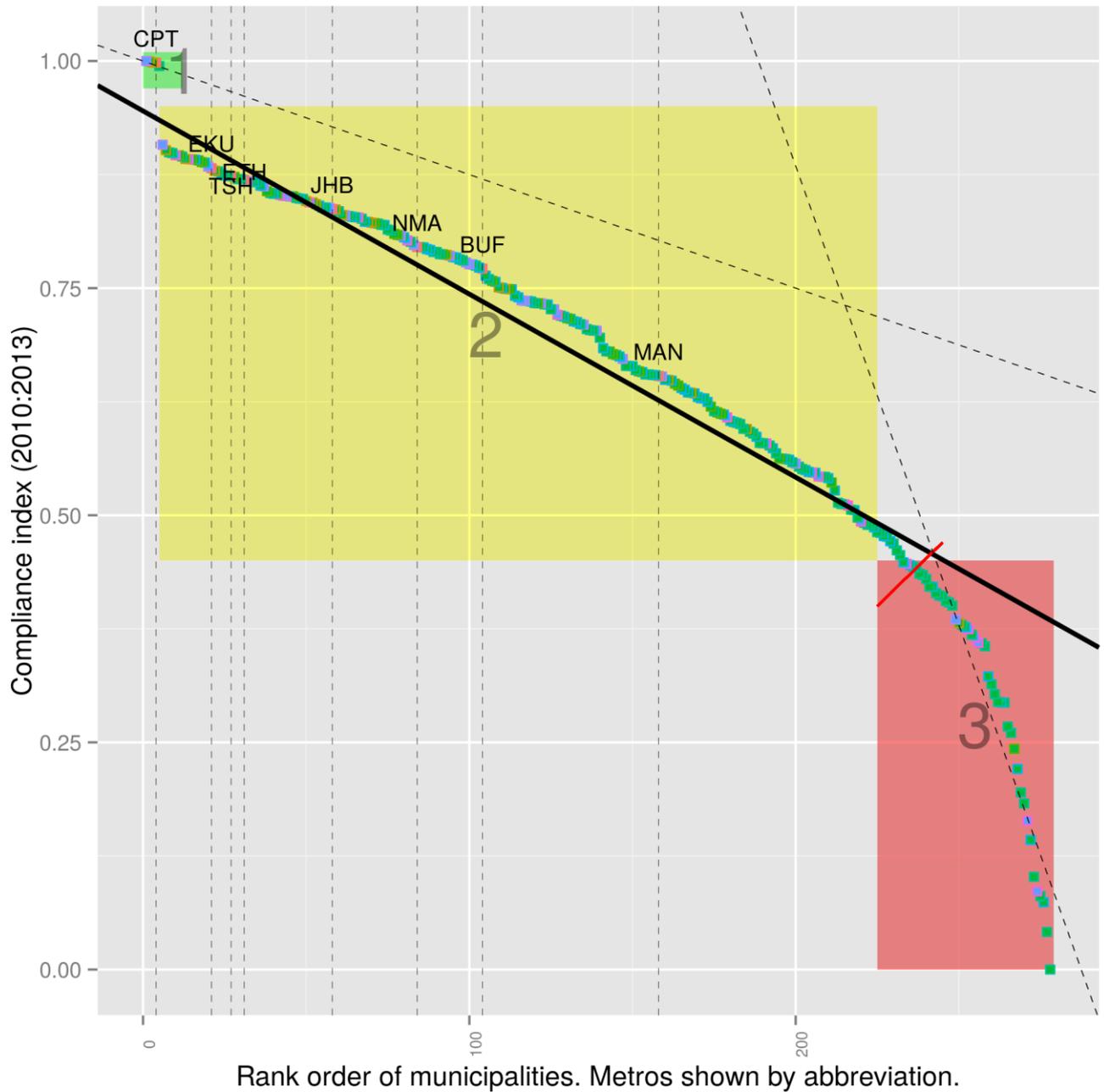
misspending as well as large deviations from their budget allocation. It is among these municipalities that the pursuit of incremental advances is not an optimal strategy (and possibly not even a viable strategy) for improving compliance. Intervention is urgently required among members of this group and it is among these municipalities that increased compliance will have the most pronounced impact on their sustainability.

As group 3 municipalities are defined by low levels of compliance with regulations and political direction there is doubt as to whether or not they can address the root causes of the problem on their own. However there, to date, has been a poor correlation between intervention in terms of section 139 of the Constitution and very low *Coml* scores. Only four of the 40 municipalities have been subject to a section 139 intervention by their respective provincial governments. Conversely, 85 percent of section 139 interventions have been in municipalities that are above the tipping point.

While larger municipalities tend to have higher levels of compliance only one city falls into group 1. While the average score for cities (metros and other large cities) was 0.8 the average for all other municipalities was significantly lower at 0.64.

One solution advocated for poor service delivery that has been the incorporation of smaller and poorly performing municipalities into their larger neighbours. The *Coml* data suggests that municipal amalgamation may result in better financial compliance - at least in terms of the proportion of budgets misspent.

**Diagram 1: Overall compliance for all municipalities**



**The cities**

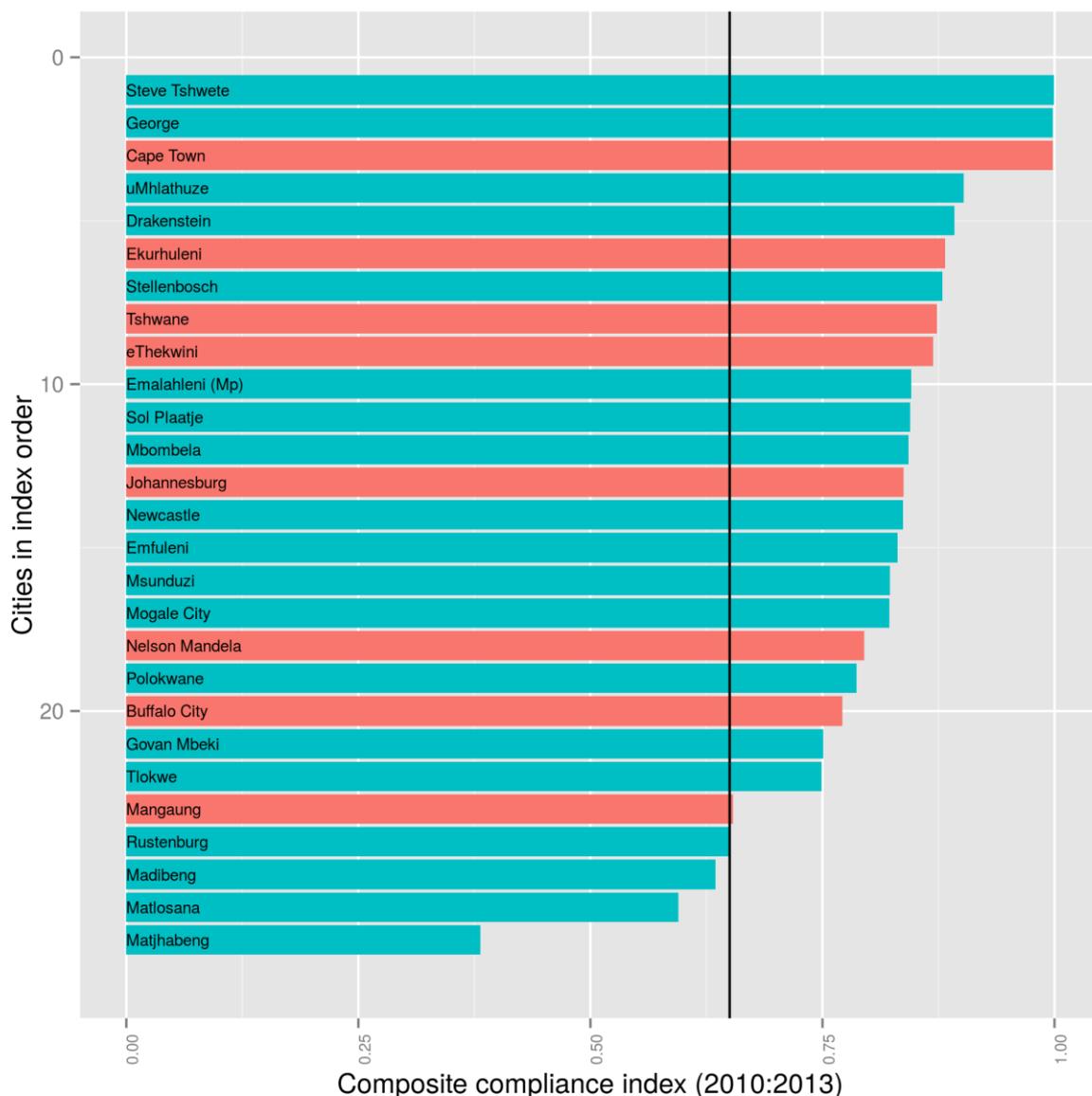
There are 27 category “A” and “B1” municipalities. Together these make up the 27 largest cities in the country and are the focus of the Capable Cities Index. In 2012/13

these 27 municipalities accounted for approximately 75 percent of the budgeted operating expenditure of all municipalities. Diagram 2 below shows how the cities are distributed on the *Coml* spectrum.

The vertical line shows the average *Coml* score for all municipalities. Only three of the 27 municipalities fall below this benchmark. This reiterates the extent to which larger municipalities are more financially compliant than smaller municipalities. Three of the five municipalities which get a *Coml* score of more than 0.99 are cities. One of these is a metropolitan municipality. These municipalities all have a “clean” MAC-B rating and consistently get “unqualified audits without findings”.

There is a significant geographic dimension to *Coml*. All municipalities in the lowest quartile of city *Coml* scores are from the Free State and North West provinces. Conversely, in terms of compliance, none of the Free State and North West cities are among the better performing 75 percent.

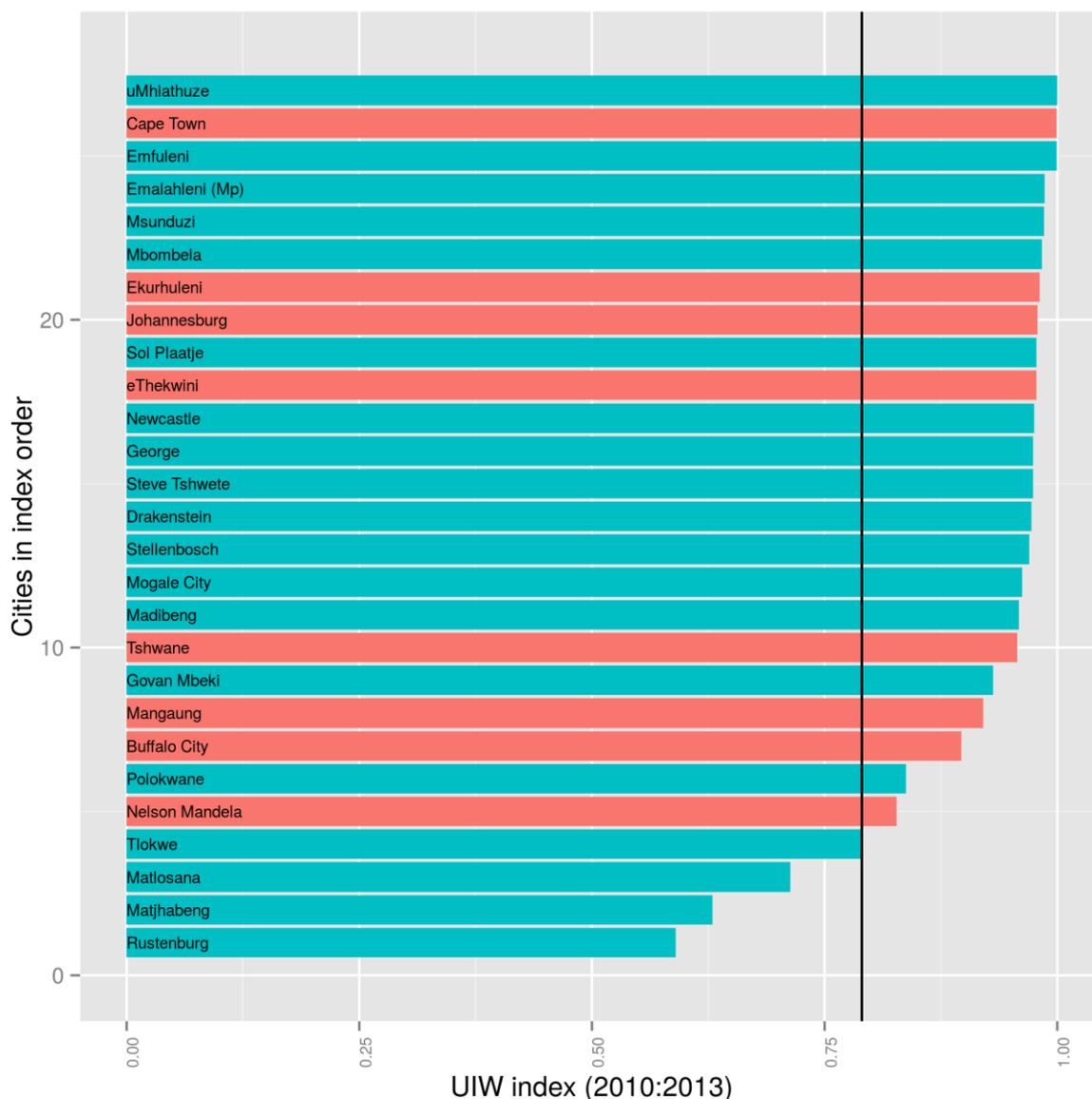
**Diagram 2: Compliance by the 27 major cities**



## Unlawful, irregular, and wasteful expenditure

The first measure is the extent to which expenditure by the municipality is associated with unauthorised, irregular or wasteful (UIW) expenditure. Diagram 3 below shows that on average, four percent of all municipal budgets are associated with unauthorised, irregular or wasteful expenditure. However, in the 27 largest cities this percentage falls to 2.3 percent. The national average score for this sub-index is 0.79 (shown by the vertical line on the graphic below). All but three of the cities equal or better this rating. This indicates that UIW compliance is markedly better among cities than among smaller municipalities.

**Diagram 3: Unlawful, irregular and wasteful expenditure by major cities**



## **Deviation from approved budget**

The primary means by which the activity of local government is directed are budgets for financing of particular objectives. When actual expenditure is significantly different from what was budgeted a deviation from the mandated activities is indicated. Such deviations arise from either under-spending or over-spending. The second component of the index measures only the extent to which deviations take place (not the direction of the deviation), with underspending treated in exactly the same manner as overspending. The deviation measure are limited to the gross operational expenditure budget and reflects neither deviations in capital expenditure nor the extent to which individual items on the operational budget deviate from allocations.

In the 2012/13 financial year operational expenditure by municipalities was within one percent of the total budget allocation. However, the match stems from over-expenditure in some municipalities being offset by under-expenditure elsewhere. When the direction of the mismatch is ignored there is an average of 11 percent deviation between budget and audited expenditure. This means that the typical municipality misses their gross budget target by almost ten percent. In the 27 cities the deviation from budget allocation was substantially lower at 4.8 percent.

The 11 percent deviation in budget (i.e. the national average) corresponds to a sub-index value of 0.82. This is indicated by the vertical line on Diagram 4 below. Most (93 percent) cities performed above this benchmark. No metropolitan municipality and only two other cities performed worse than the national average.

**Diagram 4: Deviation from approved budget by 27 major cities**

