CHAPTER 10

Measuring Fiscal Distress in South African Local Government

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10.1 Introduction

The fiscal performance of South African municipalities is under increasingly intense scrutiny, as more municipalities are failing to create and deliver public value to their communities, despite sustained national government efforts to build the capacity in local sphere and to support improvements in the quality of municipal services and the eradication of service backlogs. Many municipalities are in fiscal distress, which is a key public issue that affects the economic, social and political wellbeing of both individuals and communities (Carmeli, 2008). As noted in Chapter 6, fiscal distress may mean different things to different people. In this chapter, fiscal distress[1] is defined as the sustained inability of a municipality to fund the delivery of basic public goods and other requirements as per its constitutional mandate and also meet its financial obligations. Municipalities in fiscal distress not only fail to satisfy their service obligations to citizens but also drain the fiscus by requiring ameliorative measures, which implies forgone economic growth and development. Therefore, fiscal distress modelling is needed to provide early warnings of fiscal distress incidents in municipalities to promote proactive responses for their resolution.

Although National Treasury has developed a diagnostic tool for fiscal health, the tool reports fiscal distress when it has occurred rather than predicting it. The National Treasury indicators also do not capture the service delivery aspect of a municipality's fiscal health.[2] What is needed is a predictive fiscal distress tool that would anticipate those municipalities more likely to become fiscally distressed. Such a model would provide important insights into local government performance, focus on prevention measures as far as possible, and minimise direct and indirect costs associated with corrective measures after the fact (Boyne, 1988).

Many municipalities have fallen under section 139 interventions[3], which is sometimes a sign of less-than-optimal fiscal performance. In terms of section 139(1)(b), when a municipality cannot or does not fulfil an executive obligation in terms of the Constitution or legislation, the relevant provincial executive may intervene by taking any appropriate steps to ensure fulfilment of that obligation, including assuming responsibility for the relevant obligation in that municipality. While provincial intervention in municipal service delivery problems is discretionary, section 139(5) does require provincial government to intervene in the event of a financial crisis or failure to approve a budget. The number of municipalities under administration has remained high. For example in November 2010, 21 municipalities (eight per cent) were under section 139, whereas on 30 June 2011, 22 municipalities were either under section 139(1)(b) or 139(5)(a) interventions. The concerned municipalities were often already in a precarious financial position when these interventions were triggered. Using National Treasury measures, a significant (and increasing) number of municipalities are reportedly in financial distress. Municipalities identified as experiencing fiscal distress numbered 63 (22 per cent) in 2009/10 and 66 (23 per cent) in 2010/11.

Fiscal distress seldom emerges overnight. It develops gradually, which makes the development of an early warning system important. An early warning system can play a critical role in preventing the occurrence or mitigating the impact of fiscal distress and in improving the 3Es (efficiency, effectiveness, economy). Yet South Africa has no formal early warning system to alert policy-makers, oversight bodies, politicians, citizens and other stakeholders of municipalities heading for fiscal distress. The absence of indicators, which signal that a municipality may be in fiscal distress, has often resulted in a reactive rather than a proactive response. This chapter aims to fill this gap by (i) constructing a set of fiscal distress indicators and (ii) developing a new method for assessing and predicting fiscal distress among South African municipalities. The aim is not to advocate for specific fiscal distress indicators, but to illustrate the kind of indicators and approaches Government could practically adopt in developing a more pre-emptive early warning system.

[1] Fiscal distress has assumed many labels such as fiscal strain, fiscal stress, fiscal decline, fiscal need or fiscal hardship. It is the negative side of fiscal health.

[2] Fiscal health in this context is defined as the ability of a municipality to meet its financial obligations and to provide adequate quantity and quality of goods and services for the general health and welfare of its communities.

[3] According to section 139 of the Constitution, the responsible province may intervene when a municipality is unwilling or unable to meet its obligations.While provincial intervention in municipal service delivery problems is discretionary, section 139(5) requires that provincial government intervene in the event of a financial crisis or failure to approve a budget.

10.2 Methodology

Fiscal distress is a multi-dimensional concept, with financial, fiscal and socioeconomic aspects. Therefore, measuring fiscal distress requires putting together a set of indicators that together capture and operationalise these different aspects. The indicators to be constructed would need to satisfy the principles described in the literature and fit the South African context, especially given data availability and accessibility, and capacity to continuously generate such indicators.

Fiscal distress indicators were developed in order to rank municipalities and then used to construct an operational model for predicting fiscal distress in local government. The methodology used follows two methods, which both rely on a set of identified indicators.

Literature has an abundant list of measures of fiscal distress (e.g. Brown, 1996; Cohen et al., 2012; Kleine et al., 2003; Kloha et al., 2005; Wang et al., 2007). The point scale methodology used in this chapter draws on Kloha et al. (2005), Pierhopies and Scorsone (2011) and Zafra-Gomez et al. (2009). The point scale method works in the following manner:

- A practical measure for each identified indicator/concept is defined. For example, the ratio of total liabilities to total assets is used to measure the extent to which a municipality relies on third-party financing, instead of own resources.

- Bad and good performance is then distinguished. For the above example, a ratio equal to one or less is considered to be good and a ratio greater than one is bad.

- Each municipality is scored. A municipality that performs well (good score) receives 0 points, while a bad score means a single (1) point.

- The scores for each municipality are totalled for the year. The scores should be in the 0–X range, where X is the total number of indicators. A higher score indicates bad performance and is undesirable. This aggregate indicator provides a global overview of the financial and fiscal condition of a municipality. It is simple and accessible to local government interested parties and is more objective, as it does not place any subjective weights to variables used in the index (Zafra-Gomez et al., 2009).

The cornerstone of a credible early warning system is a sound dataset, which needs to be reliable, credible, publicly available, and not vulnerable to manipulation. The present study relies on StatsSA, audited National Treasury and Auditor-General datasets. The indicators used for the point scale analysis are grouped into four categories:

1. Compliance indicators, which are used to identify municipalities that do not comply with government regulations. Failure to comply may be an indicator of challenges a municipality is facing.
2. Fiscal performance indicators, which identify municipalities that are facing fiscal challenges.
3. Financial performance and management indicators, which seek to isolate municipalities that are facing financial management challenges.
4. Service delivery and general economic indicators. In this context, service delivery challenges are seen as a cause of fiscal distress, in the sense that poor service delivery is likely to be associated with poor fiscal and financial indicators. General economic indicators seek to identify municipalities with declining economies and productivity.

The indicators were divided into short- and long-term indicators, which are described in Tables 33 and 34. *(See Tables on page 121)*

Table 33:Short-term Indicators

Indicator	What it measures	Implications
Persistent negative cash balance	The ability of a municipality to manage its cash-flows.	A negative closing balance implies poor financial management.
Cash coverage ratio	The ability of a municipality to meet its financial obligations.	A lower ratio is adverse, implying that the municipality does not have enough cash at hand to make its payments, indicating poor financial health.
Debt impairment (bad debts) as a percentage of billable revenue	The ability of a municipality to adequately fund the provision for its debt impairment.	A high ratio is undesirable, as it shows the inability of a municipality to collect its debts.
Borrowing as a percentage of total assets	The extent to which a municipality uses credit to finance its assets.	A high percentage is unfavourable and indicates that the municipality is financing more of its assets through debt.
Percentage increase of employee cost	The municipality's efficiency on personnel expenditure.	A rapid increase or decrease in employee cost is undesirable and implies inefficiency.
Asset renewal and repair and maintenance as a percentage of total municipality expenditure	The extent to which a municipality renews its assets instead of buying new ones.	A high percentage is favourable.
Opening balance plus receipts to payments ratio	The extent to which a municipality is able to balance its expenditures with its revenue over a period of time.	A ratio that is greater than one implies that the municipality has enough revenue to meet its expenditures over a period of time, while less than one or negative implies a deficit.
Medium term expenditure review framework	The credibility of a budget proposed by a municipality.	A non-credible budget is a sign of fiscal problems.

Source: Commission's calculations

Table 34: Long-term Indicators

Indicator	What it measures	Implications
Compliance/non-compliance	The ability of a municipality to comply with regulations, i.e. the ability of a municipality to submit financial statements for auditing at a given date.	If a municipality is unable to submit financial statements on time, it means it is not complying and it may suggest a problem.
Expenditure per capita	Productivity of a municipality.	Increasing per capita expenses can indicate that the cost of delivering services is outstripping residents' ability to pay, or can indicate declining productivity.
Operating expenses to own revenue ratio	The extent to which a municipality relies on subsidies.	A higher ratio implies that the municipality relies heavily on subsidies in order to be financially sound and is therefore exposed to a risk over which it has no control.
Under/overspending	The efficiency of a municipality in its spending on capital grants, i.e. a municipality's ability to plan and budget properly.	A high percentage implies a high level of inefficiency.
Own revenue to total population ratio	The financial autonomy of a municipality and gives a picture of the socio-economic environment in which a municipality operates.	A large ratio means that a municipality has a significant population that is rich.

Source: Commission's calculations

Table 34: Long-term Indicators (continued)

Indicator	What it measures	Implications
Budget deficit/surplus	The efficiency of a municipality in its spending.	A high budget deficit ratio signifies poor planning and poor management of financial resources.
Audit opinion	Highlights management capabilities/ weaknesses/ strengths in financial management	A clean and unqualified audit opinion is an indication of good fiscal performance and compliance.
Operating deficit ratio	The efficiency of a municipality in its operating expenditures.	A high ratio suggest poor planning and poor management of financial resources.
Service delivery access	The extent to which households within a municipality have access to basic services (water, sanitation, electricity, refuse removal).	A high infrastructure index means good access.
Per-capita income	Income earned per person in a municipality.	A high ratio is desirable, while a decrease may imply a future decline in business and the amount of taxes collected by a municipality.

Source: Commission's calculations

10.3 Results

After computing the fiscal distress indices, municipalities were grouped into three fiscal health categories (fiscally neutral, fiscal watch and fiscally distressed), which are described in Table 35.

Table 35: Fiscal Health Levels

Fiscal Health Categories	Fiscal distress score range	Map Key	Intervention
Fiscally neutral	0-5		No need for government intervention
Fiscal Watch	6-7		Municipality is placed under fiscal watch for current and following year
Fiscally distressed	8-11		Municipality is closely monitored/ observed, assisted to turn around its fortunes

Source: Commission's calculations

Tables 36 and 37 show the fiscal health levels of South African municipalities over a number of years. The positions of individual municipalities in the fiscal health spectrum are also shown in the maps in the Appendix to this chapter.

As Table 36 shows, fiscally healthy municipalities decreased from 34 per cent in 2011/12 to 24 per cent in 2012/13. Municipalities in the fiscal watch category also constitute a larger percentage of municipalities across the country. The number of municipalities in both the fiscal watch and fiscally distressed category has increased over the past two years.

The long-run analysis, which is shown in Table 37, revealed that a large percentage of municipalities across the country are fiscally healthy. Compared to the other categories, the number of municipalities in fiscal distress has been relatively low. An interesting result of the long-term analysis is that no municipality was in fiscal distress in 2008/09, a remarkable feat considering the then global economic crisis. This implies that, in general, the performance of municipalities across the country is improving. However, the results from both the short- and long-term analysis also suggest a need to turn around municipalities that are heading towards fiscal distress or are already in fiscal distress.

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Table 36: Fiscal Health Levels Based on Short-term Indicators

Year	2011/12	2012/13
Fiscally Neutral	34%	24.4%
Fiscal Watch	58%	67.3%
Fiscally distressed	8%	8.3%

Source: Commission's calculations

Table 37: Fiscal Health Levels Based on Long-term Indicators

Year	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2010/11
Fiscally Neutral	66%	59%	58%	55%	83%	77%	85.90%
Fiscal Watch	32%	35%	38%	40%	17%	22%	13.70%
Fiscally distressed	2%	6%	4%	5%	0%	1%	0.35%

Source: Commission's calculations

10.4 Conclusion

This chapter sought to develop an early warning system that will detect municipalities heading towards fiscal distress and permit proactive responses to mitigate associated financial and service delivery risks. A set of indicators were used to identify the fiscal health of municipalities. Thelong-term analysis found that the number of municipalities in fiscal distress fluctuated during the study period, whereas the short-term analysis indicated an increase. The implication is that municipalities require increased support to turn around those municipalities that are fiscally distressed and to monitor closely those that may be heading towards fiscal distress. Furthermore, once the probability of fiscal stress is detected, further investigation is needed to identify the underlying root causes and frame appropriate and timely responses.

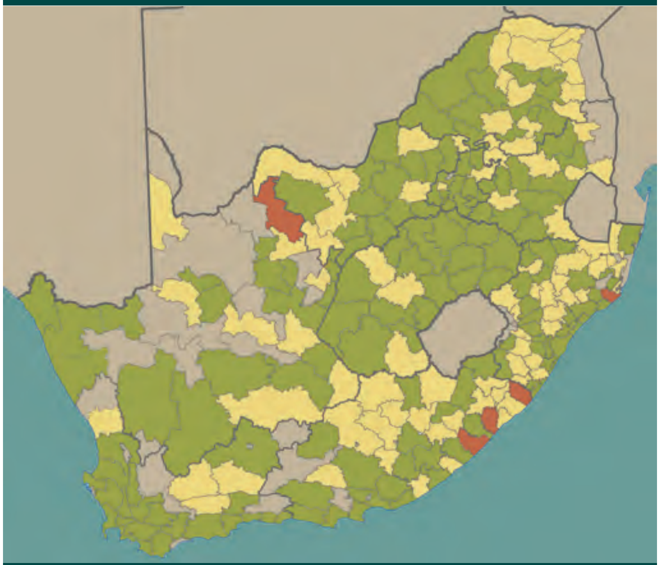
10.5 Recommendations

With respect to **detecting and managing fiscal distress within local government**, the Commission recommends that:

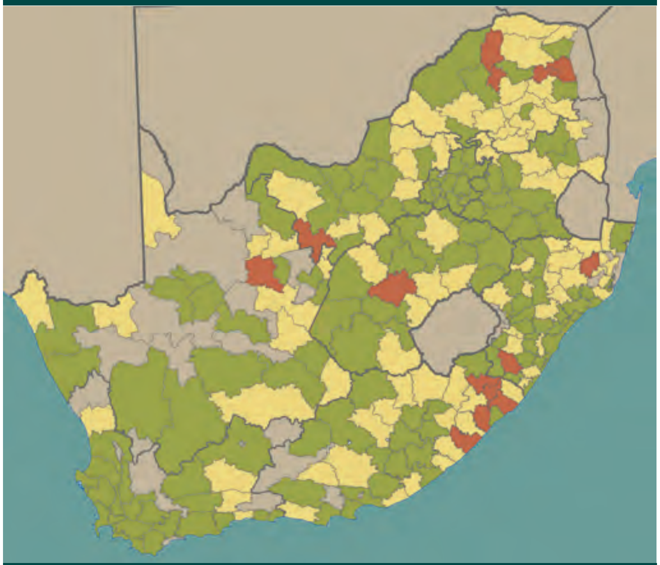
- Government develops and institutionalises an early warning system, which would identify municipalities that are heading towards fiscal distress proactively.
- Government uses the early warning system as a tool to monitor and assist municipalities heading towards fiscal distress and those already in fiscal distress.

Appendix 1 Fiscal Distress Maps

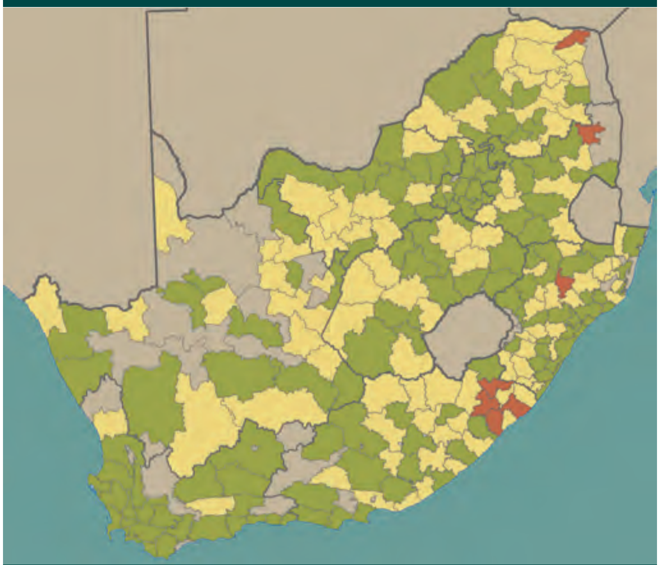
2004/05 Local and Metros



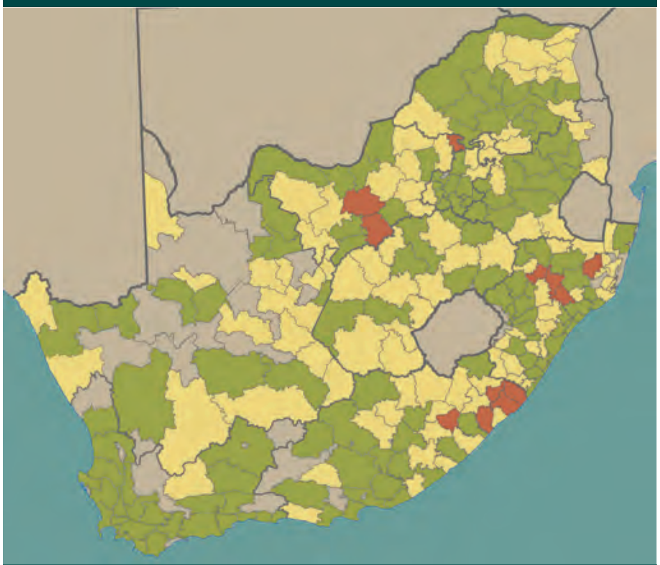
2005/06 Local and Metros



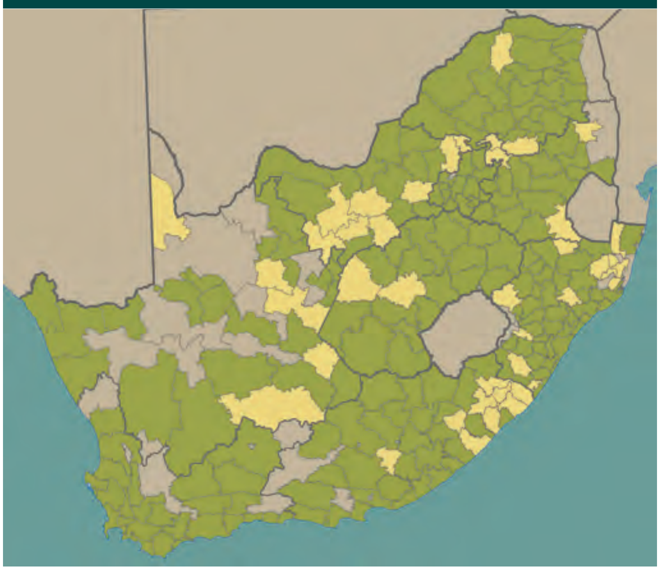
2006/07Locals and Metros



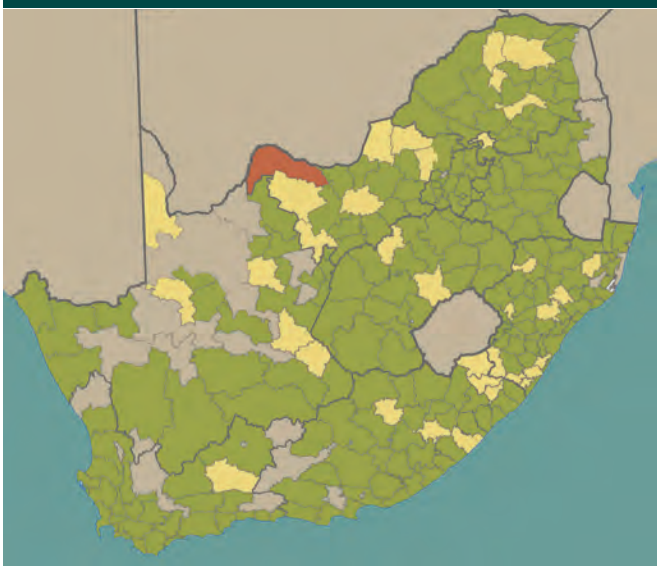
2007/08Locals and Metros



2008/10 Locals and Metros



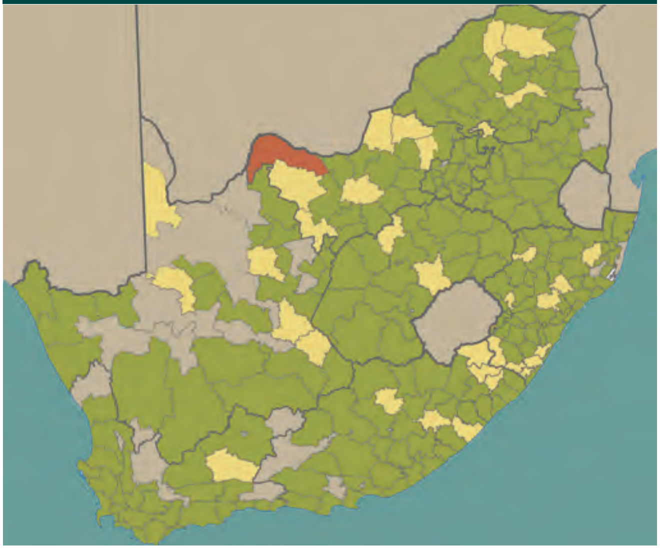
2009/10 Locals and Metros



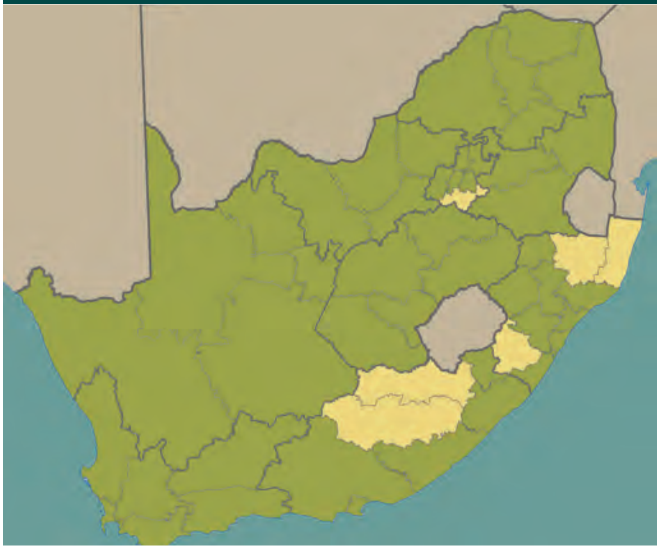
Fiscally Neutral   Fiscal Watch   Fisically distressed

Appendix 1 Fiscal Distress Maps

2010/11 Locals and Metros



2004/05 Districts and Metros



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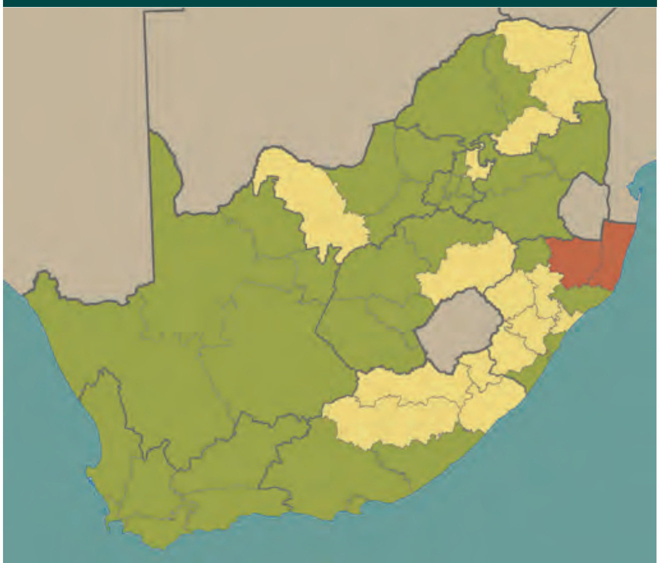
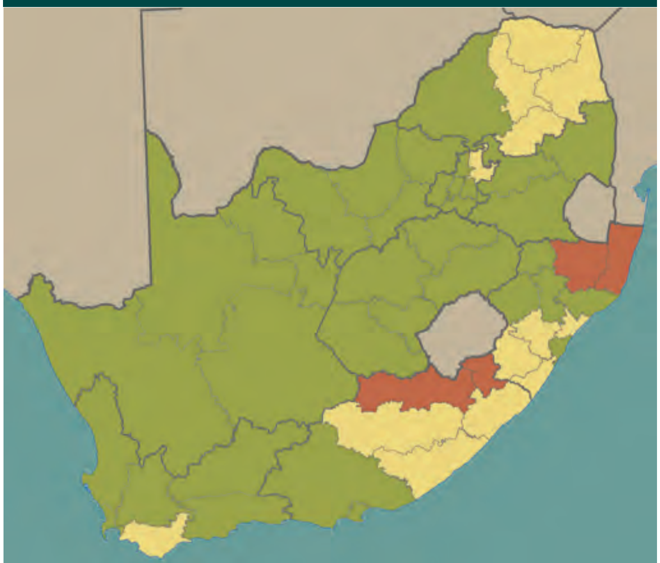
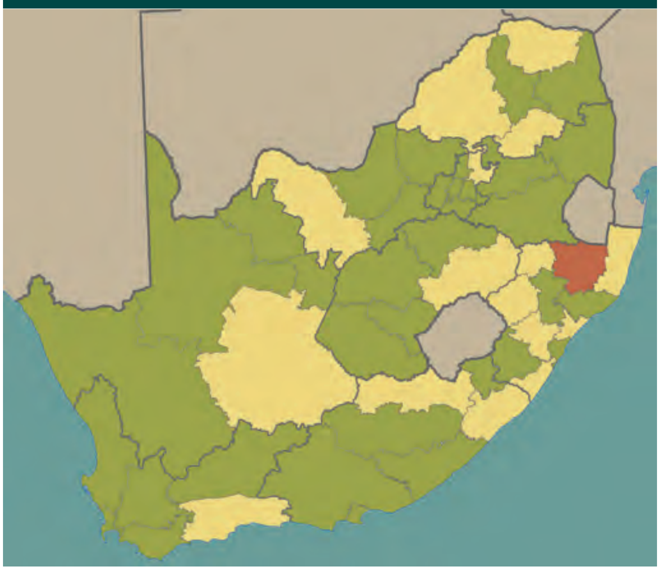


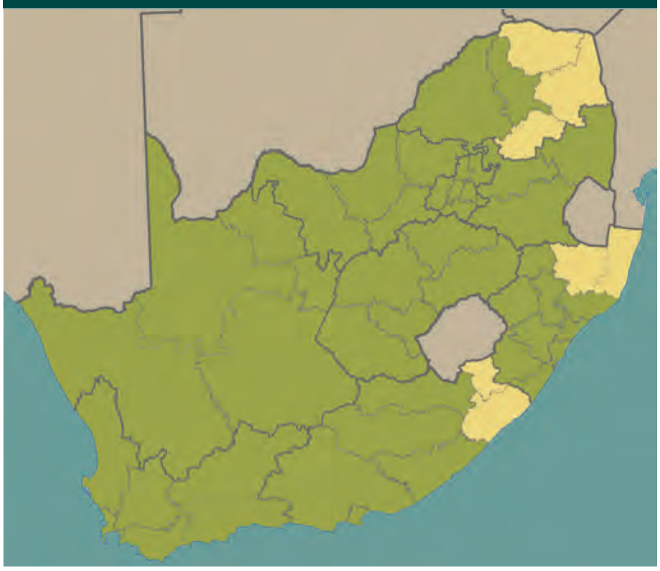
2006/07 Districts and Metros



2007/08 Districts and Metros



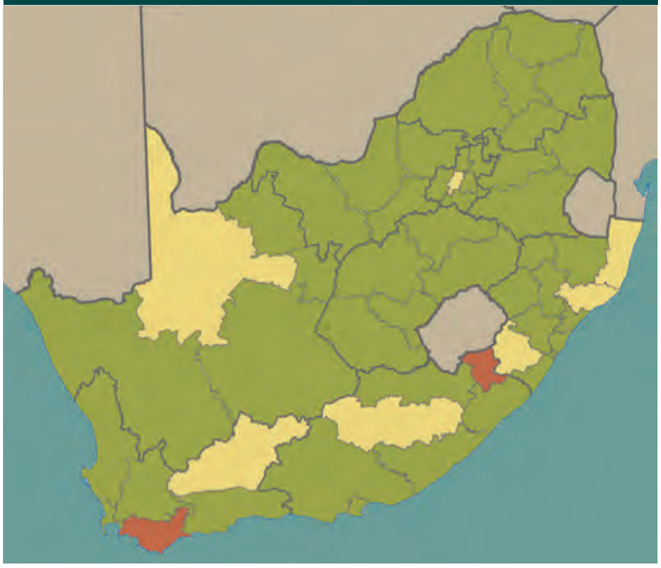
2008/09 Districts and Metros

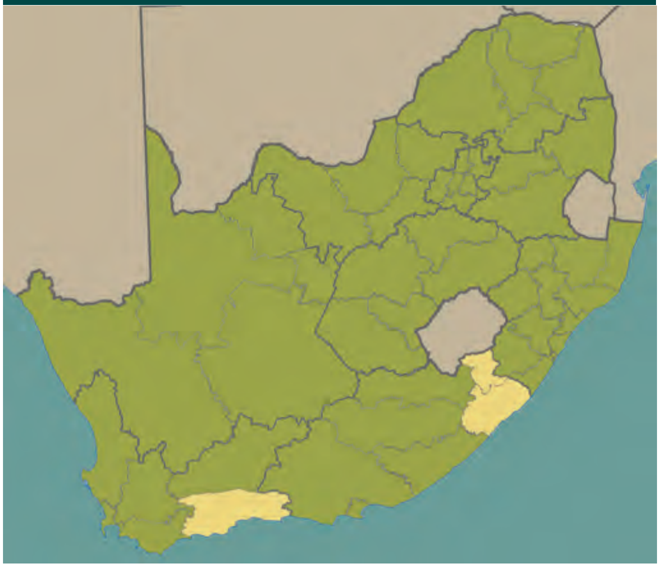


Fiscally Neutral   Fiscal Watch   Fisically distressed

Appendix 1 Fiscal Distress Maps

2009/10 Districts and Metros	2010/11 Districts and Metros





Fiscally Neutral   Fiscal Watch   Fisically distressed