



Ratings Afrika

✉ 1018 CRESTA 2118 SOUTH AFRICA ▪ Tel +27 11 478-5438

MAJORITY OF LOCAL MUNICIPALITIES IN FINANCIAL DISTRESS

Publication date: 7 August 2020

Analysts: Leon Claassen and Charl Kocks

1. Introduction

Ratings Afrika has published its annual Municipal Financial Sustainability Index (MFSI™) for the financial results of the 100 largest local municipalities in South Africa. The analyses are based on the fiscal year ending in June 2019.

The MFSI is a scoring model that evaluates six components, namely the operating performance, liquidity management, debt governance, budget practices, affordability and infrastructure development of a municipality; and scores these components out of 100.

Ratings Afrika defines financial sustainability for all municipalities as: "The financial ability to deliver services and develop and maintain the infrastructure required by its residents without unplanned increases in rates and taxes or a reduction in the level of services. Furthermore the municipality should have the capacity to absorb financial shocks caused by natural, economic, political and other adversities without external financial assistance."

Although the local municipalities are substantially smaller than the eight metropolitan municipalities, the majority of the country's population, some 60%, reside in local municipality jurisdictions. The level and quality of the services delivered by the local municipalities has a direct effect on the quality of life experienced the residents of these municipalities. The extent and quality of the services rendered is the primary governance role of the municipal councillors. Furthermore, the ability of the municipalities to deliver quality services is underpinned by the soundness of their financial sustainability.

Unfortunately the financial sustainability of the local municipalities and concomitantly their service delivery capacity, continues to deteriorate rapidly which has a disastrous effect on the quality of life for most of the South African population and the economic activity of the businesses located within the local municipal areas.

2. Provincial performance

The following table clearly depicts the deterioration in the financial sustainability of the municipalities in each province, except the Western Cape:

Average MFSI™ scores by province - 2015 to 2019					
Province	2015	2016	2017	2018	2019
Eastern Cape	34	32	31	28	29
Free State	24	24	23	21	21
Gauteng	32	33	31	32	31
KwaZulu-Natal	52	47	46	44	41
Limpopo	42	40	39	30	32
Mpumalanga	30	30	30	31	30
Northern Cape	51	46	40	35	35
North West	27	29	24	29	25
Western Cape	56	57	59	58	59
National average	42	40	40	38	37
Table 1					

The weakest provinces are Free State and North West, with average scores in 2019 of 21 and 25 respectively. It is very clear that the majority of the municipalities in these provinces are in serious financial trouble and probably dysfunctional in key service delivery aspects.

Western Cape, with an average of 59, is the highest-scoring province. It is the only province with an average score of more than 50 and the only one that has improved over the last five years, from an average of 56 in 2015 to 59 in 2019. This is a remarkable achievement for the Western Cape municipalities who were still suffering from the crippling drought during 2017 and 2018. Western Cape is the only province whose governance practices are considered to be sound.

The provinces' national score average for 2019 has deteriorated to a very low 37 out of 100. And if the Western Cape is excluded, then the average for the rest of the country is only 31. This extremely low average indicates very poor financial management practices and discipline. Furthermore the majority, namely 63 municipalities out of the top 100, achieved a score of less than 40, rendering them seriously unsustainable and perhaps even dysfunctional in terms of normal service delivery.

It is clear that the councils of these municipalities have failed miserably in their governance responsibilities by allowing them to sink into this desperate, unsustainable financial situation. Furthermore, it seems that the oversight role by the respective provincial administrations, except the Western Cape, has so far been totally ineffective to improve the financial sustainability at municipal level, as the situation has been continuing over the last five years.

It is important to note that these numbers are based on the June 2019 financial results of the municipalities and they exclude the devastating effects of the current lockdown caused by COVID-19.

3. Performance of individual municipalities

The high-scoring municipalities have also experienced a weakening trend with only 6 municipalities receiving a score of 75 or more compared with 8 in 2017. The three top scoring municipalities in the country are all in the Western Cape with Mossel Bay achieving the highest score of 76, followed by Saldanha Bay with 74 and Swartland (Malmesbury) with 73. These municipalities have exerted great effort over a number of years to strengthen their sustainability, which now places them in a very strong position to invest in infrastructure as well as be able to absorb financial shocks such as the COVID -19 lockdown.

The best-performing municipalities by province in 2019 are shown in Table 2:

Best performing by province in 2019		
Province	Municipality	Score
Eastern Cape	Senqu (Lady Grey)	57
Free State	Metsimaholo (Sasolburg)	31
Gauteng	Midvaal (Meyerton)	66
KwaZulu-Natal	KwaDukuza (Stanger/Ballito)	66
Limpopo	Lephalale (Ellisras)	46
Mpumalanga	Steve Tshwete (Middelburg)	64
Northern Cape	Sol Plaatje (Kimberley)	59
North West	JB Marks (Potchefstroom)	50
Western Cape	Mossel Bay	76
Table 2		

The high-scoring municipalities demonstrate consistency over the five years mentioned. These municipalities normally have well-entrenched financial policies and their budgets are based on sound long-term financial strategies. They normally adhere to good budgetary practices, strict financial control and good revenue collection even through tough economic conditions.

Unfortunately there are also municipalities that reflect extremely low financial stability and they are a cause for grave concern, as service delivery is normally affected adversely by financial constraints in a municipality. The results of the lowest-scoring municipalities in our index for 2019 by province are shown in Table 3:

Lowest scoring by province in 2019		
Province	Municipality	Score
Eastern Cape	Amahlathi (Stutterheim)	11
Free State	Matjhabeng (Welkom)	13
Gauteng	Emfuleni (Vereeniging)	17
KwaZulu-Natal	Newcastle	17
Limpopo	Modimolle (Nylstroom)	16
Mpumalanga	Victor Khanye (Delmas)	11
Northern Cape	Gamagara (Kathu)	25
North West	Madibeng (Brits)	11
Western Cape	Beaufort West	29
Table 3		

A common feature of the municipalities with the lowest scores is that their liquidity positions are extremely weak. Their operating revenue and expenditures are not evenly matched, resulting in relatively large operating deficits, and the quality of their infrastructure is deteriorating, caused by low spending on repairs and maintenance which could threaten long-term service delivery and sustainability. The going-concern status of these municipalities is extremely doubtful.

4. Operating performance and liquidity

The means available to a municipality that enable it to absorb financial shocks, arise through the realisation of operating surpluses and the creation of cash reserves.

The primary underlying reasons for the low scores achieved by the municipalities are visible in the operating surpluses or deficits, and liquidity surpluses or shortfalls reflected in Table 4.

Financial results 2019					
Province	Operating surpluses	Operating deficits	Liquidity surpluses	Liquidity shortfalls	Collection rate (ave)
	Rm	Rm	Rm	Rm	%
Eastern Cape	21	1 093	279	1 109	84,5
Free State		2 747		8 211	70,1
Gauteng		1 701	190	4 402	79,4
KwaZulu-Natal	203	1 710	1 233	1 069	90,9
Limpopo	22	1 590	160	1 800	82,0
Mpumalanga		2 661	755	9 196	78,7
Northern Cape		377	355	623	92,9
North West		3 284	156	3 210	63,8
Western Cape	405	406	3 723	530	94,0
Totals / Average	651	15 569	6 851	30 150	81,9

Table 4

Sound governance dictates operational profitability to be an underpin to financial sustainability. Most municipalities ignore this basic principle and the lack of proper budget planning and inadequate fiscal discipline causes these municipalities' expenses to exceed their income, resulting in operating losses. Over time these losses, coupled with low revenue collection, result in their current liabilities exceeding their current assets. The result is a working capital or liquidity shortfall that renders them commercially bankrupt. The average revenue collection rate is only 81,9%. The Western Cape municipalities' collection rate at 94% is the only province that is close to the benchmark of 95%. The low average collection rate for the rest of the provinces shows a lack of commitment from the management and political leaders to collect what is due for services delivered and rates payable on property.

Only 19 municipalities from the sample of 100 have reported operating surpluses, with the remaining 81 reporting operating deficits. The combined profits of those with a surplus amount to only R651 million whereas the combined losses amount to R15,6 billion.

Furthermore the combined working capital shortfall for the municipalities in the sample amounts to R30,2 billion, considerably larger than the R23 billion in 2018. In practical terms it means these municipalities do not have the working capital or funds available to pay their creditors within 30 days as required by the Municipal Finance Management Act (MFMA). Without working capital it becomes almost impossible for these municipalities to provide any significant services of high quality. This might lead to a total breakdown in service delivery with catastrophic consequences for residents and businesses; which in turn could encourage political unrest.

The working capital shortfalls are expected to get worse every year since the majority of the municipalities will continue to realise losses, and revenue collection is expected to remain subdued because of the slow economic growth prevailing in the country. To prevent a total collapse of these

municipalities, the only solution would be for the Government to bail them out in the amount of R30 billion. This will only bring the municipalities onto a level footing to pay their creditors as stipulated by the MFMA. Unfortunately this R30 billion burden will have to be carried by the taxpayer. This dire financial situation of the local municipal sector is prevalent even before the devastating effects of the COVID-19 pandemic.

5. Conclusion

Unfortunately, the adverse effects of the COVID-19 lockdown on the finances of the municipalities have worsened the situation dramatically. The South African Local Government Association has warned that municipalities could see a drop in revenue of up to 5%. Given that the majority of municipalities have been operating at losses, any additional erosion of their revenue will exacerbate their situation significantly, and could be disastrous in some cases. For 2019 the aggregate billings for property rates and service charges in the 100 municipality sample amounted to approximately R85 billion. If the 5% decline in revenue is sustained for a year, the combined loss of revenue to them would amount to R4,25 billion. The government has allocated additional funding of R20 billion to the municipal sector, of which R11 billion comprises an equitable share grant to cover the cost of free basic services and additional COVID-19 related costs to municipalities. This additional funding is for the municipal sector as a whole. It is clear that this additional funding for the municipalities will be hopelessly inadequate to cover the loss of revenue by the municipal sector, since the local municipalities needed R30 billion before any adverse effects of the COVID-19 catastrophe. In addition, the metropolitan municipalities might need R10 billion to cover their losses in revenue caused by the lockdown.

COVID-19 will have a prolonged effect on the finances of the municipalities even after the lockdowns have been lifted. The full effect on the financial sustainability of the municipalities will only be visible in a year or two. At the moment it is only the Western Cape municipalities that have some capacity to absorb the devastating financial effects of the corona virus pandemic.

---o0o---