FINANCIAL AND FISCAL COMMISSION

POLICY BRIEF

4/2013

Detecting Fiscal Distress within Local Government

EXECUTIVE SUMMARY

Many municipalities are exhibiting signs of fiscal distress, which not only affects the local communities, but also drains the fiscus by requiring other spheres of government to intervene. Fiscal distress refers to the sustained inability of a municipality to fund the delivery of basic services and other requirements as per their constitutional mandate. Fiscal distress develops gradually, and so an early warning system could play a critical role in preventing the occurrence or mitigating the impact of fiscal distress. A model for predicting fiscal distress was developed using fiscal distress indicators to rank municipalities. Municipalities were grouped into three categories: fiscally neutral, fiscal watch and fiscally distressed, based on short-term and long-term indicators. According to the short-term indicators, fiscally healthy municipalities decreased (from 34 per cent in 2011/12 to 24 per cent in 2012/13), and the number of municipalities in the fiscal watch and fiscally distressed categories increased. However, the long-term analysis revealed that a large percentage of municipalities are fiscally healthy, with the number of fiscal distressed municipalities remaining relatively low. Government should develop an early warning system, which would detect municipalities heading towards fiscal distress. Once the probability of fiscal stress is detected, further investigation is needed to identify the underlying root causes and frame appropriate and timely responses.

BACKGROUND

Despite sustained national government efforts to build capacity in the local government sphere, South African municipalities are failing to create and deliver public value to their communities. Many of these municipalities exhibit signs of fiscal distress, which is a key public issue that affects the economic, social and political wellbeing of individuals and communities. Fiscal distress 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. Municipalities in fiscal distress not only fail to satisfy their service delivery obligations to citizens, but also drain the fiscus by requiring other spheres of government to intervene with corrective measures, which implies foregone economic growth and development. 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 in mitigating the impact of fiscal distress. 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 Financial and Fiscal Commission (the Commission) developed fiscal distress indicators used to rank municipalities and then to construct an operational model for predicting fiscal distress in local government. The aim was not to advocate for specific fiscal distress indicators, but to illustrate the kind of indicators and approaches required for a pre-emptive early warning system.[1]

FINDINGS

Fiscal distress is a multi-dimensional concept, with financial, fiscal and socioeconomic aspects that must be captured and operationalised by the set of indicators. Therefore, the indicators were grouped into four categories and then divided into short- and long-term indicators:

- compliance indicators (to identify municipalities that do not comply with government regulations);
- fiscal performance indicators (to identify municipalities facing fiscal challenges);
- financial performance and management indicators (to isolate municipalities that are facing financial management challenges); and
- service delivery and general economic indicators (poor service delivery is likely to be associated with poor financial indicators, while economic indicators identify municipalities with decreasing economies).

The fiscal distress indicators developed were used to rank municipalities and then to construct an operational model for predicting fiscal distress in local government. Municipalities were grouped into three fiscal health categories (fiscally neutral, fiscal watch and fiscally distressed), based on short-term and long-term indicators (Tables 1 and 2).

Over the past two years, fiscally healthy municipalities decreased, from 34 per cent in 2011/12 to 24 per cent in 2012/13, while the number of municipalities in the fiscal watch and fiscally distressed categories increased.

[1] For the full study, see Ncube, M and Vacu, N. 2013. Fiscal distress in the South African local government sector, Chapter 5 in Financial and Fiscal Commission (2013). 2014/15 Submission for the Division of Revenue Technical Report, Midrand, South Africa.

Table 1: Fiscal Health Levels: Proportions - Short-term indicators

Year	2011/2012	2012/2013
Fiscally Neutral	34.0%	24.4%
Fiscal Watch	58.0%	67.3%
Fiscally Distressed	8.0%	8.3%

Source: The Commission's calculations

Table 2: Fiscal Health Levels: Proportions - Long-term indicators

Year	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2010/11
Fiscally Neutral	66.0%	59.0%	58.0%	55.0%	83.0%	77.0%	85.9%
Fiscal Watch	32.0%	35.0%	38.0%	40.0%	17.0%	22.0%	13.7%
Fiscally Distressed	2.0%	6.0%	4.0%	5.0%	0.0%	1.0%	0.4%

Source: The Commission's calculations

The long-term analysis revealed that a large percentage of municipalities across the country are fiscally healthy. The number of municipalities in fiscal distress remains relatively low. Interestingly, no municipality was in fiscal distress in 2008/09, a remarkable feat considering the global economic crisis.

CONCLUSION

The long-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, in general, the performance of municipalities across the country appears to be improving. However, increased support is required to turn around those municipalities that are fiscally distressed and to monitor closely those that may be heading towards fiscal distress. And, once the probability of fiscal stress is detected, further investigation is needed to identify the underlying root causes and frame appropriate and timely responses.

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.
- Government uses the early warning system as a tool to monitor and assist municipalities heading towards fiscal distress and those already in fiscal distress.

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