

POLICY

BRIEF

FINANCIAL AND FISCAL COMMISSION (2023)

Municipal Cost Recovery and the Affordability of Basic Services

EXECUTIVE SUMMARY

Municipal cost recovery is important for the sustainability and maintenance of services and is an important indicator of the overall financial health of municipalities. For many years before and during the onset of the COVID-19 pandemic, municipalities in South Africa have been failing to collect revenues beyond the standard 95 per cent threshold set by the National Treasury owing to several reasons, one being failure of the municipalities to recover the costs associated to providing services and this has tremendous repercussions for the municipalities. Rising municipal consumer debt levels pose a threat to the financial viability of municipalities and impact their ability to provide services in a sustainable manner. As a result of the high municipal consumer debt levels, many municipalities struggle to recover the costs of providing services. Without recovering the costs of providing services, municipalities may not have the funds necessary to maintain and invest in new infrastructure for future service provision.

An array of literature provides many reasons that lead to the failure of municipalities to recover costs from providing services. In one instance a significant reason a municipality may have challenges in achieving cost recovery is due to widespread non-payment. Various reasons explain the issue of non-payment, including the unaffordability of services or the inability of customers to pay for services. On another instance, if tariff levels are too high, this negatively impacts the affordability of services, which in turn adversely affects cost recovery. Thus, the link between cost recovery and affordability is important to consider.

The Commission undertook a study to assess the extent to which municipalities recover the costs of providing services and the relationship between cost recovery and the affordability of services. The results suggest that on average municipalities struggle to recover the costs of providing services. Furthermore, for water services, on average municipalities in category B2 had the highest coverage levels, while other municipal categories did not recover water services costs. In terms of sanitation, category A municipalities had the highest coverage levels followed by municipalities in categories B2 and B3, and category B1 and B4 municipalities did not recover sanitation costs. For refuse services, on average, municipalities in all four categories generated deficits and did not recover refuse costs.

Lastly, the study employed correlation analysis to assess relationship between cost recovery and the affordability of services and found that



THE FINANCIAL AND FISCAL COMMISSION

The Financial and Fiscal Commission is a body that makes recommendations and gives advice to organs of state on financial and fiscal matters. As an institution created in the Constitution of the Republic of South Africa, it is an independent juristic person subject only to the Constitution itself, the Financial and Fiscal Commission Act, 1997 (Act No. 99 of 1997) (as amended) and relevant legislative prescripts. It may perform its functions on its own initiative or at the request of an organ of state.

The vision of the Commission is to provide influential advice for equitable, efficient and sustainable intergovernmental fiscal relations between national, provincial and local spheres of government. This relates to the equitable division of government revenue among three spheres of government and to the related service delivery of public services to South Africans.

Through focused research, the Commission aims to provide proactive, expert and independent advice on promoting the intergovernmental fiscal relations system using evidence-based policy analysis to ensure the realisation of constitutional values. The Commission reports directly to both Parliament and the provincial legislatures, who hold government institutions to account. Government must respond to the Commission's recommendations and the extent to which they will be implemented at the tabling of the annual national budget in February each year.

The Commission consists of Commissioners appointed by the President: the Chairperson and Deputy Chairperson, three representatives of provinces, two representatives of organised local government and two other persons. The Commission pledges its commitment to the betterment of South Africa and South Africans in the execution of its duties.

The Impact of Municipal Spending on Local Unemployment and Development

FINANCIAL AND FISCAL COMMISSION (2023)

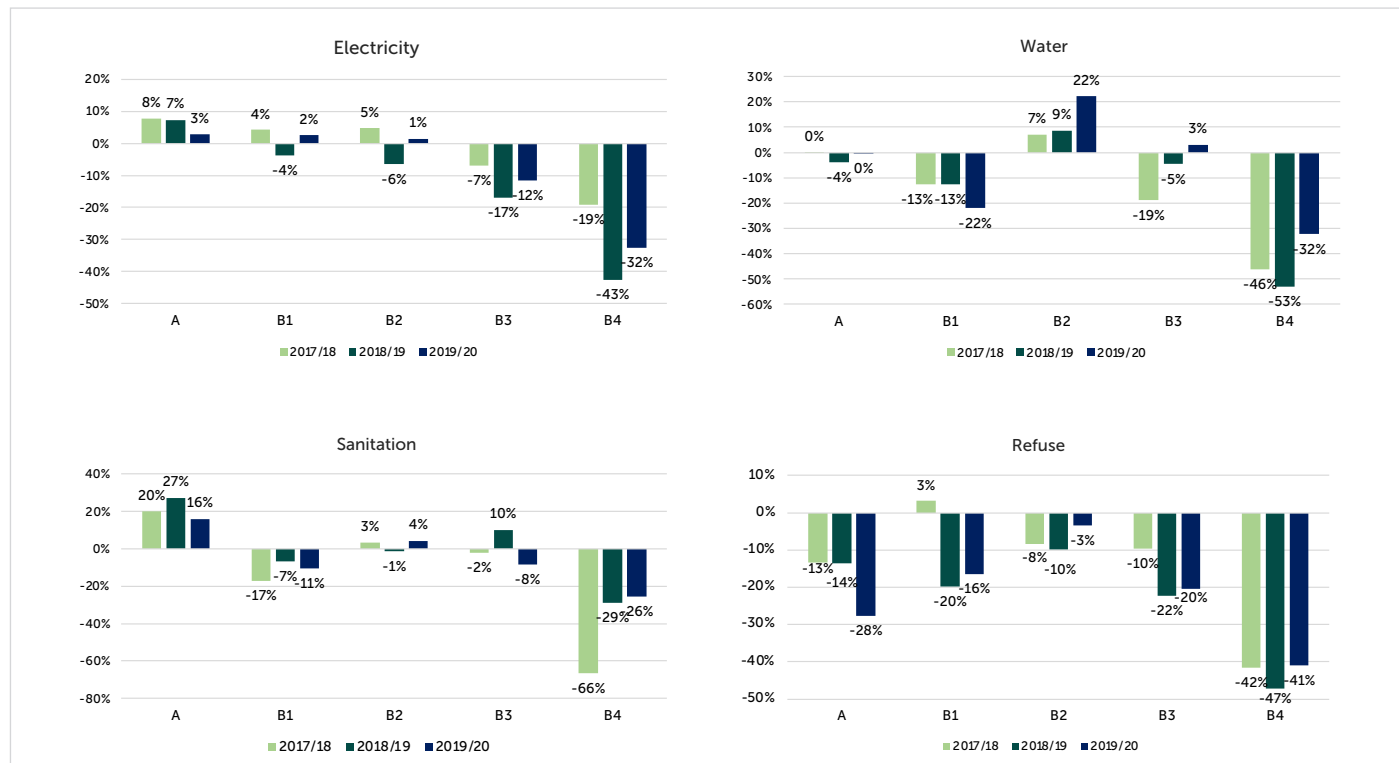
on average for electricity, water, and sanitation, municipalities that have more affordable municipal bills i.e., lower bills as a percentage of income, tend to have higher cost coverage levels., albeit a weak correlation. These results confirm that cost coverage levels are only partly explained by the ability to pay argument.

RESEARCH FINDINGS

Cost coverage

The extent to which municipalities achieve cost recovery was assessed by analysing the cost reflectiveness of each service per municipality. Cost reflectiveness is measured by calculating the cost coverage percentage of the respective service in each municipality.

Figure 1: Average cost coverage percentages for each service and municipal category



Source: Commission's calculations

The findings suggest that on average, between 2017/18 and 2019/20, category A municipalities generated surpluses and had the highest coverage levels for electricity, while municipalities in categories B3 and B4 did not recover electricity costs. Electricity coverage levels are likely to be impacted by heightened loadshedding, as consumers shift to alternative energy sources, and the Eskom tariff increases approved by NERSA.

For water services, on average, category B2 municipalities had the highest coverage levels, while other municipal categories did not recover water services costs. In terms of sanitation, category A municipalities had the highest coverage levels, while other categories generally did not recover sanitation costs.

Lastly, for refuse services, on average, municipalities in all four categories generated deficits and did not recover refuse costs. The low coverage levels for refuse services could be due to cross-subsidisation between trading services, where municipalities generate surpluses on some services while accepting deficits on others. It could also be due to the introduction of new legislation that led to increased costs for refuse services. The low coverage levels across services in 2019/20 can be explained by the decrease in revenue collection in the last quarter of 2019/20 due to the COVID-19 pandemic (National Treasury, 2020)¹.

Overall, the low coverage levels for electricity, water, and sanitation are concerning given that historically municipalities, particularly larger municipalities, have typically generated surpluses on these services which enabled them to cross-subsidise some of their

¹National Treasury. (2020). The State of Local Government Finances and Financial Management. eThekweni. (2017/18). Annual report

Municipal Cost Recovery and the Affordability of Basic Services

FINANCIAL AND FISCAL COMMISSION (2023)

services. This is also concerning as the analysis did not include the secondary costs associated with these services, such as governance and administration costs.

The variance in cost coverage levels across municipal categories can be explained by their difference in revenue raising capabilities. The low average coverage levels, particularly for municipalities in category B3 and B4, can be explained by their adverse socioeconomic characteristics. These municipalities often have a larger share of their population living in poverty (Oosthuizen & Thornhill, 2017)². As a result, these municipalities are heavily reliant on transfers to provide services as they have lower tax bases compared to larger municipalities. Nonetheless, the low coverage levels can also be explained by widespread non-payment, internal municipal inefficiencies such as incorrect or poor billing systems, and failure to implement and enforce credit control and debt collection policies.

CORRELATION RESULTS

Cost coverage and affordability

The relationship between cost coverage and affordability was assessed using correlation analysis. The Table 1 below shows the correlation results per service for two types of bills: the affordable range, and bills for indigent households. For the affordable range, median incomes were used to assess affordability. Affordability is calculated by dividing the municipal bill for each service against median household income per municipality. For indigent households, affordability is calculated by dividing the indigent bill for each service by the National Treasury threshold of a combined income of less than two old age grants. Note that in practice, municipalities have discretion in determining the income threshold for households qualifying as indigent.

Table 1: Correlation between cost coverage and affordability

	2017/18	2018/19	2019/20
Affordable range bill per service			
Electricity	- 0.27 **	- 0.25 **	- 0.11
Water	- 0.02	- 0.25 *	- 0.05
Sanitation	- 0.07	- 0.02	- 0.13
Refuse	0.07	0.05	0.21
Indigent bill per service			
Electricity	- 0.07	- 0.21 *	- 0.23
Water	- 0.08	- 0.20	- 0.30 *
Sanitation	0.06	- 0.06	- 0.22
Refuse	- 0.02	- 0.07	- 0.13

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Source: Commission's calculations

Most of the correlation coefficients are negative suggesting that on average municipalities with more affordable municipal household bills i.e., lower bills as a percentage of income, tend to have higher cost coverage levels, particularly for electricity, water, and sanitation services. This supports the argument that if tariff levels are too high, customers will not be able to afford services which adversely impacts cost recovery (Marah, Martin, Alence, & Boberg, 2003)³. However, it is important to note that the strength of the relationship between cost coverage and affordability across services is generally weak. This could be due to the quality of the data or sample size, but it also suggests that other factors play a greater role in explaining cost recovery outcomes.

CONCLUSION

Overall, the results suggest that on average municipalities struggle to recover the costs of providing services. The strength of the relationship between cost coverage and affordability across services is generally weak. These results confirm that cost coverage levels are only partly explained by the ability to pay argument.

²Oosthuizen, M., & Thornhill, C. (2017). The grant system of financing the South African local government sphere: Can sustainable local government be promoted? University of Pretoria.

³Marah, L., Martin, R. J., Alence, R., Boberg & D. (2003). Identifying Examples of Successful Cost Recovery Approaches in Low Income, Urban and Peri-Urban Areas. Water Research Commission.

Municipal Cost Recovery and the Affordability of Basic Services

FINANCIAL AND FISCAL COMMISSION (2023)

Literature notes that there are various reasons that explain the issue of non-payment, that affects a municipality's ability to recover the costs of providing services. Non-payment is heavily influenced by the culture of non-payment or entitlement, dissatisfaction with service provision, the absence of awareness campaigns to educate households about the importance of paying for municipal services, the perception that municipal workers are corrupt and mismanage municipal finances, poor governance and maladministration of municipal workers, and the lack of collaboration between councillors and municipal workers resulting in councillors' not engaging residents about the importance of paying for services (Fjeldstad, 2004; Van Schalkwyk, 2012; Worku, 2018; Enwereji & Uwizeyimana, 2020; Enwereji, 2019)⁴.

Furthermore, non-payment may also be influenced by trust relations between municipalities and society, specifically trust that municipalities will use revenues for the provision of services, trust that the distribution of services and procedures for revenue enforcement will be fairly and reasonably established, and trust that other citizens pay their share for services (Fjeldstad, 2004).

RECOMMENDATIONS

The Commission makes the following recommendations:

1. *The Commission recommends that National Treasury, in consultation with the South African Local Government Association (SALGA), Cooperative Governance and Traditional Affairs (CoGTA), and provincial governments should urge local municipalities to apply effective revenue enforcement and credit control mechanisms and improve billing and accounting systems to increase payment and cost coverage levels. Officials responsible for managing municipal finances should possess the competencies and skills required to perform their roles. In addition, municipalities should apply the prescripts of various legislation such as the Municipal Systems Act, Municipal Property Rates Act, Municipal Structures Act, Municipal Finance Management Act, and other municipal service provision by-laws to enforce payment from residents.*
2. *The Commission reiterates its previous recommendation that CoGTA, in consultation with SALGA, should ensure that the credit control systems of Eskom and municipalities are aligned by means of a MOU, and that Eskom should assist municipalities with credit control via electricity disconnections within areas supplied by Eskom.*
3. *The Commission recommends that CoGTA should engage SALGA about incorporating innovative approaches in the "Asisho! Let's Say it" campaign to increase awareness about the importance of paying for municipal services. In addition to using television to disseminate the message, other forms of media such as national and community radio stations, billboards, sending prompts via WhatsApp, SMS, and email, and inserts in newspapers should be used to reach a wider audience.*
4. *The Commission recommends that National Treasury should urge municipalities to assess the affordability of the total municipal bill as part of the municipal tariff setting process. This can be done using the tariff setting tool developed by National Treasury, that includes a component for testing the affordability of tariffs to customers.*

ENQUIRIES:

Khutso Makua

khutso.makua@ffc.co.za

Neo Malungane

neo.malungane@ffc.co.za

Financial and Fiscal Commission
11th Floor, 33 on Heerengracht
Heerengracht Street, Foreshore, Cape Town

www.ffc.co.za

⁴Fjeldstad, O. H. (2004). What's trust got to do with it? Non-payment of service charges in local authorities in South Africa. *Journal of Modern African Studies*, 539-562.
Van Schalkwyk, A. (2012). A Case Study of Non-Payment for Municipal Services In the Vhembe District Municipality. *Mediterranean Journal of Social Sciences*.
Worku, Z. (2018). Factors That Affect Nonpayment of Municipal Services in Madibeng, Mamelodi and Soshanguve Townships of South Africa. *The Journal of Applied Business Research*.
Enwereji, P. C., & Uwizeyimana, D. (2020). Municipal Consumer Debt in South African Municipalities: Contexts, Causes, and Realities. *Research in World Economy*.
Enwereji, P. C. (2019). A payment culture framework for municipal services in the North West province.