POLICY BRIEF

Financial and Fiscal Commission (2021)

Municipalities and COVID-19: Impact, recovery and opportunities

Executive Summary

When the COVID-19 pandemic hit South Africa's shores in March 2020, many municipalities were already in a precarious state. The sector was struggling to fulfil its mandate. The pandemic amplified existing challenges in the local government sector. The adverse effects of the crisis on municipalities were certain. However, the relative scale and extent of the COVID-19 impact are not understood. The purpose of this policy brief is to summarise the findings of the Commission's research on the impact of the pandemic on the local government sector and provide recommendations on how municipalities can recover from the crisis.

Background

The COVID-19 pandemic exposed many gaps and inadequacies in the Local Government Fiscal Framework (LGFF). At the onset of the pandemic, many municipalities were unable to fulfil their constitutional mandates. The sector was facing many challenges, which included poor quality basic services and weak institutional and governance capabilities. A third of municipalities were dysfunctional, and 63% of the 257 municipalities were in financial distress. These challenges manifested, among others, in poor audit outcomes, poor asset care and generally weak service delivery. The pandemic could only have exacerbated these challenges. The negative impact of the crisis on municipal economies is certain, but the relative scale and extent of this impact are less well understood. Considering that local government is a non-homogeneous sector, an understanding of the differential impact of the pandemic is critical when mapping the recovery process. Having the right empirical evidence base on the impact of the pandemic on municipalities is crucial for designing and implementing recovery strategies. The Financial and Fiscal Commission undertook a comprehensive and systematic analysis of the impact of the pandemic on the local government sector and further provided recommendations on how the sector can recover from the crisis.

FINANCIAL AND FISCAL COMMISSION

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 study adopted a three-pronged approach: an econometric analysis, a budget analysis and a local government practitioners' survey. This policy brief provides a summary of the Commission's findings and policy recommendations.

Research findings

1. Expenditure

As of December 2020, the local government sector had spent close to R25 billion on COVID-19-related expenses. These expenses reached their peak in September 2020 before easing down to R2 billion in December. As expected, the eight metros accounted for the most significant portion of the COVID-19-related expenditure. The metros accounted for 64% of COVID-19 spending between March and December 2020. This is not surprising, considering that the metros account for 40% of South Africa's population. Overall, the pandemic forced the sector to delay or defer its operational expenditures. However, the shock to operational expenditures was short-lived (it only lasted one quarter). This is not surprising, considering that operating expenditure is dominated by salaries, which are much less flexible, even in the face of a debilitating shock. Capital expenditures followed a slightly different trajectory to operational expenditures. As capital expenditures are relatively more flexible, they were at a higher risk of being deferred than operational expenditure.[1] Thus, municipalities freed up cash by deferring capital expenditure to mitigate the adverse effects of COVID-19. In the long run, this situation will contribute to the widening of the infrastructure financing gap in the local sphere, with negative consequences on service delivery.

2. Own revenue

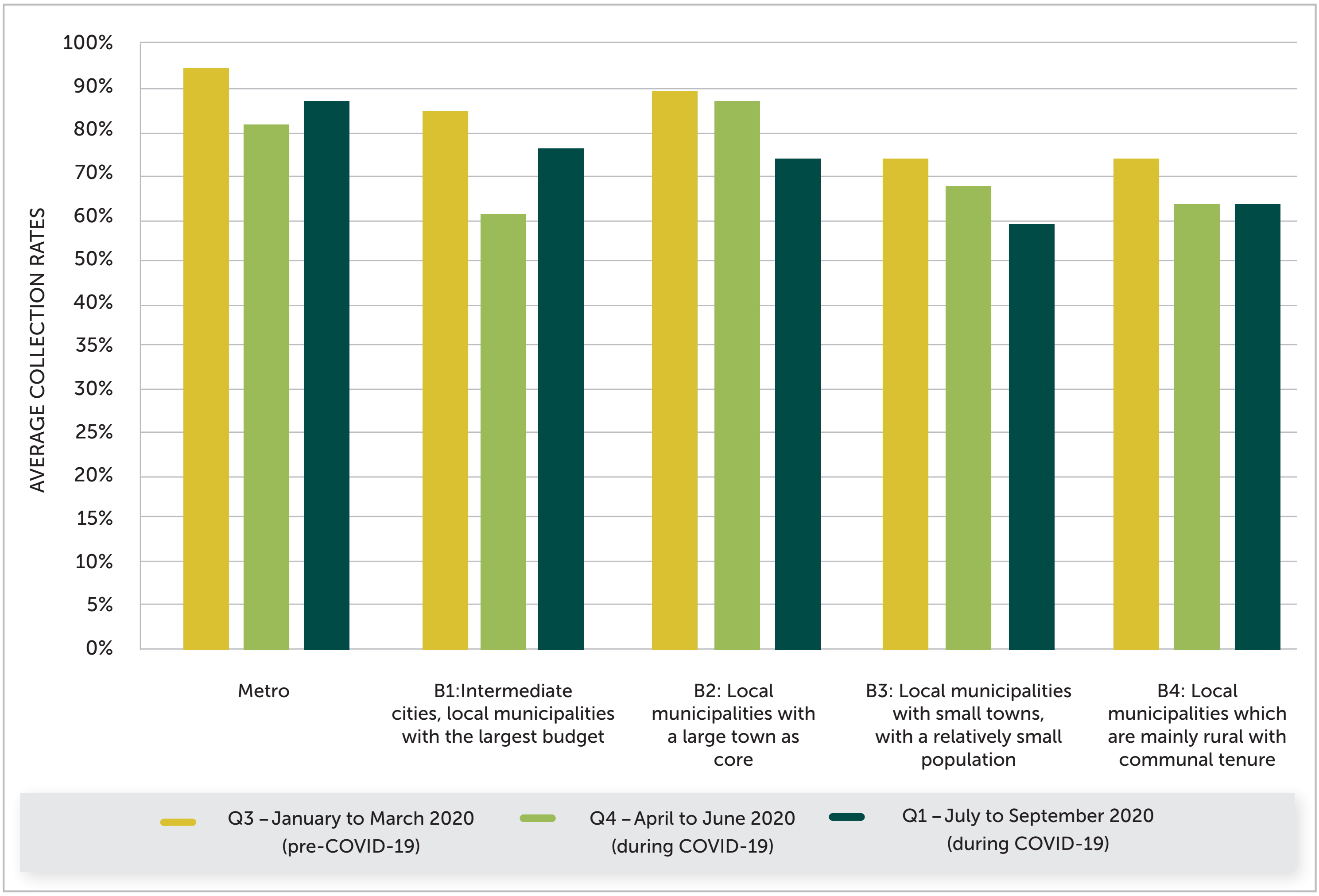
The Commission's analysis revealed that all municipal categories faced revenue collection challenges. It should be noted that, even before the pandemic, many municipalities faced serious revenue collection challenges. The pandemic intensified the problem. Metros and intermediate cities were the hardest hit. The two municipal categories rely disproportionately on own revenues relative to transfers. Intermediate cities that were collecting 88% of their own revenues before COVID-19 (i.e. below the 95% norm) only collected 71% during the first three months of the pandemic. What is interesting from Figure 1 is that the metros and intermediate cities had rebounded during the July–September COVID-19 period, while the B2, B3 and B4 municipalities,[2] continued on a downward spiral. The quick rebound of the metros and intermediate cities suggests some financial resilience, which they owe to a diversified revenue base and better collection rates before the pandemic.

The collection rates were also analysed by municipal category and revenue source. Revenues from service charges were hardest hit, primarily due to social distancing regulations and many municipalities' relaxation of credit control policies. Electricity revenues were moderately affected, mainly because of the inelastic demand for electricity. Surprisingly, property rates were the least affected revenue source for all municipal categories. However, it is essential to note that property rates continue to be at risk, especially under a cloud of a possible third wave of infections.

1 However, it is not clear if deferred capital expenditure was used for operational expenses.

2 Municipal categories are as follows: A: Metropolitan municipality (metro); B1: Intermediate cities, local municipalities with the largest budgets; B2: Local municipalities with a large town as core; B3: Local municipalities with small towns, with a relatively small population; B4: Local municipalities that are mainly rural with communal tenure; C1: District municipalities that are non-water services authorities; C2: District municipalities that are water services authorities.

Figure 1: Own revenue average collection rates



Source: Commission's calculations based on National Treasury's local government database

3. Municipal and consumer debt

More often, a shock, such as a pandemic, cuts the flow of finances from consumers, causing municipalities to default on their payments to their creditors. In other words, consumer debt can lead to municipal indebtedness. Virtually all municipalities experienced an increase in consumer debt, which created a significant shortfall on their accounts. This resulted in many municipalities failing to service their debt to Eskom, the water boards and other creditors. For example, the number of municipalities owing Eskom more than 40% of their operating expenditure increased from 34 during the pre-COVID-19 period to 50 during the COVID-19 period. Similarly, the number of municipalities owing the water boards more than 40% of their operating expenditure increased from 14 during the pre-COVID-19 period to 19 during the COVID-19 period. As noted above, the main driver for the increase in the number of municipalities defaulting on their Eskom and water boards' debt was an increase in consumer debt.

Beyond COVID-19: Some recovery strategies

The preceding summary indicates the devastating effect of the pandemic across the entire spectrum of municipal finances. In many ways, the COVID-19 pandemic has shown the necessity for municipalities to move from the status quo and challenge the traditional way of doing things. The above analysis reveals the need for municipalities to reflect on rebuilding and stimulating their economies and creating investment opportunities. Municipalities should attract investments by prioritising options that come with little or no price tags, such as changing regulations that hinder economic activity.

For example, they should reduce timeframes for getting permits or licences and reduce the compliance burden of their regulations. They should streamline small business registration and approval processes and explore the possibilities of "one-stop shop" initiatives. They should also strive for efficient digitalisation methods of interacting with the business and urban communities in general. Municipalities should also explore revenue-enhancement strategies, such as selling redundant assets and creating new revenue-generating infrastructure. As the pandemic has heightened the lack of financial resilience for many municipalities, local authorities must improve their financial resilience by embracing e-government and diversifying their revenue mix.

Conclusion

The pandemic has had far-reaching negative consequences on people's lives and livelihoods. Municipalities, being the closest sphere of government to the people, have experienced the devastating effects of the pandemic first-hand. The Commission's research has demonstrated the adverse impact of the crisis on municipal finances. However, the Commission notes that, for every crisis, there are opportunities. The pandemic has introduced some opportunities that municipalities should take advantage of. The pandemic has had some positive legacies that have transformed the way municipalities do business and deliver services. For example, the remote working experiment and new technologies have proven to be efficient, effective and therefore worth sustaining.

The Commission makes the following recommendations:

1. Municipalities should undertake a detailed and unbiased analysis of the services they provide to align their responsibilities, services and programmes to their financial capabilities. National and provincial treasuries, the Department of Cooperative Governance and Traditional Affairs (CoGTA) and the South African Local Government Association (SALGA) should ensure that municipal organograms, staffing levels and the compensation of employee budgets are set at levels that do not crowd out service delivery expenditures. In addition, these role players should ensure that municipal budgets are credible and based on realistic revenue collection rates. National and provincial treasuries, CoGTA and SALGA should support and monitor progress in this regard.
2. Municipalities should stimulate local economic growth by creating investment-friendly conditions and streamlining regulations that impede investments within their jurisdictions.
3. Municipalities should consider additional revenue-enhancing strategies, such as the selling of redundant assets and creating new revenue-generating infrastructure.
4. National Treasury, through the Municipal Systems Improvement Grant (MSIG), should support municipalities to embrace e-government (digitalisation) and diversify their revenue mix as part of building the financial resilience of local government.

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