FINANCIAL AND FISCAL COMMISSION

Policy Brief 3

Better municipal debt management

31 March 2020

Executive summary

Prudent debt management is a critical factor in ensuring that local government is able to fulfil its developmental mandate, given its central role in the delivery of basic services. Addressing the current dilemma around municipal debt is critical if the public finances and ultimately service delivery performance of municipalities are to be renewed. The Financial and Fiscal Commission (the Commission) looked at how municipalities can enhance revenue management by focussing on better debt management. The focus was on how municipalities can strengthen debt management through investigating how to alleviate the challenges of consumer non-payment and defaulting on payments by municipalities.

Background

The global financial crisis of 2008 and the recession that followed has had a significant impact on South Africa's economic performance. Economic growth has remained relatively subdued, with under 2 per cent growth rate being projected for 2018 and 2019, which falls short of the targets envisaged in the National Development Plan (NDP) (National Planning Commission, 2011). At the local government (LG)level, the financial crisis has served to reinforce the financial health issues in municipalities, as it has had a direct impact on their sources of revenue. For example, the cost of bulk electricity supply increased significantly, which resulted in businesses reducing their electricity consumption because electricity prices were too high (Steytler and Powell, 2010). The increase in electricity prices also resulted in households being unable to pay their electricity accounts, especially because many households experienced a decline in their income owing to the increases in unemployment (Steytler and Powell, 2010; FFC, 2015). The reduction in electricity consumption by businesses and consumer non-payment has resulted in municipalities having cash flow problems that also affect their ability to meet their own debt obligations and deliver basic services in line with their constitutional mandate.

A high debt burden, both in terms of consumer debt and what municipalities owe to creditors is cause for concern. Growth in consumer debt contributes to municipalities not being able to maintain positive cash flows to pay their creditors timeously (National Treasury, 2017). Such cash flow problems redirect funding away from core service delivery areas that benefit the poor, thus ultimately impacting the ability of municipalities to fulfil their constitutionally mandated responsibilities (FFC, 2011). Non-payment of municipal creditors can have consequences for the achievement of broader developmental goals. The potential for this is illustrated by the existing high levels of outstanding payment by municipalities to Eskom. Should Eskom make good on threats to interrupt the power supply of municipalities, businesses would be adversely affected, which in turn impacts negatively on job creation and broader economic development. Furthermore, non-payment of municipal debt can result in state-owned entities (SOEs) incurring ratings downgrades. To this end, municipalities with precariously high debt profiles, both in terms of what they are owed and what they owe, pose a significant risk to fiscal sustainability. It is against this background that this study investigates how municipalities can enhance revenue management by focussing on better debt management. The paper focuses on how municipalities can strengthen debt management through investigating what can be done to alleviate the challenges of consumer non-payment and defaulting on payments by municipalities.

Research findings

Non-payment of municipal creditors

The ability of municipalities to pay their creditors has remained poor over the period 2011/12 to 2017/18. This is reflected by the positive real annual average growth rates for municipal debt across the various municipal categories as shown in **Table 1**. For the period under review, the real annual average growth rate for secondary cities (22.9 per cent), large towns (30.1 per cent) and small towns (39.0 per cent) municipalities is above 20 per cent. For metros (3.3 per cent) and rural municipalities (19.9 per cent), growth has been positive but below 20 per cent.

Table 1: Real year-on-year growth in outstanding debt per municipal category, 2011/12-2017/18

Real year-on-year growth	2011/12-2012/13	2012/13-2013/14	2013/14-2014/15	2014/15-2015/16	2015/16-2016/17	2016/17-2017/18	Real annual average growth rate, 2011/12-2017/18
Metros(A)	-13.9%	7.8%	14.7%	10.4%	12.2%	-11.4%	3.3%
Secondary cities (B1)	20.4%	13.2%	12.2%	59.1%	13.9%	18.4%	22.9%
Large towns (B2)	45.4%	8.7%	42.1%	27.9%	15.9%	40.7%	30.1%
Small towns (B3)	34.3%	38.6%	46.3%	53.3%	24.4%	37.3%	39.0%
Rural municipalities (B4)	-18.7%	111.8%	41.0%	5.5%	-40.8%	21.0%	19.9%
National	-3.9%	13.6%	20.1%	25.4%	13.2%	7.8%	12.7%

Source: Commission calculations using National Treasury municipal finance database (2011-2017)

The proportion of debt to operating expenditure has also been growing steadily. With the exception of metros and rural municipalities, which experienced a decline between 2016/17 and 2018/19, there is a rising trend across all the other municipal categories. Notably, in 2018/19 the outstanding municipal debt as a proportion of operating expenditure for small towns (39 per cent) and secondary cities (23 per cent) is relatively high, which means that the rising costs associated with servicing debt in these municipalities may threaten the sustainability of the operating budget.

In terms of the total debt of municipalities, it appears that in 2017/18, bulk electricity (38.7 per cent) accounted for the largest proportion of the debt owed by municipalities. The second largest driver of the debt owed by municipalities is trade creditors (25.9 per cent) followed by bulk water (15.1 per cent). As Table 2 shows, a similar trend can be observed across the various municipal categories, where the total outstanding municipal debt is largely driven by bulk electricity, trade creditors and bulk water.

Table 2: Creditors as a share of total debt owed by municipalities (disaggregated by municipal category), 2017/18

Creditor	Metro (A)	Secondary cities (B1)	Large towns (B2)	Small towns (B3)	Rural (B4)
Auditor-General of South Africa	0.01%	0.09%	0.72%	2.47%	0.24%
Bulk electricity	23.66%	45.36%	35.83%	61.61%	11.02%
Bulk water	6.63%	28.90%	23.77%	12.93%	33.03%
Loan repayments	7.00%	0.84%	0.24%	0.20%	0.00%
Other	22.62%	3.84%	14.95%	9.43%	6.90%
PAYE deductions	1.33%	0.35%	0.79%	1.10%	1.39%
Pensions/retirement deductions	1.42%	0.36%	0.35%	1.48%	0.97%
Trade creditors	37.82%	20.14%	20.88%	10.57%	46.45%
VAT (output less input)	-0.49%	0.12%	2.47%	0.22%	0.00%

Source: Commission calculations using National Treasury municipal finance database, 2017

An analysis of non-payment of statutory duties (to South African Revenue Services (SARS)) and the three largest municipal creditors (Eskom, water boards and trade creditors) over the period 2011/12 and 2017/18 reveals that local municipalities face a significant challenge when it comes to meeting their debt obligations. For example, the total outstanding debt owed to Eskom has been on the rise, particularly between 2013/14 and 2017/18 where a sharp increase can be observed. Similarly, total outstanding debt owed to water boards and trade creditors has also been increasing over the period observed. By contrast, municipal debt owed to SARS has experienced a steady decline between 2013/14 and 2017/18.

Non-payment by municipal debtors

The analysis reveals that municipal consumer debt has been increasing for the period 2011/12 to 2017/18, particularly for rural municipalities. As shown in **Table 3**, the real annual average growth rates for municipal consumer debt for the period 2011/12 to 217/18 is declining for metros (-14.4 per cent) and secondary cities (-0.5 per cent), and there has been an increase for large towns (24.7 per cent), small towns (43.1 per cent) and rural municipalities (127 per cent). Table 4, which shows the real municipal consumer debt as a percentage of real operating revenue, confirms the severity of municipal consumer debt. Apart from metros and secondary cities, between 2013/14 and 2018/19 the proportion of real municipal consumer debt to real operating revenue has increased significantly for secondary cities, large towns, small towns and rural municipalities. This suggests that municipalities that fall within these municipal categories should be monitored closely to ensure that municipal consumer debt does not further erode the financial health of these municipalities, particularly rural municipalities which experience a higher proportion of consumer debt relative to operating revenue.

Table 3: Real year-on-year growth in municipal consumer debt per municipal category, 2011/12-2017/18

Real-year-on-year growth	2011/12-2012/13	2012/13-2013/4	2013/14-2014/15	2014/15-2015/16	2015/16-2016/17	2016/17-2017/18	Real annual average growth rate, 2011/12-2017/18
Metros(A)	13,0%	-0,7%	3,0%	5,3%	-9,2%	-97,8%	-14,4%
Secondary cities (B1)	15,4%	10,7%	0,4%	16,4%	7,1%	-52,4%	0,5%
Large towns (B2)	13,6%	3,9%	0,0%	-2,7%	19,4%	113,9%	24,7%
Small towns (B3)	18,0%	4,8%	10,2%	7,5%	14,6%	203,4%	43,1%
Rural municipalities (B4)	5,3%	50,8%	1,9%	-2,6%	8,0%	698,9%	127,0%
National	13,7%	4,1%	2,9%	6,7%	0,5%	9,0%	6,0%

Source: Commission calculations using National Treasury municipal finance database (2011-2017)

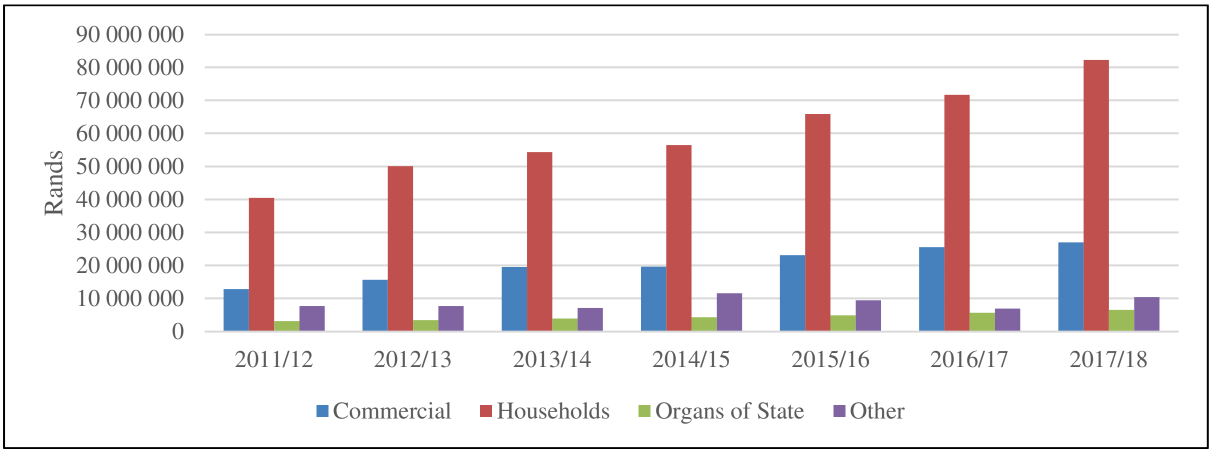
Table 4: Real outstanding municipal debt as a percentage of real operating expenditure, 2013/14-2018/19

Real municipal debt as a proportion of real OPEX	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Metros(A)	7.92%	8.84%	9.46%	13.22%	9.14%	9.54%
Secondary cities (B1)	9.01%	9.94%	15.00%	22.67%	19.43%	23.27%
Large towns (B2)	6.39%	8.66%	10.86%	12.71%	14.70%	16.06%
Small towns (B3)	9.67%	13.03%	20.41%	37.75%	35.17%	39.36%
Rural municipalities (B4)	4.84%	6.47%	5.99%	5.01%	4.27%	3.27%
National	7.44%	8.65%	10.48%	14.96%	12.48%	13.62%

Source: Commission calculations using National Treasury municipal finance database (2013-2018)

Figure 1 illustrates municipal consumer debt by consumer group for the period 2011/12 to 2017/18. It is evident that households account for the bulk of the amount owed to municipalities, followed by businesses. While the organs of states are not responsible for the largest share of municipal consumer debt, it should be noted that non-payment by this consumer group has been growing steadily over the period reviewed. In addition, while provincial government departments make up the bulk of the debt owed by organs of state, between 2013/14 and 2017/18 they have experienced the lowest real growth in debt (6.3 per cent). By contrast, other public institutions (30.1 per cent) and national government (28.1 per cent) have experienced significant increases over the same period. Between 2016/17 and 2017/18, other public institutions and national government departments recorded real increases of 48.3 per cent and 11.2 per cent respectively, while provincial government departments saw a decline of 14.9 per cent in the real growth of their debt. Water accounts for the largest share of municipal consumer debt, followed by property rates and electricity.

Figure 1: Disaggregation of municipal consumer debt by customer grouping, 2011/12-2017/18



Source: Commission calculations using National Treasury municipal finance database (2011-2017)

Drivers of non-payment

The are many factors driving non-payment and contributing to the inability of municipalities to meet debt obligations.

Drivers of non-payment by municipalities

The main reasons driving municipal defaults and non- or late payment of creditors are cash flow problems, disputes over invoices and instances where officials do not follow proper supply chain management (SCM) processes.

Drivers of non-payment by consumers

With respect to households, owing to high unemployment levels, the inability to pay is the main driver of non-payment. In the case of organs of state, the drivers of non-payment relate to the lack of responsibility by government departments as well as poor record management by municipalities which contributes to delayed payments by departments. In respect of businesses, the key drivers of non-payment are cash flow constrains.

Recommendations

With respect to debt management, the Commission recommends that:

(a) The Minister of CoGTA, in consultation with the Minister of Finance, and provincial governments should assist local municipalities, especially those with limited resources, to develop effective credit control systems;

(b) Municipalities should apply the usual credit control measures (including interruption of electricity and water services) to national and provincial government departments who do not honour their contractual obligations. In this regard it should be noted that a dispute about non-payment constitutes an intergovernmental dispute which may invoke the Intergovernmental Relations Framework Act provisions.

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