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Measuring municipal financial distress

What is municipal financial distress? When is a municipality in distress? How does financial distress relate to financial crisis that requires external intervention?

- The National Treasury (NT) published a report in 2018 which says that 128 of South Africa's 257 municipalities are 'financially distressed'. A municipality is in financial distress when it has poor cash flow and debt management.

- According to NT, *financial distress* is not equivalent to *financial crisis,* but could be a symptom. The distinction has important practical implications. Section 139 of the Constitution permits provinces to intervene to address financial distress but compels provinces or national government to intervene when there is a financial crisis. Financial crisis must trigger external intervention.

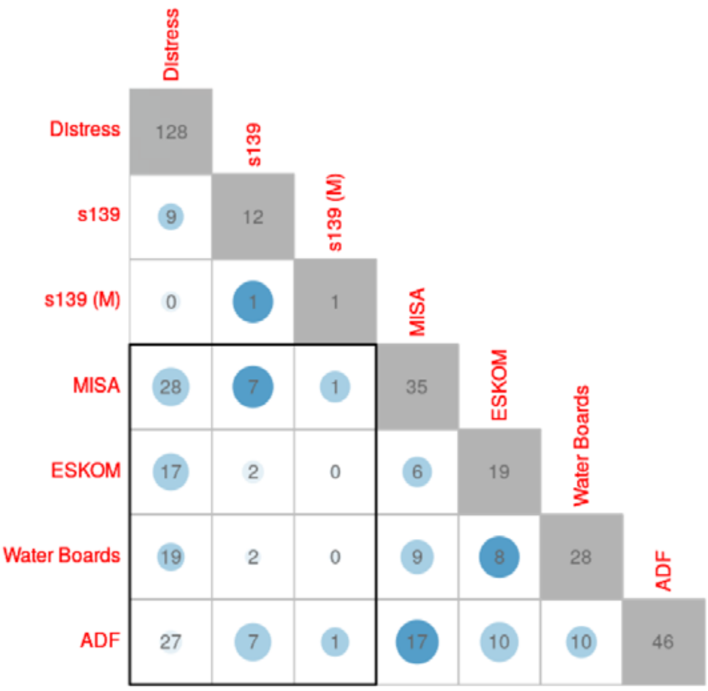

Diagram 1: *correlation between interventions*

- The diagram correlates the NT's list of municipalities in distress (128) with other lists of municipalities that arguably are in financial crisis: municipalities that are unable to spend their grant for basic infrastructure effectively (MISA); are subject to provincial intervention (s139), including mandatory intervention, due to financial crisis (s139m); are in default to Eskom or Water Boards; or persistently receive adverse audit opinions, disclaimers or fail to submit to auditing (ADF).

- In the diagram, the number appearing at the intersection of two lists is the number of municipalities that are on both. The stronger the correlation (and therefore the greater its significance), the larger the circle and darker its colour.

- There are strong correlations between municipalities in financial distress and in default to Eskom (17 of 19) and Water Boards (19 of 28) and in breach of audit rules (27 of 46). There is thus a high probability that if a municipality persistently defaults on payments to a bulk supplier and/or persistently breaches audit rules, strong grounds for mandatory intervention will exist.

- Given that high probability, the weak correlations between those problems and actual section 139 interventions (in particular mandatory) point to a 'failure to intervene' that must be explained. That deficit also suggests that the system of provincial and national supervision of local government under section 139 is not working as well as it could.

Suggested citation: DM Powell and M O'Donovan (2018) 'Measuring Municipal Financial Distress' *Public Finance Watch,* Issue 1 (November 2018)

1 National Treasury (2018) The State of Local Government Finances. Report 2016-17 (Amended) (Pretoria: National Treasury).

2 NT uses eight variables to create a composite index of financial distress: 1. Cash as a percentage of operating expenditure; 2. Persistence of negative cash balances; 3. Overspending of original operating budgets; 4. Underspending of original capital budgets; 5. Debtors as a percentage of own revenue; 6. Year-on-year growth in debtors; 7. Creditors as a percentage of cash investments; and 8. excessive reliance on government transfers. Poor performance in three or more results in a categorisation of 'distressed.'

3 See National Treasury (2018) p. 4 at note 1.

4 MISA is a unit with the Department of Cooperative Development and Traditional Affairs (CoGTA) established to provide technical support to targeted municipalities. Its purpose is to assist municipalities to improve their operations, maintenance and infrastructure planning.

5 Department of Cooperative Governance and Traditional Affairs. 'CoGTA Budget Vote Speech, 15 May 2018.' Department of Cooperative Governance and Traditional Affairs, May 2018.

6 Auditor General of SA (2018) Consolidated General Report on the Local Government Audit Outcomes: 2016-17 (Pretoria: Auditor General South Africa, May).

7 This is a graphical representation of a matrix of the correlation coefficients between variables. The coefficients are calculated using Pearson's method.