REPORT OF THE SELECT COMMITTEE ON FINANCE ON THE STATE OF LOCAL GOVERNMENT FINANCES AND FINANCIAL MANAGEMENT, DATED 12 NOVEMBER 2019.

1. Background

The Select Committee on Finance, having considered the request by the National Council of Provinces (NCOP) to consider and report on state of Local Government Finances and Financial Management as at 30 June 2018, reports as follows:

In terms of NCOP Rule 101, the Office of the Chairperson of the NCOP referred the paper tabled requesting the committee to consider and report to Parliament in terms of Rule 102 on the state of Local Government Finances and Financial Management.

The National Treasury then briefed the Committee on the Audit outcomes of 2017/18 Municipal Financial year and the outcomes of financial assessment of municipalities it conducted. The briefing included key highlights of the Section 71 4th quarter report and preliminary analysis of over and underspending as at 30 June 2018/19 and financial health of municipalities in 2018/19.

2. Summary of the presentation made by the National Treasury

2.1 Summary of the Audit outcomes for the municipal financial year 2017/18

The 2017/18 Auditor General (AG) audit outcomes revealed a reduction in the number of clean audits and that municipalities with unqualified financial statements decreased from 61 per cent to 51 per cent. About 63 municipalities regressed in their results and only 22 municipalities improved). There has been a high level of non-compliance with key legislation since 2011/12 (81 per cent). It was also revealed that there was R907 million paid to consultants to assist with preparation of financial statements and only 19 per cent of municipalities could provide financial statements without material misstatements. About 74 per cent of municipalities did not adequately follow up on allegations of financial and supply chain management for misconduct or fraud, whilst 45 per cent of municipalities did not have all the required mechanisms for reporting and investigating transgression or possible fraud. Irregular expenditure was found to be still high at R25.2 billion in 2017/18 (a slight decline from R29.7 billion in 2016/17).

The key challenges identified by the Auditor General in 2017/18 are summarized below:

2.1.1 Overall, the audit outcomes regressed

Municipal audit outcomes have shown little improvement. The deadline for submission of the annual financial statements to the AG had been met by only 90.7 per cent of municipalities. The municipalities with unqualified audit outcomes with no findings have decreased from 33 in 2016/17 to only 18 in 2017/18, while those with disclaimers increased from 24 to 26 in the same period. Overall the audits of 63 municipalities have regressed.

2.1.2 A lack of consequences for transgressions and irregularities

The AG noted with concern that recommendations made in previous years to improve audit outcomes and/or investigate irregularities were not implemented. The AG also stated that status record review and engagements with municipal managers yielded little benefit as recommendations were not implemented. Management (municipal managers and senior management), political leadership (mayors) and oversight bodies (municipal councils and portfolio committees) did not respond with the required urgency to the AG's messages about addressing risks and improving internal controls. Political infighting at council level and interference in administration weakened oversight; hindering the effecting of consequences, and making local government less attractive for professionals to join.

2.1.3 Increasingly difficult environment for auditors and other role players in accountability

The AG expressed his concern about pressure that is placed on auditors to change conclusions to avoid negative audit outcomes or the disclosure of irregularities and also intimidation and threats towards auditors were reported. Protest actions at municipalities also impacted the auditing process and resulted in delays to the finalization of audits.

2.1.4 **The impact of deteriorating accountability**

The two key areas of impact were identified, namely, the financial health of municipalities and the delivery and maintenance of municipal infrastructure.

There were vacancies and instability in key positions. There were increasing indicators of a collapse in local government finances and the inability to collect debt from municipal consumers. The results in financial woes of local government also weighed heavily on municipal creditors. Another impact was shortcomings in the development and maintenance of infrastructure, lack of attention paid to water and sanitation infrastructure while maintenance of roads also did not receive the necessary attention.

2.2 State of Local Government Finances as at 30 June 2019

About 48 per cent of municipalities had less than three months of cash coverage and this included three of the metros. Overspending of operating budgets has shown only a marginal improvement from the previous year, thus there are still 51 per cent of municipalities which overspent in 2017/18. About 25 of these municipalities (including 2 secondary cities) overspent by more than a quarter of their total adjusted budget.

Underspending of capital budgets persisted with almost 36 per cent of municipalities underspending by more than 30 per cent, whilst metros failed to spend 20.6 per cent of their capital budgets. Total outstanding consumer debtors have grown significantly over the last financial year. Total consumer debt was reported as R152.7billion in 2017/18, an increase of R44.5 billion from 2016/17. Total outstanding creditors remain concerning and the problem is particularly acute in the metros and secondary cities. About six metros and 13 secondary cities have creditors exceeding 75 per cent of available cash and investments. Water and electricity losses were still very high and consequently had a negative impact on potential revenues.

2.2.1 **Outcomes of financial assessment**

A financial assessment has revealed that overall, the audit outcomes has regressed in cash coverage ratio and cash positions have deteriorated. The assessment further revealed a significant improvement in budget assumptions, overall poor performance against the capital budget and continuous growth in debtors compared to own revenue. Also, debtors increased significantly, with slight improvement in creditors as a percentage of cash and slight improvement in reliance on national and provincial transfers.

The underspending of capital budgets in municipalities is mainly attributed to difficulties with planning and executing capital projects. It could also be associated with over ambitious capital programmes and potential cash flow problems in municipalities. The underperformance of actual collections against billed revenue can be attributed to amongst others, the affordability, economic slowdown, poorly designed revenue management, indigents, debtor policies and resistance to pay for services.

2.2.2 **Unfunded budgets**

There has been a growing phenomenon of municipalities approving unfunded budgets. About126 Municipalities adopted “unfunded budgets” for 2019/20 financial year and the number of unfunded budgets are increasing at an alarming rate. In the financial year 2016/17, about 74 of a total 257 (28.8 per cent) municipalities adopted unfunded budgets. In the next financial year, 2018/19 the number increased from 74 to 113 (44 per cent) municipalities while the number reached 126 (49 per cent) in 2019/20.

The new demarcations in 2016/17 did not assist in improving the overall funding position of municipalities. An unfunded budget position is indicative that municipalities will not have adequate resources to fund the operational expenditure and to meet all current liabilities over the Medium Term Revenue and Expenditure Framework (MTREF). Municipalities have over R35.7 billion in creditor arrears according to the s71 of the Municipal Finance Management Act (MFMA) report for the period ending 30 June 2019. Included in this amount are arrears for electricity to Eskom (over R28.8 billion (s41 – R22.2 billion)); and water to the water boards and raw water to the DHSWS (over R9.5 billion (s41 – R6.7billion)).

The analysis shows that some municipalities would take up to 22 years to repay their debts to Eskom based on the current financial situation. Losses in the VBS have undermined the ability to pay creditors and salaries.

2.3 Section 71 fourth quarter local government results

This section summarises the results of the local government finances in the fourth quarter of the financial year 2018/19 based on the Section 71 report.

2.3.1 Revenue performance

Aggregated billing amounted to 92.1 per cent or R404.7 billion of a total adopted revenue budget of R439.5 billion (total revenue excludes capital transfers).

2.3.2 Expenditure performance

Municipalities in aggregate spent 87.9 per cent or R391.8 billion of the total adopted expenditure budget of R445.7 billion.

2.3.3 Capital performance

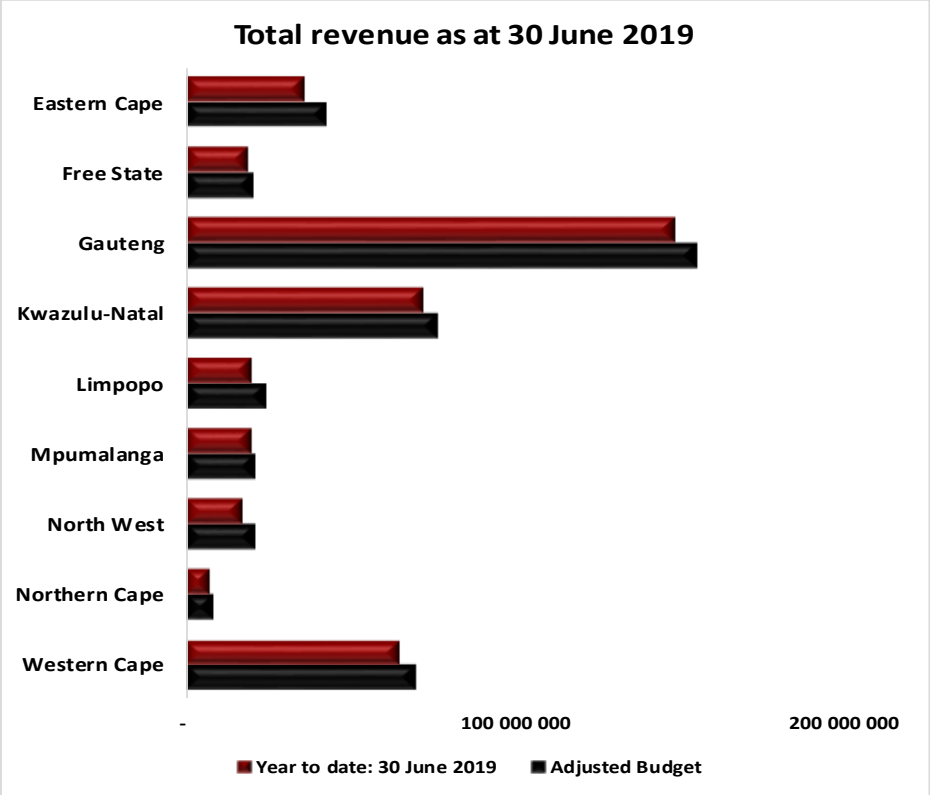
Municipalities capital budgets was R73.6 billion, which is an increase of R2.2 billion when compared to the same quarter in 2017/18 financial year. Capital spending levels for the 4th quarter was 75.3 per cent or R55.4 billion.

2.3.4 Conditional grant performance

Grant expenditure was 80.1 per cent or R27.2 billion of the R33.6 billion transferred.

2.3.5 Revenue analysis

In Metros, 60.7 per cent of total aggregated revenue in 2018/19 operational revenue collection 94.8 per cent (30 June 2019). Please rephrase, does not read right?



Source: National Treasury

2.3.6 Capital expenditure as at 30 June 2019

As at 30 June 2019, municipal capital spending average was at 75.3 per cent. The biggest capital spending was allocated to water followed by roads, transport, electricity and housing. A slight decline in the capital spending was observed when compared to the previous years. Overall, performance remained unsatisfactory. Weak multi-year budgeting, limited planning and project management skills and Supply Chain Management (SCM) inefficiencies contributed to this underperformance.

2.3.7 Over and underspending of total budget 2018/19

There was a decrease in the underspending of the capital budget from 2017/18. About 222 municipalities underspent their total budget by more than 15 per cent and 21 municipalities were on target with regard to their total adjusted budget spending whilst only 14 municipalities overspent their total budget.

2.3.8 Financial health of municipalities

In aggregate, the municipalities closed the 2018/19 financial year with positive cash balance of R50.1 billion (S71, Q4, 2018/19). This showed an improvement in cash balances and the major contributors were the metros and local municipalities. Overall, all municipal categories (metros, local and district) experienced increase in debtors. Metros was the only category that experienced a decrease in creditors and this trend indicates the increasing financial pressures as consumers are not paying for services and municipalities are not paying suppliers.

3. Committee observations and recommendations

3.1 The Committee acknowledged and appreciated the presentation made by the National Treasury, which highlighted that local government finances are in distress and that the situation is not sustainable.

3.2 The fact that about 74 per cent of municipalities did not follow up on allegations of financial misconduct and that consumer debt increased by more than 30 per cent in one year, was a major cause for concern for the Committee. The Committee recommended that National Treasury should ensure that the municipalities employ competent people to carry out their constitutional mandate and ensure that quality services are delivered to the people as budgeted for.

3.3 The Committee raised concerns about under-collection of revenue at some local municipalities and also noted that lack of consequences for poor revenue management perpetuates the problems at municipal level while lack of incentives for achieving clean audits may be causing some municipalities to decline. The Committee recommended that there should be consequences for municipalities which received disclaimers and unqualified audit outcomes to encourage them to improve. National Treasury could achieve this by implementing punitive measures through its budget approval process and its oversight role over the finances of these municipalities.

3.4 Members noted that the municipalities have not been able to attract and retain quality and competent staff and that the National Treasury could partly be responsible for that because of the regulations they put on salary caps. The Committee recommended that National Treasury reviews these regulations to avoid unintended consequences of the salary caps.

3.5 The Committee further noted that there are no incentives for competent and appropriately qualified employees working in a chaotic municipal environment and that some municipalities are continuing to approve unfunded mandates. The Committee recommended that the National Treasury should implement consequence management in cases of non-compliance with legislation in Section 139 municipalities.

3.6 The Committee noted that the decisions taken by the Demarcation Board to merge some municipalities have had unintended consequences of regression in performance of municipalities and that is a problem. the Committee recommended that the Demarcation Board needs to engage with the National Treasury as they do not seem to have adequate capacity to make these changes and mergers of municipalities.

3.7 The Committee noted that the focus of the National Treasury's report is on financial assets and health of municipalities and recommended that National Treasury should also report on the health of non-financial assets in order to understand the goodwill of these assets.

3.8 Given the findings of the status of local government report, the Committee urged National Treasury to put measures in place to hold officials and politicians accountable for financial misconduct, intervene and take appropriate actions when approving budgets while the Parliamentary Committees must utilise their oversight mandate to intervene.

Report to be considered.