Local Government Fiscal Risk –Discussion Document

The South African Context

JONATHAN CARTER AND TANIA AJAM

1. Background

Nearly a decade of prudent fiscal policy and financial management capacity has resulted in stabilisation of national and provincial government finances. Local government as a sphere, however, has undergone such fundamental restructuring that it is difficult to assess the financial status of the sphere as a whole, and that of individual municipalities it comprises. These changes include: the redemarcations of municipalities, shifting of functions to and within the local government sphere (and consequent possible unfounded mandates), the introduction of free basic services, changes in design of grants, the restructuring of the electricity, reforms to the property rate system and the introduction of the municipal finance management bill.

International experience has demonstrated that fiscal prudence at national level can be undermined by fiscal risk exposure at subnational level – particularly at local government level.

To assess this thoroughly it is necessary to construct risk profiles of the individual municipalities in South Africa. This research paper explores a methodology that could be used to construct such risk profiles. The document begins by introducing the concept of fiscal risk and comparing international experiences and approaches to managing fiscal risk. It then draws attention to factors for consideration in managing and profiling local government fiscal risks including indicators for monitoring. It concludes by considering whether current financial management and planning systems are adequate in managing local fiscal risk, and what additional capacity is required. This will be considered in the context of the initiatives that government has already proposed in the municipal finance management bill.

2. The Fiscal Risk Matrix

Fiscal risk can be defined as "a source of financial stress that could face a government in the future (Polackova Brixi and Schick, 2002)." Fiscal risks arise from obligations governments make that could require government finance and only become apparent when the institutions conducting fiscal analyses look beyond the government's budget and debt to include contingent and explicit liabilities (Polackova, 1998 The concept of contingent and explicit liabilities are defined below.

There are four categories of fiscal risks: they are either direct or indirect (contingent) and they are either implicit or explicit (Brixi and Mody, 2002). Direct liabilities are predictable obligations that will arise under any circumstances (e.g. once government has purchased goods from a supplier on credit, government is liable to pay for these goods irrespective of the state of the world). Contingent liabilities, however, are obligations triggered by a discrete but uncertain event (in other words, contingent liabilities may or may not be realised depending on whether a particular circumstance occurs or not e.g. a government guarantee may not actually result in an expenditure unless the guaranteed party defaults.. Explicit liabilities are specific government obligations defined by law or contract whereas implicit liabilities represent a moral obligation based on public expectations or political pressures. The table below presents a matrix of these categories with further examples:

Table 1: Government Fiscal Risk Matrix

	Direct **(Obligation in any event)**	**Indirect** **(Obligation if a particular event occurs)**
Explicit **(Government liability as recognised by a law or contract)**	• Sovereign debt • Expenditure composition • Expenditures legally binding in the long term	• State guarantees for non-sovereign borrowing • Umbrella state guarantees for various types of loans • Trade and exchange rate guarantees issued by the state State guarantees on private investments • State insurance schemes
Implicit **(A moral obligation of government that reflects public and interest group pressures)**	• Future public pensions • Social security schemes • Future health care financing • Future recurrent costs of public investment projects	• Default of a sub-national government or public/private entity on non-guaranteed debt/obligations • Banking failure • Cleanup of liabilities of entities being privatised • Failure of a non-guaranteed pensions fund, employment fund, or social security fund • Possibly negative net worth

		and/or default of central bank on its obligations • Environmental recovery, disaster relief, military financing

Source: Polackova (1998)

Direct explicit liabilities are legal or contractual obligations of the government that will arise irrespective of the state of the world. They are: the repayment of sovereign debt, expenditures based on budget law in the fiscal year, expenditures in the long term for legally mandated items such as civil service salaries and pensions and where applicable the entire social security system.

Direct implicit liabilities will arise irrespective of the state of the world, but the government is not legally bound to act on them. They usually arise as presumed obligations established by public expenditure policies in the medium term. An example is the completion of public investment and maintenance; the government is expected to make the full payments, but not obligated by law.

Contingent explicit liabilities are government legal obligations to make a particular payment only if a particular event occurs. The cost of contingent explicit liabilities is hidden until they are triggered and therefore represent a hidden subsidy, blur fiscal analysis and drain government finances only later. For that reason, state guarantees and financing through state-guaranteed institutions look political more attractive than budgetary support even if they are more expensive later. State guarantees are the most common form of explicit contingent liabilities and create moral hazard (moral hazard causes market participants to take greater risks as they know their commitments are covered by other spheres of government.)

Contingent implicit liabilities depend on the occurrence of a particular event and the willingness of government to act on them. These events are usually not recognised until after the event has occurred. The triggering event, the cost at risk and the required size of the government outlay are uncertain. In most countries the financial system provides the most serious contingent implicit liability. The moral expectation of government to lend financial assistance after a national disaster is another form of contingent implicit liabilities.

Traditionally, public sector organisations tended to budget for and report on mainly their direct explicit liabilities in their financial statements. Therefore these tended to be managed better than the other categories, which remained largely hidden until trigger circumstances occur which result in these potential liabilities being realised.

3. Dealing with Risk in Fiscal Analysis and Fiscal Management

Governments cannot avoid fiscal risks and should therefore try control and manage their risk exposure. The need for good risk management processes also goes beyond matters of exposure to issues such as operational and allocative efficiency. As there are always alternatives to the chosen financial commitments, it is vital that governments manage their risks in such that also maximises the return from their resources.

Internationally the capacity to do so varies greatly, but the medium term expenditure framework (MTEF)[1] used in South Africa and Australia is a good example of how fiscal performance can be predicted and makes governments accountable for their risk analysis as well as macroeconomic and demographic assumptions.

In Canada, the Netherlands and the United States the analysis of selected contingent liabilities and tax expenditures is incorporated into budgetary frameworks, requiring budget allocations and reserve funds to reflect the present value[2] of future potential outlays and foregone revenues.In other countries debt management agencies track and manage the risk of contingent liabilities, and they require the beneficiaries of government guarantees to pay the full present value of their expected fiscal cost up-front into a reserve fund (Brixi and Mody, 2002).

There are three dimensions to the analysis of government exposure to fiscal risk: the macroeconomic context, specific fiscal risks and the institutional framework (Brixi and Mody, 2002):

- The ***macroeconomic context*** relates to the country's capacity to absorb financial pressures it may realise in the future. Limits to this capacity could be caused by fixed exchange rate arrangements, and by trends, rigidity, and sensitivities of the general governments expenditure and revenues. The access a government has to reliable sources of finance would be another indicator of such capacity.
- Managing ***specific fiscal risks*** requires dealing with the sources of the fiscal risk, the types of risks government is exposed to and how sensitive the overall fiscal position of the country is to various sources and types of risk.
- The ***institutional framework*** for dealing with fiscal risks relates to the rules and practice of information disclosure, monitoring, fiscal planning and budgeting. This affects the

1 The MTEF process requires a budget to be specified for a period of three to five years. The first year of the MTEF is the approved annual budget and the rest of the framework budget figures are indicative forward budget estimates (both revenue and expenditure). If the estimates identified in the framework are correctly calculated they provide a way for managing expectations. The process also requires an assessment of spending and revenue forecasts that encourage realistic budget practices and therefore limit the likelihood of risky budget commitments.

2 A present value of a future financial commitment is the value of that commitment in today's terms taking inflation into account.

government's incentives and ability to constrain, control and manage its fiscal risks. The framework must be such that it promotes a risk-awareness culture in government and minimises the scope for fiscal opportunism.

4. Reducing government risk exposure

Risk exposure is reduced through the practice of hedging risks through debt instruments or the use of reinsurance[3]. The practice of risk management is an extremely complex process and is an industry on its own. The objective of risk management is to align the demand for funds with revenues (Brixi and Mody, 2002) and can be exercised through the use of insurance products or debt instruments. The main debt instruments used by risk managers are financial derivatives. These include futures contracts (buying or selling a commodity in the future at a set price), options (buying or selling the option to buy or sell a commodity at a certain price in the future) and swaps (the exchange of the stream of payments of two different assets).

The correct pricing of these derivatives and insurance products is an extremely complicated process as it involves estimating the future movement of prices and position of markets and economic conditions. Derivatives can be used to price almost any kind of product and require a buyer and a seller of the product. The same can be said for insurance products. This requires a market for these products. Therefore, for governments, the management of risks requires three complementary tasks:

(1) involving the private sector (mitigating the risk at the source and developing financial markets),

(2) transferring the risk to parties better able to bear the risk (creating risk sharing arrangements), and

(3) managing any residual risk that cannot be mitigated or transferred (monitoring, building reserves, and hedging) (Brixi and Mody, 2002).

Involving the private sector in risk management is the most desirable log-run strategy as it reduces both the government's exposure to fiscal risks and the vulnerability of the economy to shocks. Instead of assuming risk, government would enable markets to deal with it. By supporting the development of the markets for risk instruments, government can effectively withdraw from its direct role in dealing with many risks. Involving the private sector will only happen if an economic incentive can be provided for private participation and therefore governments must ensure the insurance and risk management they require can be parcelled in such a way that private investors can profit from selling these products to government.

3 Reinsurance is the process of sharing insurance between two firms to share the risk associated with the insurance

To deal with residual risks that cannot be mitigated or transferred the government can either build up reserves or use financial hedges. Building up reserves (contingency reserves) has political implications as the reserves could be used for other purposes and are often subject to misuse. Governments can hedge programmes by either offering bonds or creating additional programmes that will diversify government risk.

Schick (2002) identifies four approaches to managing risks:

- Firstly governments can adopt a transparent approach and be open about the types of risks it faces, the volume and possible costs of these liabilities and the probability that these commitments will come true.
- Secondly, governments can incorporate decisions on risks into the ongoing budget process, thereby enabling the government to compare direct and contingent expenditures without biasing the outcome in favour of one or another type of transaction. This approach should ensure budget neutrality.
- Thirdly government can manage risks by limiting risk before they are taken. This requires establishing criteria for determining how government should manage these risks (guarantees, contingent commitments or refusing to take on risks). This approach rests on the notion that governments should be risk averse.
- Fourthly the government can rely on market type mechanisms to shift all or a portion of the risk to private entities.

5. Budgeting for fiscal risk

Conventional budgets provide a poor measure of fiscal risk. Firstly the annual or (or in the case of medium term budget frameworks) three to five year horizon does not capture downstream risks taken by government and, secondly conventional budgets tend to only capture cash flows and do not account for the build-up of liabilities, contingent obligations or the future cost of past commitments (Schick, 2002).

An important first step in budgeting for risks is identifying the potential risks. It is not possible to control or manage these risks if they are not known and an effective way of identifying these risks is to use the fiscal risk matrix as a framework to list risks the government faces. This has been done in South Africa and highlighted a number of risks previously not recognised which was a useful step in mapping out the government's exposure and possible responses.

In compiling such an inventory it is important to get the state entities and programs to identify the agencies authorised to enter into commitments, the transactions or conditions that have been insured, the contingencies that would trigger government payments and the volume of outstanding liabilities. There are two contradicting schools of thought on how

transparent government should be in this regard. The one school of thought advocates transparency and explicitness, as this will decrease moral hazard as long as government credibly sticks to its policies. The other school of thought suggests that such explicitness actually encourages moral hazard: the government has made it very clear to those market participants who would behave inappropriately how their risky decisions will be covered by state guarantees.

The Draft Guideline for Government Financial Reporting issued by the International Federation of Accountants (IFAC) in 1998 take the position that commitments and contingencies do not meet the criteria to be included in financial statements. According to IFAC a liability should only be recorded in financial statements if the results from a settlement of a present obligation and the amounts involved can be measured reliably. Contingent liabilities do not match these criteria as they cannot be reliably measured and depend on future circumstances. Nevertheless, the IMF code of Good Practices on Fiscal Transparency requires that contingent liabilities be published in statements with the annual budget.

Measuring these liabilities is a complex process. This paper has already touched on risk measurement practices and hedging strategies. There is no reason why these techniques cannot be applied by government. Few governments, however, have the necessary experience or capacity to do so (Schick, 2002). As governments gain experience in assessing risks, the quality of their estimates is likely to improve. Risks should be estimated in terms of a range with the key assumptions and probabilities published alongside the estimates. Governments with limited capacity to estimate risks should first concentrate on the riskiest endeavours that are likely to account for the most downstream liabilities. Next they should make precise cost estimates only when warranted by experience and when the risks are pooled rather than concentrated and, lastly, they should report fiscal risks even when it is not possible to quantify costs.

There is an international trend towards publishing contingent liabilities as notes to financial statements. This has been encouraged by the following developments: a) the shift from cash based public accounting to the accrual basis; b) the growing reliance on financial statements to report on a government's financial condition; and c) the broadened role of auditors in reviewing these financial statements and assessing the governments performance.

There are four basic approaches to budgeting for fiscal risk:

- ***Present information on contingent liabilities and other financial risks in the budget.*** The information relating to fiscal risks is included in accompanying documentation to assist parliament, interested groups and the public in assessing the government's

budgetary intentions. However, these estimates would not be included in budget estimates nor would they be voted on.

- ***Devise a separate budget for contingent liabilities and risk***. A separate "contingent liabilities" budget could be drawn up and voted on. This budget would list all the commitments authorized for the fiscal year and may limit the amount of contingent liabilities outstanding and set aside cash resources for expected calls on contingent liabilities during the year. Few governments have the necessary data to compile such a budget in complete format .In cases where all the necessary data are not available, government should rely on data that are realistically available. Alternatively governments could budget for the changes in the volume of known contingent liabilities and to concentrate on those prospective losses that can be estimated rather than all such liabilities. Whichever of the above options is pursued, the initial years of doing so are likely to produce dubious results. However repeating the process on an annual basis and comparing procedures from one year to the next will no doubt quickly result in reliable figures.
- ***Integrate direct and contingent liabilities in the cash based budget***. Governments could combine payments on contingent liabilities with the conventional cash-based budget. The government sets aside resources in the budget to pay for losses during the year or over the medium term. The budget would also be used to regulate the total volume of guarantees or new guarantees to be issued during the fiscal year.
- ***Budget for the cost of contingent liabilities***. This system is used in the United States and Netherlands and shifts the budgetary basis of loans and guarantees from cash flow to subsidy cost. This cost (in the US) is defined as "the estimated long term cost to the government of a direct loan or a loan guarantee, calculated on a net present value basis, excluding administrative costs." The budget process requires the discounting of estimated costs of liabilities and balancing these against estimated cash inflows associated with the liabilities. A separate appropriation is made for projected subsidies and included as an outlay, even though the money will not likely be disbursed until later years.

6. The issue of capacity and fiscal risk

Parts of this paper have commented on the need for capacity in governments to be developed in the field of risk management and how the lack of this capacity can detrimentally affect the ability of a government to identify and correctly prepare for risks. As government's policies should reflect the interest of the public, the public should also gain an understanding of the importance of risk management and budgeting for risks. It is also vital that a country has the institutional capacity to deal appropriately with fiscal risks.

To ensure prudent fiscal policy, policymakers must be able to understand identify, classify and understand the fiscal risks facing the government. Comprehension of these risks should encourage behaviour that will avoid these risks in a politically meaningful time horizon. However beyond that time horizon coercion may be required to discipline government's fiscal behaviour. This can be applied internally and externally. Internal coercion can be applied through auditing processes assessing the fiscal risks of each government agency. External coercion would then be applied by the public in response to comments made by the auditor general. This assumes that scrutiny by the public is sophisticated enough to understand the nuances of ratios and measures used to illustrate the risk profile of fiscal policy. However, pressure from the markets in terms of credit ratings would carry greater weight. This external pressure could force government to meet certain quality standards in terms of defining, measuring and monitoring fiscal performance in full, using sound indicators and methods.

There are three main measures that can be used to encourage sound fiscal behaviour to improve the understanding of policy makers, the public, and the markets of the fiscal risks. These measures should ensure that government include in its fiscal analysis and decision-making process, its fiscal risks in the context of its risk preference, risk financing, and risk management capacities.

Firstly, fiscal policy should consider fiscal performance in full, beyond the budget and debt. Fiscal analysis has to consider the possible implications of budget decisions beyond the budget system. Guarantees, loans and various forms of government support may claim significant public resources in the future.

Secondly, fiscal policy must require that all fiscal risks are identified, classified and analysed in a single portfolio. This will ensure that policy and decision makers have stock of all possible risks caused by decisions made in various government institutions and by various government programmes.

Thirdly, fiscal policy should determine the government's optimal risk exposure and reserve policy based on its risk preference and risk management capacity. Ideally the risk strategy of a government would be based on the risk preference of its median voter. Government would then assess new programs based on their marginal impact or overall risk exposure and fiscal outlook. Expansions of programs and would only occur if government is able to evaluate, regulate, control and prevent the risks. If a government has a poor capacity to manage risks, the best approach is to favour direct subsidies and provision of services over guarantees.

In terms of the institutional framework, sound fiscal performance will only be pursued if the framework includes both direct and contingent fiscal risks. A framework for public finance management that ignores future fiscal implications of off budget liabilities makes such form

of government support look inexpensive and politically attractive. An adequate institutional framework requires that government treat any non-cash program involving a contingent fiscal risk as it does other budgetary or debt items form the viewpoint of aggregate fiscal stability and allocative and technical efficiency, control, public disclosure and accountability. There are two main measures an institutional framework can adopt in its approach to managing fiscal risk to ensure sound fiscal performance.

Firstly, institutions must internalise and disclose the full fiscal picture. All potential costs involved with contingent risks adopted by an institution should be fully disclosed to the public to ensure accountability for these decisions. This encourages institutions to ensure that their risk practices are aligned with their risk appetite and capacity to manage risks.

Secondly, institutions should monitor, regulate and disclose fiscal risks to the public and private sectors. The continual monitoring, regulating and reporting on risks taken prevents moral hazard and market failures (Polackova, 1998).

7. Monitoring and Managing Local Fiscal Risk

The paper thus far has reviewed fiscal risk from a country perspective. The following section reviews some international experiences in monitoring local fiscal risk (Ma, 2002).

7.1 United states: ACIR Indicators of Local Fiscal Health

Due to a large number of local debt defaults between 1945 and 1969, the US Advisory Commission on Intergovernmental Relations (ACIR) developed eight measures of that could act as warning signals of local financial emergencies:

- *deficits*: general fund expenditures exceeded revenues by more than 5 percent.
- *persistence of deficits*: general fund expenditures exceeded revenues for two consecutive years with the second year larger.
- *trend of deficit growth*: expenditure growth rates exceed revenue growth rates.
- *balance sheet gap*: general fund-accumulated deficits (net liabilities) as a percentage of general fund revenues.
- *liquidity*: net liquid assets (cash and liquid assets minus short term debt outstanding) as a percentage of general fund expenditures.
- *debt maturity*: existence of short term debt as of the end of the fiscal year.
- *tax compliance*: property tax collection rate.
- *unfunded pension liabilities*: (a) net amount of payments for benefit and withdrawals, shown as a percentage of receipts; (b) benefit and withdrawal payments from the local fund as a percentage of the total assets fund.

Ohio State has used these measures to apply a fiscal watch program. This program is implemented and operated by the Office of Auditor of State. A number of indicators, that measure specific states of municipal finance, have been developed around these measures and are used to trigger whether a municipality should be under a "fiscal watch". The auditor general determines whether a municipality should be put under the watch and the watch will remain in place until it is lifted or until the auditor general determines a state of fiscal emergency exists. This process provides municipalities with an early warning system and has resulted in a marked change of financial management practices that lead to the avoidance of fiscal emergencies.

According to the Fiscal Emergency Law, once a local government is declared to be in state of emergency, the state shall establish a "financial planning and supervisory commission" to assume supervisory power of the locality's fiscal management. Within 120 a financial plan is developed that contains actions to:

- eliminate all fiscal emergency conditions.
- eliminate the deficits in all deficit funds.
- restore to construction funds and other special funds moneys that were used for purposes not within the purpose of such funds.
- balance the budgets.
- avoid any fiscal emergencies in the future.
- restore the ability of the local government to market long-term general obligation bonds.

The main powers and functions of the commission include:

- review all tax, expenditure, and borrowing policies to require that they are consistent with the financial plan.
- brining civil actions to enforce the fiscal emergency law.
- ensuring that books of account, accounting systems, and financial procedures and reports are in compliance with the auditor of the state.
- assisting the municipal executives in the structuring of the terms of, and the placement or sale of, debt obligations.

7.2 Brazil: Limits on Sub-national borrowing.

In response to the Brazilian debt crises in the late 1990's the senate issued resolution 78. This tightened the central government's monitoring and control over sub-national borrowing. The main provisions of this resolution include:

- Sub-national governments are not permitted to borrow from their own enterprises or suppliers.
- Borrowing must be equal to or less than the capital budget.

- New borrowing cannot exceed 18 percent of net current revenue, debt service cannot exceed 13 percent of net current revenue, and the debt stock must be less than 200 percent of net current revenue.
- Any borrowing government must have a primary surplus; defaulters are not permitted to borrow.
- The total outstanding guarantees issues by the government must be less than 25 percent of net current revenue.
- Short-term revenue anticipation borrowing may not exceed eight percent of net current revenue.
- New bond issues other than rollover are prohibited.
- At least 5 percent of any bond issue must be retired at maturity, and any borrowing government whose debt service obligations are less than 13 percent of net current revenue must retire up to 10 percent of bonds at maturity or spend 13 percent of net current revenue, which ever is less.

This resolution was followed in September 1999 by resolution 2653 of the national monetary council. This resolution imposed a complementary set of restrictions on the supply of credit to sub-national governments in two main ways. Firstly, it authorises the central bank, in its capacity as supervisor of the domestic banking system, to control the supply of credit to sub-national governments by the central bank. Secondly, it authorises the central bank to enforce Senate Resolution 78's controls on sub-national borrowing.

As the program is administered by the central bank,, there are two concerns. First, the system relies heavily on restrictive government regulations rather than on market discipline. This creates the impression that the federal government stands behind all sub-national credit operations. Second, even under the new system the senate can ignore its own resolutions, therefore making the control mechanism susceptible to political pressures.

7.3 Colombia: the "Traffic light system"

Colombia adopted a system, administered by the Ministry of Finance that uses indicators to grade a municipality green, yellow or red. Two ratios are used. Firstly a liquidity indicator that measures the debt interest relative to operational savings and secondly the solvency indicators that measures the debt stock relative to the current revenue. These ratios are estimated and depending on the size of the ratio the municipality is either given a red, orange or green rating. If the municipality is given a green rating it may contract new credit autonomously. If the municipality is given a yellow rating and the new loan does not increase the debt stock by more than the (centrally set) inflation target the municipality may contract new debt autonomously. If the loan will increase debt stock beyond this limit then the debt authorisation of the Ministry of Finance is required with the condition that a

performance plan is signed with the lending financial institutions. If the municipality is given a red rating (critical indebtedness) authorisation is required to start credit operations, and a performance agreement with the lending financial institutions must be signed.

The following conditions applied to a performance agreement signed in the most indebted province:

- the province must contract irrevocable trust deposit with a fiduciary society, which will administer all the provincial government's funds.
- the province must contract an irrevocable trust deposit with a fiduciary society, which will administer and sell shares of the two main corporations owned by the provincial government.
- the province must have authorization from the central government to roll over or refinance its short-term loans, to increase it levels of indebtedness.

The province was also required to reduce personnel and other current expenditures by at least 5 per cent a year for 2 years. Any increase in revenue must first be used to service debt before such revenues can be used for other purposes.

7.4 Australian and New Zealand: Accounting for government contingent liabilities

Australia and New Zealand are two of very few countries that have developed a system for accounting and reporting government contingent liabilities. In Victoria, Australia, the treasurer is required to include a statement of risks in the annual and semi-annual budget reviews. This statement describes the factors that could have a significant effect on the fiscal outcome of the state, including:

- Changes in economic parameters such as the generalized system of preferences (GSP), employment, wages, prices and interest rates;
- Fiscal risks associated with the occurrence of identifiable events that affect specific revenues or expenditures but are of uncertain likelihood or timing.
- The realization of contingent liabilities arising from non-quantifiable commitments made by the government.

New Zealand's Fiscal Responsibility Act of 1994 requires the central government to include, on an annual and semi-annual basis a statement of contingent liabilities in its financial statements. Some examples of contingent liabilities included in these statements are:

- Guarantees and indemnities: government guarantees for local government or enterprise borrowing from foreign or domestic sources; claims for indemnification from private

corporations/individuals for property damage or loss of value; and a government guarantee for deposits.

- Uncalled capital: the government's uncalled capital subscriptions to international financial institutions.
- Legal proceedings and disputes: interest and principal costs that may be claimed if legal cases were decided against government agencies and state-owned enterprises.
- Other quantifiable contingent liabilities: contingent liabilities relating to fulfillment of conditions for payment by government agencies of grants and compensation; claims against the government for people's personal injuries; promissory notes issued by the government to international financial institutions; other claims against state-owned enterprises.

8. Fiscal Risk Management in South Africa

This section selects some examples of fiscal risk management in South Africa.

Section 3 of this paper discusses the three dimensions of the analysis of government exposure to fiscal risk (macroeconomic context, specific risks and institutional framework). In terms of these dimensions the macroeconomic context includes:

- full transparency of fiscal management to ensure accountability (failure to comply with reporting requirements is a criminal offence);
- a medium-term expenditure framework, which enhances transparency and predictability;
- intergovernmental fiscal arrangements involving constitutional restrictions on the ability of provincial governments to borrow and powers for the national government to intervene in the event a province incurs an unauthorised expenditure;
- a coordinating and supervisory role in borrowing by state owned enterprises (SOEs); and
- a regulatory environment for the banking and financial sector so that systemic risks do not pose a threat to planned fiscal outcomes.

The process for analysing specific risk includes:

- quantification of all financially related assets and liabilities;
- a clear distinction between contingent liabilities and actual liabilities;

In terms of the institutional framework dimension, the following processes are followed:

- strict guidelines for issuing guarantees – no guarantees to assist private institutions unless management decisions can be influenced directly; guarantees may be provided where there is an obligation in terms of international treaties, or where foreign loans are considered to be in the national interest;

- guarantee fees to act as a disincentive to use guarantees and to create a level playing field where SOEs are competing with the private sector;
- a Public Finance Management Act that establishes full accountability, clear reporting responsibilities, and the use of accrual accounting principles, including the production of a consolidated balance sheet; and
- management of implicit fiscal risks through classifying SOEs on the basis of the tolerable risk appetite per institutional type(Kruger 1999, in Petrie 2002).

In addition to the above, Project Viability contributes to fiscal risk management in the micro and the institutional dimensions.

The South African Policy Approach is tabled below:

Table 2: South African Fiscal Risk Policy Approach

Type of risks	Policy Approach
Explicit Direct Risks	
Sovereign borrowing	Identify risk and formulate risk-averse strategy
Medical schemes	Adjust policy in budget
Civil pensions	Adjust policy in budget
Explicit contingent risks	
Loan guarantees	Phase out guarantees
	Revise authority to borrow and issue guarantees.
	Cap borrowing authorities and approve and coordinate borrowing strategies
Guarantees on private investment	Share risks (contracts)
	Establish joint project limits
	Establish country limits
	Cap limits per institution
State insurance schemes	Cap government risk exposure
	Share risks (also offshore)
Implicit direct risks	
Socio-economic expenditure	Analyse policies
	Establish medium-term expenditure framework also to reflect contingent liabilities.
	Better reflect cost in annual budget
Recurrent expenditure of public investment	Incorporate in fiscal planning and budgeting
	Introduce “corporate governance” in projects.
Implicit contingent risks	
Default of sub-nationals	Monitor and introduce ex ante warning signals
Systemic risks	Monitor
Liabilities and risk of policy failure from privatisation/commercialisation	Consider fiscal risks when restructuring Monitor

Disaster relief/unavoidable expenditure	Build contingency reserves
	Establish contingent credit lines and purchase reinsurance
Monetary/exchange management	Rethink interest rate and exchange rate policy to contain government risk exposure
	Monitor central bank reserve management, derivative use and risk exposure.

Source: Schick, 2002.

8.1 Fiscal Risk Management at the South African local government level

At time of writing the Municipal Finance Management Bill (MFMB) was being debated in Parliament and a final version of that bill is not yet available. When enacted this legislation will govern municipal financial management in South Africa. At present the Local Government Transition Act (Act 209 of 1993, The LGTA) performs that role. The other legislation currently in place regarding municipal governance is the Local Government Municipal Structures Act (Act 117 of 1998, the Structures Act) and the Local Government Municipal Systems Act (Act 32 of 2000, The Systems Act).

The LGTA implicitly refers to risk management in sections 10G(2), which requires the MEC to, whenever he or she is of the opinion that finances of a municipality are or may become unsound, instruct the council concerned to take such steps he or she may specify in writing. The Structures Act does not refer to risk or risk management. References to risk management in the Systems Act is limited to defining the legal nature of a municipality as "a separate legal personality which excludes liability on the part of its community for the actions of the municipality (s2(d))", and allowing governing bodies of multi-jurisdictional municipal service districts to insure themselves against any loss, damage, risk or liability (s92 (c)(3)). However the Systems Act does require municipalities to table an Integrated Development Plan that is a potential source of fiscal risk, and is discussed below.

8.1.1 Socio-economic rights

The Bill Rights confers a number of socio-economic rights that are justiciable. Although they are limited by qualifications such as realisation "within the available resources", they could create direct implicit liabilities for all spheres of government.

8.1.2 Integrated Development Plans

Chapter five of the Municipal Systems Act requires municipalities to prepare developmental plan for the municipality. A municipal council is required to adopt an IDP for the duration of its term. Therefore the IDP should set out the municipality's commitments to the community for a period of five years. This imposes an immediate fiscal risk as the council is legally committed to achieving the targets and goals set out in the IDP but may be subject to

economic or environmental shocks that could affect the service delivery capacity of the municipality in such a way that does not allow it to achieve these goals.

The Systems Act requires municipalities to prepare a five-year financial plan with the IDP. This is another potential risk mitigation process as if the municipality develops the financial plan correctly the municipality should conduct a number of feasibility and cost analyses. This practice also allows for a thorough analysis of the revenue required from communities and thus reduces the risk that the municipality will encounter financial crises.

8.1.3 Financial management frameworks and fiscal risk

The MFMB requires the Municipal Manager ensures the municipality has and maintains "effective, efficient and transparent systems of financial and risk management and internal control (s59(c)(i))". Important to risk management, a municipality is also required to maintain a "system of internal audit operating in accordance with any prescribed norms and standards (s59(c)(ii))." The internal audit must advise the municipal manager on matters pertaining to risk and risk management (s159(2)(b)(iv)) and audit committees are required to provide comment to senior management and the political executive on risk and risk management in the municipality (s160). National Treasury may prescribe uniform norms and standards "concerning … financial risks … where a municipality appoints an external mechanism for the performance of a municipal service(s20(b)(vi))." A municipal council must consider the financial risks associated with long term contractual obligations before approving the contract (s31(1)(b)(ii)(bb)).

The bill does not allow municipalities to incur a risk or liability payable in a foreign currency. However, municipalities are permitted to procure goods in a foreign currency as long as the value of the Rand is set at the time the procurement is settled (s157).

The accounting officer of a municipality is responsible for the management of municipal liabilities and must ensure that the municipality maintains a management, accounting and information system that accounts for the assets and liabilities of the municipality; cause the municipality's assets and liabilities to be valued in accordance with standards of generally recognised accounting practice; and establish and maintain a system of internal control of assets and liabilities, including an asset and liabilities register, as may be prescribed (s60). National Treasury may monitor a municipality's compliance with the Generally Recognised Accounting Practice (s5).

The Generally Accepted Municipal Accounting Practice (GAMAP) is the standard for accounting in municipalities in South Africa. GAMAP defines a liability as "an obligation of the municipality that will result in an outflow of future economic benefits for which service delivery must still be provided." These are explicit commitments for which payments can be

accounted and budgeted for. GAMAP does not require that contingent liabilities be recognised in the balance sheet, but must be included in the notes. Events occurring after the year of the financial statements do not need to be recognised in the balance sheet, but must be comprehensively discussed in the notes.

The MFMB requires municipalities to prepare a medium term budget by "setting out indicative revenue per revenue source and projected expenditure by vote for the two financial years following the budget year (s17(1)(c))." The value of the Medium Term Expenditure Framework in risk management was discussed in section three of this paper.

Chapter six of the MFMB details the requirements for municipal debt arrangements. The bill strictly limits municipalities to raising short-term debt only if the municipality can pay off the debt based on realistically anticipated revenue or enforceable allocations. Short-term debt must be paid off within a financial year, thereby reducing the risk of rolled over debt. Long-term debt can only be raised for the purposes of capital expenditure on property, plant or equipment to be used for the purposes of achieving municipal constitutional objectives. Both forms of debt must be approved by resolution in the council and both the mayor and the municipal manager must sign the agreement. This chapter has two conditions that reduce the risk of moral hazard. Firstly, section 42(5) does not allow a lender to wilfully extend short-term credit beyond a financial year and if the lender does so the municipality is not obliged to repay the loan or interest on the loan. Secondly, the Minister of Finance and the provincial MEC for finance are required to approve provincial and national guarantees on municipal debt. In addition, no municipality or municipal entity may incur a liability or risk payable in a foreign currency (s 157 (1)). This limits what is known as currency risk, the risk of debts spiralling out of control due to currency depreciation.

However, municipalities are permitted to, subject to council approval, guarantee the debt of municipal entities under their sole ownership. A municipality may also, subject to National Treasury approval, guarantee the debt of any other person but as long as the municipality maintains liquid assets to cover the financial exposure and purchases and maintains a policy of insurance against the guarantee.

Chapter 13 of the MFMB deals with resolution of financial problems. If the substance of this chapter is not fundamentally altered when the bill is promulgated, this chapter will make way for the establishment of Municipal Finance Emergency Authorities (MFEA). An MFEA will be established when a municipality is in a state or approaching a state of financial crises and is unable to or is about to be in a position where it will be unable to provide basic municipal services. The bill requires a process of provincial intervention and the establishment of the MFEA will then construct a recovery plan and once the municipality is financially viable again, the MFEA will withdraw from the municipality. There are a number of technical and

legal processes that still need to be clarified, but this system does create a means by which municipalities will be under continual watch and therefore reduces the likelihood of bankrupt municipalities and hence mitigates fiscal risk of municipalities.

The bill identifies a number of conditions that can be used in determining if there are serious financial problems in municipalities (s 132) and if a case for provincial intervention exists these conditions are:

- The municipality has failed to make payments as and when due.
- The municipality has defaulted on financial obligations for financial reasons.
- The actual current expenditure of the municipality has exceeded the sum of its actual current revenue plus available surpluses for at least two consecutive financial years.
- The municipality had an operating deficit in excess of fiver percent of revenue in the most recent financial year for which financial information is available.
- The municipality is more than 60 days late in submitting its annual financial statements to the auditor general.
- The auditor general has withheld an opinion or issued a disclaimer due to inadequacies in the financial statements or records of the municipality, or has issued an opinion which identifies a serious financial problem in the municipality.

S139 Of the constitution provides the constitutional backdrop for the above sections of the MFMB.

National Treasury are able to directly control the growth of local government budgets. This puts a limit on the expenditures municipalities are entitled to incur and thereby reduce the risks of uncontrollable expenditure.

The MFMB requires that an annual budget can only be funded from a previous years uncommitted surplus or "realistically anticipated" revenue (s 18(1)). This requires municipalities to base their revenue forecasts on actual revenue raised in the previous two financial years. This keeps revenue forecasts realistic and mitigates the risk of the municipality over estimating future revenues only to be caught in a debt trap due to the miscalculations.

8.1.4 Municipal Entities

The above section discusses the MFMB. The promulgation of this bill has been a long awaited event and once of the causes of delay in this is the clarity required in the chapter dealing with municipal entities. Municipalities will form municipal service partnerships with these entities and help municipalities spread the risk associated with their services. At time of writing it is very unclear as to how these arrangements will work exactly as this chapter may be part of the Systems Act rather than the MFMB and therefore what is available to

discuss is very temporary in nature. However, it is worth noting that entities will provide a means of risk sharing.

8.1.5 Intergovernmental Fiscal Relations

There are a number of grants available that municipalities are able to access. This grant funding is either disbursed by National or Provincial departments and recent regulations require these grants only be disbursed to municipalities if the way in which the funds will be used is identified in the IDP. However, the level of detail describing how these funds will be used is not clear and this opens the door for municipalities to apply for funds without assessing the long-term implications of spending the grant money.

The grant money can be used for expenditure ranging from capacity building and systems improvements to capital expansion. For instance if a municipality applies for funds for a water services related expansion, which the municipality is then committed to covering the operation and maintenance costs of the water services through the levying of fees. If the municipality has not correctly assessed the long term operational and maintenance implications of such expenditure, grant funding can actually create a fiscal risk.

Similarly a provincial or national programme may not fully contemplate the operational and maintenance implications of a national or provincial programme that requires the municipality to maintain after implementation and thus create a fiscal risk in that the municipality will not be able to sustain the costs of such a programme and will require financial assistance, quite often soon after the programme is left in the hands of the municipality.

Municipalities are entitled to an Equitable Share of national revenue. It is an unconditional grant that municipalities are allocated based on the population size of their authority, the average income of the community and the number of households with access to basic services. Municipalities are required to use the Equitable Share to cover the cost of providing basic services. However, municipalities are permitted to pledge this revenue as collateral to raise short-term debt. This creates the potential for a situation where a municipality defaults on debt and a lender is entitled to intercept the equitable share and thus putting the municipality in a very tight financial position.

8.1.6 Powers and functions

At the time of writing the final assignment of powers and functions to municipalities, from national and provincial spheres, was not yet finalised and exactly how these will be allocated is, as yet, undecided. However, there may be a number of shifts in functions, and although a number of analyses such as feasibility studies and institutional analyses will be conducted before a transfer of powers and functions the risk that the studies were not exhaustive enough

is always present. In the case of a general assignment, when a power and function is shifted to municipalities in a certain category, the risk is present, for reasons that are not possible to predict, some municipalities will not be able to perform the function and encounter serious financial problems.

8.1.7 Constitutional provisions

Section 139 of the Constitution requires that a municipality intervene in the operation of a municipality when that municipality is unable to fulfil an executive obligation. When the solution to the problem lies mainly in the realm of improved financial management the legislative framework provides clear guidelines as to how an emergency authority will operate and how that process will terminate. The province could refer this problem to the Emergency authority and an administrator would be appointed to improve financial management systems and restore the municipality to financial health. The cost of this sort of intervention is likely to be relatively easy to establish.

However the legislation does not give precise indication as to what processes must be followed when a financial crisis in a municipality does not have its origin in bad financial management, but instead in structural economic shifts. Under these circumstance, due to the structural mismatch between the vastly reduced revenue base and cost commitments which are unlikely to be rapidly reduceable in the short term, there is likely to be a financial crisis which a recovery plan alone is unlikely to solve – without some sort of financial assistance to the affected municipality. If the provincial government does not have sufficient resources and therefore does not intervene, the national government would have to intervene in the place of the provincial government. This would create a direct implicit risk for the national government in the short term. Eventually the economic impact would show up in the census data and hence in the equitable share process, but until then how this fiscal risk should be dealt with is uncertain.

8.1.8 Project viability

Project viability was launched in 1995 by the Department of Provincial and Local Government (DPLG) to monitor the ongoing liquidity of municipalities. In 1996 the scope of this was extended to include a full support programme by both provincial and national governments. This framework encompasses the following integrated phases:

- monitoring of municipal finances through a quarterly questionnaire;
- management audits to identify problem areas in municipalities that appear to be facing financial difficulty;
- a management support programme that provides technical support to municipalities in order that they may improve their financial management;

- training of Councillors and senior municipal officials and mentoring of municipal officials to ensure the practical application of financial management techniques.

Early warning indicators have been developed and are continually being refined to ensure that the main areas of support can be easily identified and that support programmes can be designed or amended to meet the changing needs of the local government sphere. Four main areas are checked:

- Governance: Compliance with the minimum number of Council meetings, appointment of senior management, dishonoured cheques etc.
- Capacity to deliver services.
- Compliance with Legislative:
- Financial indicator: These are broken down into the following criteria:
  - Cash + investments + monthly income (discounted by 10%) / wage bill
  - Cash + investments + monthly income (discounted by 10%) / total monthly current expenditure
  - Cash + investments / wage bill.

If it is established through the questionnaires and early warning indictors that a municipality is fiscally vulnerable, assistance to strengthen the financial management capacity is given through dispatching management support teams to the municipality. Funding is made available through the Management Support Programme and more specifically through the Local Government Support Grant. The province should support municipal efforts to restructure systems to deliver services correctly. However, the municipality will only receive funding once and must move from crisis management to strategic planning. Poor performance is not rewarded through the provision of these funds and municipalities must prove they will use the funds to restructure their organisation (Manyindo, 2002).

The Department of Provincial and Local Government made confidential information from Project Viability available to the authors. The Project Viability reports for December 2001 and 2002 were analysed and a number of trends identified. The reports cautioned the reliability of using the data produced at face value as the number of municipalities responding to the questionnaires varied considerably from quarter to quarter. However, notwithstanding this, the following cautionary trends could be established (these issues are discussed in the context of the fiscal risk matrix in section 10.6):

Socio-economic

8.1.8.1 Growing Consumer Debt

Municipal consumer debt is increasing i.e. debt owed by private consumers to municipalities. The age of this debt is slowly getting older and the majority (75.8% of debt) is older than 90

days. This is an alarming figure that is getting increasingly worse with seeming little chance of reclaiming this debt. In 2001 the reports suggest that the majority of this debt is owed by businesses and in the 2002 report suggests private consumers owe the majority of debt. The reason for this change is unclear as are the reasons for poor debt collection. A survey of related studies are unable to suggest a reason definitively. There are two views. On the one hand communities cannot afford to pay for services (and hence low fiscal capacity) and on the other municipalities do not have the capacity to collect debt (and hence low fiscal effort). A survey of project viability information that shows low levels of managerial competence in municipalities suggests that poor management in municipalities must at least take part of the blame. However, the size of consumer debt (approximately R25 billion in December 2002) is distressing and poses a huge fiscal risk. The aggregate percentage for bad debts for 2002 was 22%, this is a small increase from the previous year, but suggests that municipalities are making provisions to write off increasingly more debt.

Institutional

8.1.8.2 Poor skill levels

In December 2002 33% of metros, 14% of local municipalities and seven percent of district municipalities reported that they could bring their financial statements up to date in the following month. These figures are improving, however are extremely low. Training in GAMAP, reconciliation of control accounts, budget preparation and monitoring, debtors administration and accounting for transactions were continuously identified as priority training areas. Computerising of systems in municipalities is happening at a slow, but steady pace. However the capacity to produce useful, credible and timely financial information in municipalities often does not exist and nor is this capacity being developed at sufficiently rapid rate. There is no reason to believe this situation will improve in the near term and could in fact worsen, thereby making it increasingly difficult for other spheres of government to monitor the fiscal risks created by municipalities.

8.1.8.3 Staff shortages

The data provided suggest that metro and local municipalities are facing increasing shortages of staff, whereas the district municipalities are continuing to employ a surplus of staff. Shortages in staff will affect the municipalities' ability to deliver services and if current trends continue this could create problems for municipal service delivery. In 2001 more than 90% of municipalities failed the project viability early warning indicators for the capacity to deliver basic services. Both of these points send alarming signals about municipalities abilities to provide basic services on a sustainable basis.

8.1.8.4 Ineffective council governance

In 2002 and 2001 about 37% of municipal councils met more than 6 times per year. The remaining 63% met less often than this. If the majority of councils are meeting less than 6 times per year it raises questions as to how accountable these councils are to their communities, as well as how accountable the administration is to the Council and upholding constitutional intentions of democratic local government.

Financial

8.1.8.5 Limited use of cash flows

The December 2001 report stated that only 60% of municipalities prepare cash flows. It is unclear what level of cash and expenditure management the other municipalities can perform without this basic tool.

8.1.8.6 Poor budget management

In December 2002 municipalities had, on average, raised 49% of the revenue budget for. In isolation this raises questions as to how municipalities can operate on such low levels of revenue (even taking into account accrual accounting considerations)The corresponding figure for actual expenditure was even lower than this at 42.9%. This shows that municipalities are on average operating on cash surpluses. However the large variance from budgeted figures is worrying and builds on comments elsewhere about financial management capacities at municipalities.

8.1.8.7 Inadequate risk management

In December 2001 only 62 municipalities had risk management sections, this figure has not changed significantly. 239 municipalities are insured against public liability, 217 against fraud and 240 have insured their assets externally. However, R420 million worth of assets is left uninsured, creating a potential liability to government.

8.1.8.9 Inadequate auditing capacity

In December 2001 only 40% of local municipalities had audit committees in place. This figure does not appear to be any better in the districts. The number of district and local municipalities with audit committees in place has improved, but only marginally. Without audit committees in place municipalities have a limited capacity to report essential financial information for financial risk management purposes. In the period prior to December 2001 73% of municipalities either received qualified audit reports or their audit reports were withheld. In the period prior to December 2002 this position had improved marginally; 40% of municipalities received unqualified audit reports. However, these figures show that 60% of municipalities are not presenting financial statements correctly. This point builds on

comments elsewhere about the lack of capacity at the local government level to manage finance correctly and report on this.

8.1.9 National Treasury Debt Disclosure RegulationsNational Treasury released draft municipal debt disclosure regulations. These regulations require that when a municipality enters into a discussion to incur debt it must make available to the lender certified copies of its audited financial statements for the preceding three financial years and certified copies of repayment schedules pertaining to existing debt obligations. If the municipality has not been established for three years, then they must make available financial statements for the years since establishment. These requirements are not unusual, but considering the comments elsewhere on the poor reporting of municipalities, this requirement alone will prohibit a large number of municipalities from accessing debt. But, this makes sense as if a municipality is unable to submit financial statements, that municipality should not be allowed to raise debt. Also, private lenders will have no excuse for moral hazard behaviour as audited financial statements provide a very good assessment of the municipalities credit worthiness.

Municipalities are also required to prepare disclosure statements if they wish to raise debt through securities. These disclosure statements are required to include the following local economic indicators:

- The average income levels of persons employed within the municipality.
- The number of persons employed within the municipality.
- The ten employers employing the greatest number of persons within the municipality.
- The ten major contributors to the municipal rates base.
- Growth projections for the next five years.
- The material risk factors which, in accordance with the municipality or the municipal entity's assessment, will have a direct impact on its ability to meet repayment obligations.

These indicators provide a good indication of the economic health of the municipality and lenders with a very good indication of the municipality's likely ability to pay back loans and thus feed well into a framework for assessing local fiscal risk. Municipalities that are likely to use disclosure statements are most likely to be municipalities that are economically and financially healthy and not likely to be potentially fiscally unsound. It is unfortunate that the above indicators are not required of all municipalities as they are valuable fiscal risk indicators, but the minority of South African municipalities actually have the capacity to gather such information.

The regulations also require municipalities, in their disclosure statements, to provide the results of credit rating from a rating agency.

When a municipality has raised debt it must notify lenders, representatives of lenders, applicable exchanges and National treasury of:

- The happening of any event which is likely to have an impact on the ability of the municipality to meet its repayment or security obligations in respect of debt incurred.
- Any failure to meets its repayment obligations on due date.
- Any failure to meets its obligations that may constitute a default.
- Any new debt incurred or the provision of any additional security to existing creditors.

These requirements are fairly onerous and require proactive monitoring of municipalities of their own financial positions. It is questionable whether municipalities actually have the capacity to produce this information. However if the information can be produced it will contribute significantly to fiscal risk management processes. The information described above must be captured by National Treasury on the "Municipal Debt Database". National Treasury are required to allow lenders access to the above database. The regulations also require municipalities to make information on the details of municipal debt available to any interested parties.

The requirements described above, requiring municipalities to disclose information to the public provide a means by which communities can exert pressure on municipalities to follow credit worthy practices. The community's understanding of creditworthiness will have a direct bearing on how effective public disclosure of information is on promoting creditworthy behaviour within municipalities, but at least the regulations open this form of check and balance on municipalities.

8.1.10 Planning and Performance Management regulations

DPLG gazetted the Local Government: Municipal Planning and Performance Management regulations, (2001) to clarify for municipalities as to what should be included in Municipal Performance Management Systems and Integrated Development plans. The regulations require municipalities to provide the following indicators in their performance management processes:

- The percentage of households with access to a basic level of water, sanitation, electricity and solid waste removal.
- The percentage of households earning less than R1100 per month with access to free basic services.

- The percentage of a municipality's capital budget actually spent on capital projects identified for a particular financial year in terms of the municipality's integrated development plan.
- The number of jobs created through municipality's local, economic development initiatives including capital projects.
- Financial viability indicators showing the municipality's debt coverage, outstanding service to debtor ratio and cost coverage.
- The percentage of a municipality's budget actually spent on implementing its workplace skills plan.
- The number of people from employment equity target groups employed in the three highest levels of management in compliance with a municipality's approved employment equity plan.

Municipalities must have mechanisms, systems and processes for monitoring these key performance indicators. These systems, mechanism and processes must a) report to the municipal council at least twice a year; b) be designed in a manner that enables the municipality to detect early indications of under-performance and c) provide for corrective measures where under-performance has been identified.

The regulations require internal auditors to continuously audit the performance measurements of the municipality and submit quarterly reports on these audits to the municipal manager and the performance audit committee.

Section 10 describes a number of indicators that can be used for fiscal risk management processes in municipalities. A form of all the indicators above, except for the last one, is listed in that section as possible measures of fiscal risk. This shows that at least some of the indicators listed are already part of the reporting requirements in municipalities, however this does not dispel the concerns raised about poor reporting raised in sections 8.1.7 and 8.1.8 above.

8.2 The Dimensions of Risk Analysis and South African Risk Management Practices

Section three describes the three dimensions to fiscal risk analysis as the macroeconomic context, specific fiscal risk (microeconomic framework) and institutional framework. It is important that all of these dimensions are properly covered in a country's fiscal management process to ensure that the overall impact of the risks faced is clearly understood, the cause of the risk is assessed and managed and the processes followed in handling risks are clear.

In terms of the macroeconomic dimension South Africa has a sufficient number of processes in place to assess its exposure at this level. These are shown at the beginning of this section.

In terms of identifying the causes of risks on the microeconomic scale, the present risk management processes require strengthening. The municipal finance management bill goes some way in structuring the micro management of risk at local government level. Although project viability uses a number of techniques to assess potential local fiscal risks the information above shows that the required institutional framework does not yet exist and municipalities are unable to report the required information and there are still insufficient mechanisms in place that require decision makers to identify the cause of fiscal risks and how to respond to them. The municipal finance management bill addresses this issue by requiring audit committees to meet frequently, but most municipalities have not yet restructured their organisations sufficiently to affect this. The capacities required within organs of state to identify and manage fiscal risks that are threatening at the local level are not adequate. Therefore explicit procedures for the collection and monitoring of local fiscal risks need to be established, with respective roles and responsibilities outlined, and risk management financing arrangement clarified. This will be explored in greater detail later.

9. Credit rating in South Africa

Understandably credit rating agencies were cagey about the information they use to assess risk in municipalities. Information of this kind is kept confidential in a highly competitive information intensive industry, however some general information about the risk rating process was obtained.

Municipalities are rated according to five criteria: financial position, economic position, socio-economic circumstances, environmental condition and institutional capacity.

The financial position is assessed by the use of a number of financial ratios that can be ascertained from financial statements, balance sheets, income statements and cash flow statements. These ratios include an analysis of the municipalities gearing (debt to assets), debt to income ration, interest burden and interest coverage ratio.

Through the economic assessment the agency attempts to assess the viability of the local economy and how vibrant the local economy is. To do this a stress indicator is used to assess the diversification in economic activity. Other indicators used are the growth in property rates and physical infrastructure.

In terms of institutional capacity the experience and qualifications of senior management is assessed. The environmental assessment looks at the threat the natural environment poses to the viability of the municipalities and projects that are underway. The socio-economic

analysis requires census information and factors such as the number of people with (or without) housing, electricity and water will inform decisions.

10. Methodology for assessing municipal fiscal risks in South African Municipalities

The previous section discussed the criteria used to evaluate the risks in municipalities. This section uses derivatives of these criteria to propose a framework (or methodology) that could be used to assess the fiscal risks municipalities pose on the South African fiscal system. Much of what is discussed below is an ideal, and much of the information required is likely only to be available to a minority of all municipalities.

In assessing the fiscal risk of local government for the purposes of this paper, we are trying to assess the risk a municipality poses on the national fiscus. A municipality poses this risk if it needs to be bailed out by national or provincial government and this will occur if a municipal is in a financial crisis, or does not the financial resources to cover the cost of its operations and commitments. This macro management of fiscal risk should be complemented by micro risk management at the level of the municipality itself.

This section looks at a number of criteria that can be used to assess how close a municipality is to a financial crisis (financial indicators) and if a municipality is showing signs of progressing towards a financial crisis (the indicators in the other four categories).

A key principle followed in the development of these indicators is that they must be useable in a framework of differentiated roles. National, provincial, district and local governments should have distinctive roles in fiscal risk management. It must be clear which indicators can be used in the three spheres of government. This is important in ensuring that there is no duplication of risk management activities such as monitoring, evaluation and data collection. If the roles are clear it should contribute greatly in assisting the coordination of risk management practices.

The indicators described below are meant to be illustrative and serve as a starting point for further discussion. As far as possible, indicators should use information already reported by municipalities.

10.1 Economic criteria

In the drafting of an IDP municipalities are required to identify a number of development objectives. These objectives should be communicated in the terms of measurable objectives and the process should filter down through programmes to projects to a form of output.

These outputs should be costed. If a municipality is able to do this it is able to assess the cost of the IDP and accurately identify the budgetary allocations and commitments required to deliver the IDP. The specified outputs would represent a direct explicit municipal fiscal risk as they are legally committed to delivering this output. The risk this imposes can be greatly mitigated if there are the economic resources in the municipality that can be tapped to cover their cost. This sub-section details a number of indicators that can be used to show the economic health of the municipality. An indication of this health shows how sustainable municipal programmes are and the likelihood that the community will or will not be able to support them. There is a direct negative correlation between the economic health of a municipality and the likelihood it will encounter a financial crisis. The indicators described below cannot be used to show how close a municipality is to a financial crisis, but could be used to show if a municipality is progressing towards an economic position that may lead a municipality to a financial crisis may occur in time to come.

- ***Municipal economic output or Gross Geographic product (GGP)***
  - This can be broken down per sector and from the sector analysis percentage sectoral contribution can be assessed to provide how diversified economic activity in the region is. This provides an assessment of how well the local economy could handle sectoral shocks.
  - Growth in economic output also provides an indication of the health of an economy and how well the economy is able to sustain growth objectives identified in the IDP. Sectoral growth analyses would provide additional useful information.
- ***Value of infrastructure and construction expenditure***
  - Growth in this expenditure gives a very good indication of the rate of growth of economic activity. This expenditure could be broken down per sector to provide additional analysis of how susceptible the municipality is to sectoral shocks. However caution against over expansion in this area must be emphasised and debt verse capital stock ratios and growth in infrastructure expenditure verse economic growth can provide a measure of how sustainable expansion is. If expansion is not sustainable the municipality may find itself in a debt position that could quickly escalate out of control.
- ***Average household income***
  - Analyses of average household income can provide another indication of how well a municipality can pay for services. Analyses of this are most useful if information is accurate and specific enough to categorise the community into quartiles or even quintiles of income brackets and provide percentages of communities in these quintiles. Data this accurate can facilitate analyses that will allow an understanding of what levels of surcharges are likely to be accepted by the community.
- ***Level of employment and employment growth rates***

- This provides an indication of current and future ability of a community to bear the costs of programs. Again, if this data is available for each sector it gives an idea of how susceptible the municipality is to shocks in one sector.

- ***Municipal rates revenue and growth in this revenue***
  - This provides an indication of how willing the community is to pay for municipal services and service expansion. Growth in revenue collection provides an indication of trends in this regard and can provide signals of the potential ability to pay for services.

10.2 Financial criteria

Financial assessment of a municipality provides an indication of the financial stress a municipality is under and therefore a direct indication of how close the municipality is to a financial crisis (Ma, 2002).

- ***The size and persistence of deficits and growth rates***
  - To measure this, ratios could be used that compare revenue to expenditure and measure this over a number of years. Where deficits of a certain size exist and/or persist a response mechanism could be formulated. The cause of the deficit (caused by increased expenditure or decreasing revenue) would affect the desired response.
- ***Balance sheet gap***
  - A measurement of net liabilities as a percentage of revenues shows how a municipality is able to repay the debt from revenues.
- ***Liquidity***
  - Net liquid assets as ratio of expenditures gives an indication of how well the municipality can handle shocks to expenditure requirements.
- ***Debt maturity***
  - A measure of short term debt at the end of the year gives an indication of the pressure a municipality is under to repay debt, or how likely the municipality is to default on the debt.
- ***Tax and rates compliance***
  - The compliance of communities to pay for taxes and services is not only an economic indicator, but can also provide a very good indication of the financial stress a municipality is under.
- ***Debt standing***
  - How well a municipality is able to pay off debt will depend on the collateral used to raise the debt. Therefore ratios that compare the size of debt commitments to the

collateral provide good measures of how likely a municipality will default on a debt. In this regard the following ratios are useful:

- Long-term debt to capital stock
- Short-term debt to revenue
- Percentage short-term debt rolled over.
- Value of short-term debt rolled over as a percentage of current revenue.
- Value of new borrowing compared to revenue.

Age of consumer debt

Extension of municipal wage arrears

Ratio of uncommitted cash to cash collected in the previous year.

- ***Allocation of National transfers in ways other than stipulated in transfer conditions***.
  - As discussed above the correct use of national or provincial transfers and the analysis of long-term implications is important in mitigating the risk of municipal debt or service delivery problems. Therefore, some form of indicator needs to be developed to show how well a municipality has assessed the long-term implications of transfers. This indicator is not a purely financial indicator as there are institutional conditions that will affect whether the correct analyses have been performed.

10.3 Institutional indicators

A previous section of this paper discusses the institutional measures that can be implemented to ensure sound fiscal compliance. The institutional arrangements in a municipality do not only enhance sound fiscal compliance but also have a substantial impact on the overall performance of a municipality. A key contributor to this is the line of responsibility and reporting. These lines affect the autonomy and independence of decision makers and obviously their day-to-day conduct. In addition, the competence of councillors, mayors and senior management will have a fundamental effect on the performance of municipalities. As discussed above for economic indicators, these indicators cannot be used to show how close a municipality is to a financial crisis, but an observer can use to assess if existing municipal institutional practices may contribute to poor financial performance, which in time could lead a municipality in to a position of financial stress.

Indicators to measure the following need to be developed:

- ***The competence of councillors and senior management to understand the risks associated with IDP programmes.***
  - The competence of councillors and senior management to develop and understand measures required by performance management systems and strategic management processes. This contributes significantly to how well strategic plans are adhered to

and specified outputs delivered. Associated with this is the ability to compile accurate and detailed performance reports.

- ***The reporting lines between political officer bearers and senior management.***
  - The clearer the lines of delegation and reporting are the less potential there is for misinterpretation of roles and responsibilities. The more everyone understands their limits of authority and what their responsibilities are the greater the effectiveness of staff.
- ***Other specific measures of capacity and institutional performance are:***
  - The frequency with which audit committees meet: shows how often risk management processes may occur. The autonomy and independence of the audit committees provides an idea as to how objective and free of political influence the risk management process is.
  - How often municipal financial statements are submitted on time provides an indication of how well the budget office is managed. How often these financial statements are given an unqualified opinion is the acid test as to how well a municipality is recording finances.
  - Where in the municipality risk management processes are allocated and how free they are from influence of political bodies, senior management and other parties with potentially vested interests.

10.4 Socio-economic indicators

Socio-economic indicators can provide an indication of the living standards of communities within a municipality. Municipalities have a constitutional objective to provide social and economic development to municipalities. If this is not delivered there is the threat of community dissatisfaction that could be expressed through non-payment of rates and migration away from the municipality, which leads to lower income and in time will create financial stress. One drawback of socio-economic indicators is that due to demographic variety across the country it is extremely difficult to develop generic indicators that can be applied nationally. However, indicators that capture the following measures need development:

- The percentage of households with access to potable water and/or have in house water.
- The percentage of households with access to electricity, in house sanitation, refuse removal.
- The percentage of people with(out) housing.

10.5 Environmental indicators

Environmental indicators should be used in a risk assessment as the impact of an environmental disaster could destroy municipal and community resources that will require extremely costly reconstruction that may be too much of a financial burden for municipalities

to bear, and therefore impose an implicit indirect fiscal risk of provincial or national government support. Environmental indicators are probably the most difficult kind of indicators to develop, simply due to the diversity of the South African landscape and natural resources that an attempt to identify indicators that could be used by all municipalities in the mitigation of fiscal risks is very ambitious. The type of environmental threats, relevant to South Africa that could pose a country fiscal risk are natural disasters such as floods, and natural fires. These are difficult to predict but the risk they impose can be limited by ensuring fires can be controlled and that communities do not reside in flood plains. Therefore, an indicator that measures the percentage of the total community living in areas not accessible to fire fighter and below the flood line provide a good assessment of the risk these natural disasters pose.

The Disaster Management Act (Act 57 of 2002), details how environmental disasters will be financed. Section 56 (2) allows national, provincial or municipal organs of state to contribute financially to "response efforts and post disaster recover efforts" and places the responsibility of financing the cost of replacing or repairing public infrastructure on the organ of state responsible for the maintenance of that infrastructure. This provides a good incentive for organs of state to ensure that infrastructure for which they have responsibility, is constructed and maintained at a level that ensures the possible cost implications of natural disasters are kept at a minimum. However, the Act (s56 (3)) allows for a framework, in which if a certain financial threshold is met, the municipality may access national funding for relief. The FFC has recommended that in the event of a disaster, if the cost of damages is above a certain percentage of municipal revenue, national funding must cover the costs of recovery. This has some interesting risk implications. On the one hand there is the explicit contingent liability for national government to assist municipalities in the event of an emergency. But there is also the potential to create moral hazard, as if the environmental damage caused by a natural disaster is more expensive than a certain amount the municipality is able to access national funding, therefore municipalities may have an incentive to follow practices that do not actually ensure environmental damage is constrained as much as possible.

10.7 Application of indicators

The following tables show a number of indicators that have been conceptualised from the logic that resulted in the indicators provided by Ma (2002). These indicators can be used to assess if a municipality could be posing a risk of requiring financial assistance from either the province or national government. The indicators are split into three tables. Table 3 shows a set of indicators chosen for national government to use to monitor the country fiscal risk posed by a municipality. Table 4 shows the same kind of indicators that provincial governments can use and table 5 shows these for district municipalities.

The intention is that these spheres of government can use these indicators to provide independent risk assessments of municipalities. The level of aggregation was chosen, as the data required for calculating the various indicators are most suitable for the sphere for which they are prescribed to collect according to legislated monitoring roles. The general principle would be that national government would have the most comprehensive but high levelled coverage, whereas the spheres closer to the municipality would monitor over a more confined geographic area, but in greater detail. The indicators listed below are could be used as a means of examining if a municipality is or could be posing on country fiscal risk. For instance in table three, a district municipality should consistently ask of the municipalities in their district: a) if the biggest sector in the municipality is contributing more than 80% towards GGP, then the municipality and district should monitor that industry and ensure it is sustainable and devise a contingent development plan in the event the industry collapses.

Most of the indictors provided below are leading indicators. A leading indicator will send a signal or lead the observer into deducing that a fiscal problem could occur. In other words, when the municipality reaches the threshold identified below, this does not imply the municipality is currently in a state of crisis, but merely the municipality could be vulnerable and preventive action is required. On the other hand some of these indicators are lagging indicators and suggest that if the threshold is reached a problem has already occurred and curative response is required.

Another dimension to these indicators that is important to consider is associated time lag. For some of the indicators if the threshold limit is reached, immediate action is required either to prevent (leading indicator) or construct a recovery plan (lagging indicator), whereas for others a response is less urgent.

The levels of the thresholds have been arbitrarily set in the tables below for illustrative purposes.

Table 3. Local Government Fiscal Risk Indicators: Sample National Government Indicators

Type of indicator	Indicator	Risk threshold *	If threshold exceeded, what action should be taken	Responsibility for collecting the data	Responsibility for monitoring
Economic	Gross geographic product / capita	< R250 / month	Municipality must be under continual watch	STATS SA	DSD
Financial	Municipal deficit /municipal turnover	>5%	Prepare case for intervention under section	National Treasury	National Treasury
Institutional	Percent senior managers in permanent positions	< 60%	Municipality put under special watch to see if municipal programmes are implemented correctly	DPLG	DPLG
Socio-economic	Percent of community without housing	<20%	Municipality identified for special watch to monitor community satisfaction	Stats SA	DSD
Environmental	Percent of community in housing that is exposed to environmental disaster	>30%	Municipality to be put under watch	DWAF	DWAF and DSD

* These figures are purely indicative

Table 4. Local Government Fiscal Risk Indicators: Sample Provincial Government Indicators

Type of indicator	Indicator	Risk threshold**	If threshold exceeded, what action should be taken	Responsibility for collecting the data	Responsibility for monitoring
Economic	Growth of GGP / capita	< 0%	Placed under economic watch	STATS SA	DTI
	Growth in construction expenditure	< 0%		Provincial Treasury, Development Agencies	DTI, Provincial Treasury,
	Growth in the level of unemployment	> 5%		Provincial Treasury, Provincial DSD	DSD, PT
	Growth of municipal rates revenue	< 0%		National and Provincial Treasury,	PT
Financial	Growth of municipal deficit	> 5%	Application for municipal emergency	PTs, PLG's	MECs for Local Government
	Net liquid assets / municipal revenue	< 10%	Municipality placed under special watch	PT,	MECs for LG
	Growth in non-payment of rates and tariffs	>5%	Municipality placed under special watch	PT	MEC for LG
	Long term debt / capital stock	> 5%	Municipality placed under special watch	PT, INCA, DBSA	MEC for LG
	Short term debt / municipal revenue	> 5%	Restrict borrowings	PT, DBSA, INCA	MEC for LG
Institutional	Last financial statements to be awarded an unqualified opinion	> 3 years	Perform institutional analysis of municipal budget office	NT, A-Gs office	MEC for LG
	Last time budget	> 2 years	Perform		

	approved on time		institutional analysis of municipal budget office		
	Percent of administration budget spent on capacity building	<1%	Perform skills audit in municipality	PT's,	PLG's
	Percent of IG transfers allocated for correct use	<70 %	Municipality to be monitored and devise plan to eradicate poor management practices	NT, PTs, PLGs	PLG's
Socio-economic	Percent of community without access to basic services	> 70 %	Municipality to be placed under social watch	DSD	DSD
** These figures are purely indicative					

Table 5. Local Government Fiscal Risk Indicators: Sample District Fiscal Risk Indicators

Type of indicator	Indicator	Risk threshold***	If threshold exceeded, what action should be taken	Responsibility for collecting the data	Responsibility for monitoring
Economic	Percent GGP earned from single biggest sector	> 80 %	Monitor sector for possible collapse. Consider contingency plan in even of sectoral collapse.	Development agencies	District Council
	Percent of labour force employed in biggest sector	> 80%			
	Percent growth in infrastructure expenditure	< 0 %	Perform economic analysis of Municipality to establish poor growth	Development agencies	District Council
	Growth in infrastructure expenditure relative to growth in GGP	>30%	Perform economic analyses to assess if growth can be sustained	DSD, Development Agencies	MEC for LG
Financial	Value of consumer debt older than 30 days/ municipal revenue	>20%	Application for municipal emergency (s139)	PT, Municipal Budget Office,	MEC for local government, District
	Value of consumer debt older than 60 days/ municipal revenue	> 15 %			
	Value of consumer debt older than 90 days/ municipal revenue	> 10 %			
	Percentage of consumer debt from service with most consumer debt	> 70 %	Municipality put under special debt watch	PT, Municipal Treasury	MEC for LG, District

	Value of consumer debt and value of total municipal debt both increase	> 5 %	Municipality put under special debt watch	PT, Municipal Treasury	MEC for LG, District
	Percent of short term debt rolled over	>5%	Municipality put under special debt watch	PT, Municipal Treasury	MEC for LG, District
	Value of new short term debt/ current revenue	> 5%			
	Value of new long term debt / capital budget	>10%			
	If deficit present and is caused by expenditure increasing greater than a percentage	> 5 %	Municipal budget constrained – case for intervention investigated	PT,	MEC for LG
	If deficit present and caused by revenue decreasing by greater than a percentage	> 5%	Municipality put under watch – systems analysis conducted and economic survey of community	PT, DSD, Development Agencies	Development Agencies, MEC for LG
	Uncommitted cash at year end / revenue	>5%	Put under watch	DC, Municipality	MEC for LG
	Grant funding accessed with accompanying long term sustainability analyses	< 70 % funds applied for			

	National and Provincial programmes requiring municipal maintenance not identified in IDP				
Institutional	No of times per year the audit committee meets	< 4 times	Municipality requested to perform quarterly internal audits	PT,	MEC for local government
	Percent of members in audit committee employed in municipality	>50 %	Internal audits reviewed by A-G	A-G, PT	MEC for LG
	Independent risk assessment performed in municipality	Never	A-G require audit committee to perform risk assessment	A-G, PT	A-G
	If risk manager employed: number of times meet with councillors other than for official presentation	> 0 annually	Audit committee to investigate reason for councillor and risk manager to meet	Municipality, DC	DC, MEC for LG
	Number of times municipal officials report interference in municipal operations	> 5 annually	PT and PLG to investigate interference	PT, PLG, Municipalities	MEC for LG
	Number of times municipal officials report interference in appointment of staff	Ever	PT and PLG's to investigate council conduct and suggest remedy	PT, PLG's, Municipality	MEC for LG
	Number of	<60%	DC to place special watch	DC	MEC for LG

	department heads signed performance contracts		on overall municipal performance to ensure municipality operating correctly		
	Number of departments aligned with IDP	< 60 %	DC, province and development agencies to assist aligning municipal departments with IDP	DC, PLG's	MEC for LG
	Number of times council meets per year	≤ 4	DC to place special watch on overall municipal performance to ensure municipality operating correctly	DC	MEC for LG
Socio-economic	Percent households without access to electricity	< 70 %	DC to monitor state of the municipality and recommend ways to improve living conditions for the community	DC, DSD, Development Agencies, Municipality	MEC for LG
	Percent households without access to water	< 70 %			
	Percent households without refuse removal	< 70 %			
	Percent households living in temporary houses (< 1 year)	> 60 %			
Environmental	Percent houses situated below flood plain	> 20 %	DC and municipality to prepare contingency plan (buy insurance) for disasters	DC, Municipality	MEC for LG
	Percent houses without quick access in the case of fire	> 20 %			
	Percent houses under threat from mud slides	> 25 %			

* These figures are purely indicative

10.6 South African Local Government Fiscal Risk Matrix

The table below is an application of Table 1, into South African municipalities.

South African Local Government Fiscal Risk Matrix		
	Direct	**Indirect**
Explicit	List IDP program deliverables and the required financial commitments. List promises of free service delivery and the cost implications attached. List the value of performance contract with municipal staff members List all debt the municipality owes.	List guarantees made to municipal entities or other persons. List guarantees made with respect to local economic development programmes.
Implicit	List number of households below poverty line and without basic services. List the consumer debt owed to the municipality. List all municipal services expansion funded by national or provincial grants List National or provincial programmes that require your municipality to maintain them	List potential environmental disasters that could occur: Large rivers in the municipality with history of flooding. Alien vegetation in the area that may assist spread of fire. According to indicators (number of people living below flood line, etc) describe how likely the municipality is to handle environmental disasters.

The aim of the above table is not to be exhaustive, but to serve as a basis for discussion in designing a comprehensive fiscal risk management system.

Section 8.1.8 discusses number areas of concern identified by Project Viability data. In terms of the fiscal risk matrix all those issues discussed pose substantial indirect explicit risks for the country. At the moment municipalities can continue to function and deliver services despite the alarming indicators discussed, however if a number of situations do not improve many municipalities will reach a position where they will no longer be able to function and the other spheres of government will be required to intervene and restore these municipalities to sound fiscal positions. Of special concern in this regard is the growing level of consumer debt, the cost that this creates for municipalities and the threat it poses to long-term municipal financial sustainability. The symptom of this problem is unclear at present, but two scenarios exist. Firstly, communities do not earn the level of incomes that can pay for the services, in other word the fiscal capacity is not present. Secondly the cause is structural and the poor levels of capacity in municipalities have a direct bearing on the potential of municipalities to raise revenue and report municipal financial position, in other word weak fiscal effort is being exerted. More data than was made available is required to assess this, however if the problem is structural it can be addressed by building the necessary capacity at municipalities. However, if the consumer debt is a symptom of week fiscal capacity the

problem may require firstly, a restructuring of the current intergovernmental grant system, to assist municipalities close the gap between current payment levels and required payment levels, and/or secondly investigating if current levels of service delivery suit consumer needs and their ability to pay.

11. Concluding discussion

Section 2 of the report introduced fiscal risk and mentioned that risk is inherent in government operations. The task risk managers and policy decisions makers have is to ensure this risk is managed at a level that government can handle. Striking the right balance between exposing government to the correct amount of risk, but ensuring that limited resources are used optimally is a complicated process that includes not only trying estimate future uncertain events, but the potential impact these events will incur.

There are a variety of risk management tools that governments can use, however to ensure that government does spread it risk with the private sector, government must provide the private sector with incentives to sell risk products to government. This is best achieved by creating products that the private sector is able to exchange and this process requires innovative product design to create private sector interest and cover the risks taken by government. The potential of moral hazard in the market place must influence the decisions taken by policy makers as this poses a fundamental threat on many government programmes and often risk management programmes. Sometimes explicit detail from government as to exactly how risks will be managed encourage moral hazard and it vital that government consider the threat this behaviour can pose.

Fiscal risk management is a topic that still needs to be developed fully and South African fiscal risk practices also require refinement. Due to the nature of the Intergovernmental Fiscal Relation System in South Africa a clear framework to direct risk management and risk monitoring in South Africa is critical. This framework must clearly stipulate the roles of and responsibilities of decision makers within the three spheres of government to avoid fragmentation and ensure there is no duplication or repetition, but must cover all risks that could result in municipalities posing a threat to country fiscal stability.

The Municipal Finance Management Bill establishes measures that should encourage sound specific fiscal risk management. If Municipal Financial Emergency Authorities are established as described in the present form of the bill, the role of provinces and municipalities in monitoring local fiscal risks will be further clarified. DPLG, in their performance management regulations, also provide a number of explicit indicators that municipalities must report on that could be instrumental in the fiscal risk process. However, legislative prescriptions alone do not ensure sound fiscal risk management. For the above

system to work effectively a number of regulations and financing arrangements for fiscal risk management and support will need to be developed, but above all human capacity at both provincial and municipal level is required. At the municipal level capacity is required for collecting and preparing the data that will be submitted in the form of monthly reports. At present the majority of municipalities struggle to provide this information on an annual basis. Section 8.1.8 discusses Project Viability as a means for assessing fiscal risk, however municipalities need to have the required reporting arrangements in place to make such a system work effectively. Data produced by Project Viability reviewed in section 8.1.8 shows that this capacity does not exist, nor does it appear that there is a trend in municipalities to address this lack of capacity. However, for risk management processes to prevent the damaging consequences of fiscal risks effectively, the information used must be current and readily available. The bill requires the accounting officer to maintain systems of risk management. To do this, reporting systems and the human capacity to manage and use these reporting systems effectively must be established. However, risk management at municipalities is unlikely to be effectively conducted if the capacity to monitor information provided by municipalities is not present at provincial level. There are two dimensions in this regard. Firstly, if there is no pressure being exerted on municipalities by provinces, the incentive to provide the desired information is limited and will therefore not be produced even if national organs of state wish to monitor local fiscal risks. Secondly, the information is useless if the intended recipients of the information are not able to put the information to good use. The capacity issue at provincial level is caused by both a lack of skills and number of staff to carry out the required responsibilities.

The greatest threat facing long-term financial sustainability in South African municipalities is growing consumer debt, that is unquestionable, however the cause of the problem is uncertain. Data surveyed suggests that part of the problem can justifiably be blamed on poor capacity within municipalities and this is a need that must be addressed urgently. However, trends in the needs of capacity building and the presence of skills do not suggest skill levels are rising at a sufficiently rapid rate to be able to address the negative consequences this will cause.

References

GAMAP. An introductory guide to GAMAP. Local Government Budgets, National Treasury.

Ma, J. (2002). Monitoring Fiscal Risks of Subnational Governments: Selected Country Experiences***.*** ***In Government at Risk: Contingent Liabilities and Fiscal Risk.*** Hana Polackova Brixi and Allen Schick (Eds.) The World Bank, Washington, 2002.

Manyindo, D. (2002) ***Project Viability: Quo Vadis?*** Paper presented at the IMFO Annual Conference, 9 October 2002.

Petrie, M (2002). Accounting and Financial Accountability to Capture Risk. In ***Government at Risk: Contingent Liabilities and Fiscal Risk.*** Hana Polackova Brixi and Allen Schick (Eds.) The World Bank, Washington, 2002.

Polackova, H.(1998). ***Government Contingent Liabilities: A Hidden Risk To Fiscal Stability***. The World Bank. Policy Research Working Paper 1989.

Polockova Brix, H. and Schick, A. (2002). ***Introduction. In Government at Risk: Contingent Liabilities and Fiscal Risk.*** Hana Polackova Brixi and Allen Schick (Eds.) The World Bank, Washington, 2002.

Polockova Brixi, H.and Mody, A. (2002). **Dealing with Government Fiscal Risk: An overview.** In ***Government at Risk: Contingent Liabilities and Fiscal Risk.*** Hana Polackova Brixi and Allen Schick (Eds.) The World Bank, Washington, 2002.

Republic of South Africa. Municipal Finance Management Bill (2003). National Treasury: Draft 31 March 2003

Republic of South Africa, 1998. Local Government: Municipal Structures Act (Act 117 of 1998).

Republic of South Africa, 2000. Local Government: Municipal Systems Act (Act 32 of 2000).

Republic of South Africa, 2002. Disaster Management Act (Act 57 of 2002.)

Schick, A. (2002). Budgeting for fiscal risk. **.** In ***Government at Risk: Contingent Liabilities and Fiscal Risk.*** Hana Polackova Brixi and Allen Schick (Eds.) The World Bank, Washington, 2002.