Sector Commentary

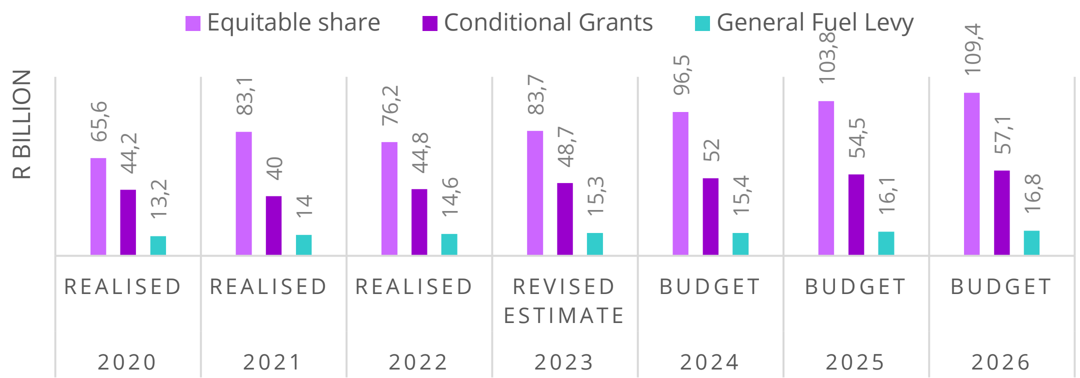
South African Municipalities Face Credit Risks Due to Slow Growth in Conditional Grant Allocation

28 February 2023

The South African national government has announced a budget allocation of R163.6bn to municipalities for capital infrastructure for FY2024-2026, as per its announcement on 22 February 2023. However, this allocation will only make up 10% of the municipalities' total expenditure on average, according to the [2022/23 Medium Term Revenue and Expenditure Framework (MTREF)](). Additionally, the allocation growth rate of 5.3% is only slightly higher than the 3.7% recorded in FY2021-2023.

This low growth in conditional grant allocation is a major concern for South African local governments as they already face a significant infrastructure backlog, including the maintenance of existing infrastructure and the need for new infrastructure. The negative impact of this slow growth will mostly affect 205 (Category B1-B4) Local Municipalities and 44 (Category C1-C2) District Municipalities. These municipalities rely heavily on government allocations to fund their capital infrastructure requirements and, as such, conditional grant allocations are their primary and dependable sources of funding for infrastructure investment.

LOCAL GOVERNMENT ALLOCATION



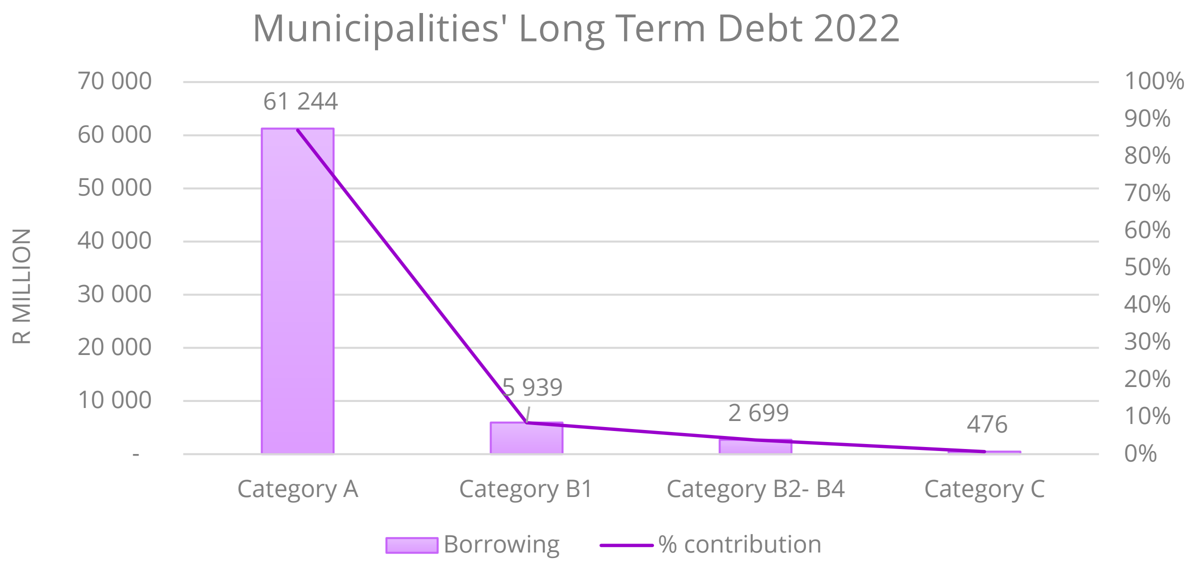
Source: 2023 National budget

These municipalities are generally characterised by poor economic performance, low revenue collection rates, and weak liquidity positions, which negatively impact their ability to diversify their infrastructure funding sources. Even if these municipalities were to improve their revenue collection efforts, the likelihood of success is low due to the high level of poverty and unemployment among the population. As a result, these municipalities are heavily dependent on government transfers to fund their capital infrastructure investments, as they cannot access funding from the market or use their own funds due to their weak balance sheet.

Most of these municipalities are spending between 5% and 10% of their total expenditure on capital infrastructure, which is lower than the National Treasury's recommended range of 10% to 20% of total expenditure. Unless the national government reviews the conditional grants allocation formula, particularly for medium, small, and rural municipalities, we expect prolonged service delivery challenges in the medium to long term. This low growth in conditional grants will exacerbate service delivery challenges for most of these municipalities.

Most municipalities, including metropolitan municipalities, are not adequately providing for repairs and maintenance, nor are they prioritising the renewal and upgrading of their existing infrastructure. On average, only 4% of the municipalities' operating expenditure in FY2022 was allocated to repairs and maintenance, which is below the recommended norm of 8%.

Unlike most Category B and C municipalities, metropolitan municipalities and some secondary cities are able to diversify their capital investments. These municipalities are generally characterized by a large and diversified economic base, allowing them to generate up to 80% of their operating revenue from their own sources. Between FY2023 and 2025, these municipalities plan to fund 60% of their capital expenditure from transfers, 18% from borrowing, and 22% from internally generated funds. According to the April 2022 Municipal Borrowing Bulletin, borrowing was a significant part of the funding sources for Metropolitan municipalities, with outstanding debt for metros at 87% (R61.2bn) of total municipal debt in FY2022. In comparison, Category B1 contributed 8% (R6bn) and other local municipalities and district municipalities contributed only 3% (R3bn) and 1% (R0.5bn), respectively.



Source: Municipal Borrowing Bulletin April 2022

Category A municipalities have an advantage in being able to diversify their funding sources, which allows them to fund economic infrastructure through borrowing and through their own funds. On the other hand, smaller municipalities are not able to provide funding for economic infrastructure within their boundaries. If this situation continues, service delivery challenges will persist and development will only be concentrated in larger provinces such as Gauteng, KwaZulu-Natal, and the Western Cape.

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