DEPARTMENT of FINANCE
LEFAPHA LA DITŠHELETE
UMNYANGO WEZEZIMALI
DEPARTEMENT van FINANSIES
Office of the Director General ● Kantoro ya Mokaedi Kakaretso
Lhhovisi likaMqondisi Jikelele ● Kantoor van die Direkteur-generaal

X115, PRETORIA, 0001

● Fax (012) 315 5045
● ☎ (012) 315 5154
● Ref FS 2/B
● i T Pillay
● Date 31 March 2000

TO ALL MUNICIPALITIES

Sir/Madam

BUDGET: 2000/2001 FINANCIAL YEAR

Our vision and our commitment are clear, to build a better life for all our people. This is our course. Sustainable growth and development call for on-going structural transformation of our economy so that we can take advantage of the untapped potential in our midst and the opportunities presented by globalisation. Sustainable growth and development also depend on our ability to overcome the scourge of poverty and the deep inequalities that we inherited.

Minister Trevor Manuel
2000 Budget Speech

SUMMARY

After providing some *background*, this circular:

- Provides guidelines for preparing municipal budgets and financial statements in the light of *demarcation*.

- notifies you of the Minister of Finance’s determination under section 10 of the Local Government Transition Act of *maximum expenditure increases* of 5% for each of the capital, special & trust funds, and operating budgets;

- provides an update on the implementation of *GAMAP*.

- encloses and explains the form that should be used for your *return to the Department of Finance* to record your budgeting decisions (as required in section 10 of the Local Government Transition Act) by <u>31 May 2000</u>;

- provides some *general guidelines* for councils to follow in formulating their budgets; and

- notes some *up-coming changes and legislation*.

BACKGROUND

1. The process of transformation and change, as outlined in the White Paper on Local Government, is rapidly unfolding. This will affect all residents, impact on the places where they live and the services they have access to. Local governments should not lose sight of their pivotal role to provide for basic and effective delivery of services to communities across the country. It is essential that individual municipality's finances are sound at all times to be in a position to discharge this mandate. As part of its responsibility in maintaining macro-economic and fiscal stability, the Department of Finance annually determines aggregate guidelines with regard to the capital and operating expenditure of municipalities.

2. During the 1999/2000 financial year, municipal budgeted expenditure increased by 5,5% representing R58,1 billion (1998/99 R54,9 billion). The budgeted capital expenditure remained unchanged at R13,7 billion while the operating expenditure increased by 8% to R44,4 billion. The 1999/2000 municipal budgets amounted to 10% of GDP. Municipal finances therefore have a significant effect on the national economy.

3. In order to finance their operating and capital expenditure, municipalities increased property rates and tariffs by an average of 11.2%. The average monthly householder's account as of 1 July 1999 was R612 per household compared to R551 for 1998/99 (based on 1000m2 land, 1000 units of electricity and 30 kilolitres water usage). Therefore, while expenditures were largely within the 5,5% limitation, rates and tariffs increased at a much higher percentage.

4. Certain negative trends identified during 1998/99 continued during the 1999/2000 financial year in many municipalities. These included significant increases in administrative and personnel expenditure components, the lack of fiscal and financial discipline and the lack of regular internal reporting on actual financial position. Municipal salaries, wages and allowances still absorb a high percentage of total operating budgets.

5. The Municipal Demarcation Board will be announcing new municipal boundaries, with MEC's allocating the powers and functions to Category B and C municipalities and issuing establishment notices in terms of section 12 of the Municipal Structures Act, 1998 shortly. For many municipalities, implementing the new boundaries and adjusting to the changes to powers and functions will impact on the preparation of budgets and financial statements. They will also have to hold Council elections mid-way through the financial year. This circular provides guidance for preparing budgets and financial statements in light of demarcation and elections.

DEMARCATION

6. Municipalities should prepare their 1999/2000 financial statements for existing structures, timeously ensuring that all assets and liabilities are clearly listed in the accounting records and registers. All outstanding financial statements should be finalised before the municipal elections. The registers should be updated monthly thereafter to ensure all necessary information will be available for demarcation implementation later in the year.

7. Municipalities should prepare their 2000/2001 budget based on the 12 months to 30 June 2001 and on existing municipal boundaries. Whenever possible, this budget should be compiled in a format that will facilitate the transition to the newly demarcated municipalities and thereafter, the consolidation of figures. Thus a "holding" budget approach is recommended.

8. Unless your municipality is unlikely to be affected by demarcation, your 2000/2001 budget should primarily be a maintenance budget with no major commitments to new programmes, capital projects or debt obligations. Major new initiatives should be left to the new Councils, which will be elected later in the year.

9. For those municipalities that have already made substantial progress towards amalgamation and institutional reforms, a longer-term focus may be taken in preparing budgets and Councils may also plan to make major revisions to the 2000/2001 budget around January/February 2001 after the new Councils take office.

10. For practical and accountability purposes, as soon as the new Council is elected later in the year, the new Council should consider and approve the existing budgets with minor changes. This will give municipalities sufficient time to begin preparation of the 2001/2002 budgets, taking into account the new Councils' plans and priorities.

11. Municipalities should take advantage of the current information available on demarcation to begin negotiations and consolidation plans with neighbouring municipalities they may amalgamate with. This will assist them to obtain the necessary resources and achieve the necessary consensus with regard to, for example, the allocation of assets and liabilities. Special preparations will be necessary when a municipal area is divided into two or more separate new municipalities.

12. The 2000/2001 financial statements should be prepared on a similar basis as the budget. That is for the full financial year based on existing boundaries, and consolidated thereafter into the newly demarcated structure. For accountability purposes the individual financial statements will be subject to audit by the Auditor-General. A clear audit trail should be documented for the consolidation. The chief executive officer/municipal manager as at 30 June 2001 will remain responsible for timeously obtaining the individual financial statements to be consolidated. The compilation of individual financial statements and the consolidation thereof should be properly planned beforehand as to not cause undue delays. For purposes of the

disclosure in the consolidated income statements, a consolidated budget document, which includes the amendments made by the new Council, should be compiled and linked to the individual approved budgets and amendments in a clear manner.

13. On a cautionary note, salary scale increases, promotions, filling of vacant posts and councillor allowance increases should be cautiously undertaken, if at all, during the period leading up to the elections, with due consideration of budgetary constraints and affordability for the newly demarcated municipalities. Higher increases than the announced 5% in these components will be viewed in a serious light and will be understood to mean that communities serviced by your municipality have access to adequate infrastructure. The Auditor-General will be requested to report on any misuse of funds in this regard.

GAMAP IMPLEMENTATION

14. As most municipalities are aware, a new accounting standard, Generally Accepted Municipal Accounting Practice has been developed for South African local governments. The Department or the to be established Accounting Standards Board will soon set guidelines for GAMAP implementation. Once the guidelines have been established, the Auditor-General will prescribe a new format for financial statements. Our goal is to assist municipalities with full implementation of GAMAP beginning with the 2001/2002 financial year.

15. A number of municipalities have prematurely begun to implement GAMAP, and some have proposed taking advantage of GAMAP to inflate surpluses due to the write-down in statutory fund balances and reversal of excessive provisions. It should be noted that when GAMAP is introduced, there may need to be possible write-offs of irrecoverable debtors' balances and other costs. It is planned that the write-down in statutory fund balances and the reversal of excessive provisions will be used to offset these costs.

16. Therefore, the Department recommends that, although municipalities should prepare for implementing GAMAP, they should continue to prepare financial statements in the currently prescribed formats. Complete asset registers, for example, should be prepared in advance of the implementation of GAMAP.

MAXIMUM EXPENDITURE LIMITS

17. Under section 10(G)(4)(b) of the Local Government Transition Act, Act no 209 of 1993, the Minister of Finance may determine maximum expenditure limits for the budgets or components of such budgets of municipalities for a financial year.

18. In order to maintain macro-economic stability, the Minister of Finance has set the guideline growth rate increases for local government for the 2000/2001 financial year at 5%. As explained below, this 5% limit will apply separately to each of the following:

- capital budget;

- special and trust budget and;

- operating budget.

19. It must be emphasised that the Minister of Finance determines overall maximum expenditure limits for local governments in order to fulfil his task of managing the economy and maintaining fiscal stability. Local governments should operate within these limits.

20. Local governments that can succeed in limiting their expenditure to a level less than the prescribed guidelines should not refrain from doing so out of fear that it will impede their growth in the 2001/2002 financial year. Under appropriate circumstances, and considering the impact of the new structures, the levels of expenditure calculated on the guideline growth rates for 2000/2001 will be used as a base to determine the limits for the 2001/2002 financial year.

21. Under exceptional circumstances an increase above 5% may be considered, provided that –

    (a) reasons for the excesses are advanced, fully explaining and motivating the request;

    (b) the continuation and expansion of essential services on a sustainable basis are thereby promoted; and

    (c) an unreasonable financial burden is not placed on the inhabitants (as reflected by the rates and tariff adjustments according to section E of the attached schedule).

Capital Budget (Maximum 5% Increase)

22. The *relevant capital budget* to which the expenditure limit applies is basic capital expenditure excluding <u>ad hoc</u> expenditure, which is either financed from other government departments (e.g. CMIP funds, grants and subsidies) or complies with paragraph 24 below.

23. The relevant capital budget expenditure limit for 1999/2000 will be used as the basis for the determination of the 5% expenditure limit for 2000/2001. In other words, the relevant capital budget for 2000/2001 should not be more than 5% above the expenditure limit for 1999/2000.

24. Projects intended for the improvement of previously disadvantaged areas, the creation of infrastructure for the provision of essential services, the urbanisation process, housing development and the provision of facilities to provide for community and welfare needs, may be considered for inclusion in the ad hoc category, provided that:

    (a) the remaining projects of the basic capital programme are of fundamental importance for the well-being of the inhabitants;

    (b) the consequential capital charges and other operating costs do not place an unreasonable burden on the residents; and

    (c) full particulars of the financial implications are provided separately in the return form (section F) in respect of each ad hoc project.

Special and Trust Fund Budgets (Maximum 5% Increase)

25. The *relevant special and trust fund budgets* consist of operating expenditure, constituting a direct debit against a reserve or special fund. Capital expenditure cannot be included here and is already included in the relevant capital budget.

26. The relevant special and trust funds expenditure limit for 1999/2000 will be used as the basis for the determination of the 5% expenditure limit for 2000/2001. In other words, the relevant special and trust fund budget for 2000/2001 should not be more than 5% above the expenditure limit for 1999/2000.

Operating Budget (Maximum 5% Increase)

27. The *relevant operating budget* consists of all operating expenditure.

28. The relevant operating expenditure limit for 1999/2000 and the realistically projected income receivable will be used as the basis for the determination of the 5% expenditure limit for 2000/2001. In other words, the relevant operating budget for 2000/2001 should not be more than 5% above the expenditure limit for 1999/2000 taking cognisance of the income collected by council during this period. It is appreciated that extraordinary rapid development will result in greater demands, but resolute steps should be taken to accommodate the operating commitments within the parameters of the 5% limit.

RETURNS TO THE DEPARTMENT OF FINANCE

29. According to section 10(G)(4)(c) of the Local Government Transition Act (Act no 209 of 1993), a council's budget shall be submitted to the Minister of Finance within 14 days from the adoption thereof by the Council for the purpose of monitoring whether the maximum expenditure limits have been complied with.

30. As described below, the returns should be submitted to the Department of Finance before 31 May 2000. Since the Department is not empowered to grant extensions, should it prove to be impossible to meet this deadline, please notify the Department and advise when the submission can be expected. This should be as soon as possible after 31 May. Please notify the Department immediately if your planned timetable changes and will delay the preparation of the budget.

31. The attached schedule must be completed as fully and as accurately as possible as part of the return and sent to the Department of Finance, together with one copy of the Council's budget. You are also requested to submit a copy of the Council's budget to the provincial department responsible for local government for information purposes.

32. All expenditure to be incurred during the 2000/2001 financial year should be included in the return, *irrespective of the source of finance or whether it has been included in a previous budget*. Expenditure financed by grants/contributions received from other government departments, services/district/regional councils, transitional metropolitan councils, town developers and members of the public, must therefore also be included in the budgets. Funds for capital expenditure received from the above sources should be reflected under the capital budget and not as income under the operating budget.

33. The expenditure results for the 1998/99 financial year and the expected expenditure and actual income for the 1999/2000 financial year will be taken into consideration when the 2000/2001 budget is evaluated. It is important that these figures are provided on the attached return form. Also kindly submit a copy of the financial statements for the 1998/99 financial year with the required information.

34. Circular FS 2/B of 26 March 1998 called on Councils to prepare multi-year budgets incorporating their Integrated Development Plans. Councils that have finalised this process should complete the sections pertaining to the 2001/2002 financial year. (See column D on the return form).

35. To expedite the evaluation and finalisation of the budget, care must be taken to ensure that the return form is completed in full and where required, is supplemented by explanations and such additional information as may be of assistance. The motivation should include specific projects that provide evidence of re-prioritisation.

36. Funding of capital projects must be reflected in the return. Confusion has arisen on the interpretation of external and internal loans. External loan financing should be interpreted as loans that will be sourced from private lenders and/or financial institutions. Internal loan financing should be interpreted as loans that are derived from municipalities' internal capital development funds. Loans taken up to reimburse or replenish funds in the Consolidated Loans Fund must be reflected as external loans.

37. Funds received for capital undertakings must not be reflected as revenue in the operating budget but must be included as capital expenditure and reflected under sources of finance.

38. You are referred to paragraph 2.4.2 of the circular FS 2/B dated 3 March 1997 for the raising of loans for capital expenditure. Also attached to this letter is a form that must be completed in respect of each loan application.

39. Should a deficit be reflected in column B of the return's operating account, the source of finance to fund such a deficit must be clearly stated.

40. Clear information regarding the following should also be submitted:

    (i) The tariff structure charged to business, commerce, industry, and householders, together with a breakdown of recoverables and costs relating to economic services (see section H of the schedule).

    (ii) The number of staff in each service component, together with the total costs and the recoverable costs of each component. (See sections H and I of the return).

41. Within the financial year, local governments should monitor their spending closely and incur additional expenditure only if sufficient savings can be achieved elsewhere. However, in exceptional cases a revision of the set maximum expenditure levels will be considered after 7 or 8 months of the financial year has elapsed and on receipt of the following information:

    (a) nature of additional expenditure and reasons,
    (b) total expenditure incurred up to that point in time,
    (c) total income collected up to that point in time,
    (d) expected expenditure for the remainder of the financial year, and
    (e) source of finance for the additional expenditure.

EXPENDITURE: 1998/99 FINANCIAL YEAR

42. It is assumed that your Council's final results for the 1998/99 financial year are already known and that, where necessary, corrective measures to improve in-year budget monitoring and control have been introduced. Please complete the attached form regarding the 1998/99 financial year and return it with a copy of the financial statements and accompanied by an explanation of material over- and under expenditures. The department is not in a position to accept any requests for revision of budgets or to change determinations after the close of the financial year.

GENERAL GUIDELINES

43. The following important issues should also be taken into consideration when compiling the budget:

- Affordability: The effect that increases in tariffs will have on industry, commerce in general and the residents within the municipal boundaries.

- The effect of non-payment on potential income: Despite notice of this matter in previous communications, many municipalities still maintain that 100% of income will be realised. It is suggested that this assumption be reconsidered in the light of trends experienced in the previous year. The Council must ensure that mechanisms are in place that will result in effective metering, billing, cost recovery and credit control.

44. Councils are strongly advised to secure the necessary sources of funding before finalising their budgets.

45. A constant shortcoming in the budgetary process is a failure to provide adequately for a working capital reserve. It is important that a provision for working capital be made in the 2000/2001 operating budget. This should be at least equal to the level of non-payment, during the previous financial year. If this amount exceeds 25% of total income, the Chief Executive Officer should provide reasons to the Department and the Council for not collecting arrears.

46. In order to assist municipalities in addressing the backlog in service delivery, given the financial constraints, Councils should seriously review their activities in terms of their core areas of competency and encourage the involvement of the private sector in performing certain functions.

47. Local Government in general must improve the system of regular internal and external reporting. In order to properly account for its responsibilities to the community, audited financial statements should be presented timeously. The introduction of benchmarks, to compare the outputs of one municipality against another should be undertaken. Improvements in the level of services that lead to improved economies of scales and generally benefit the public must be vigorously pursued. It is also important that Councils regularly inform their communities on progress.

48. Disturbing trends have been noted in the previous financial year regarding

increases in general administration and salary components. It is advised that Councils exercise extreme caution when these components are considered so as not to hinder development and prejudice the financial viability and sustainability of local government.

UP-COMING CHANGES AND LEGISLATION

49. The Local Government Finance Management Bill is now in the final drafting stage. Current plans are to publish the Bill in April/May and then hold several workshops for stakeholder input. The overall approach of the Bill is to enable managers to better manage their jurisdictions by requiring standard accounting practices, a clear and transparent multi-year budget process, and simplified reports (requiring only information they should already be using to manage their organisations).

50. The National Government's 2000 Budget provides for two new conditional grants. A restructuring grant will assist eligible municipalities whose financial status are of such a scale that they pose a significant threat to national economic development. The grant will be funded from the additional local government allocation in the 2000/01 Budget framework. The total envelope for the restructuring grant will be R300 million in 2000/01, R350 million in 2001/02 and R400 million in 2002/03.

51. The other new grant is for financial management capacity. The first stage of this programme will focus on building the financial management capacity of the metros and district councils, as well as the implementation of impending budget reforms. In the second stage of the grant programme, planning and performance management capabilities will be built upon the financial management capacity developed in stage one. The proposed allocation is R50 million for 2000/01, R60 million for 2001/02 and R70 million for 2002/03. Conditions for eligibility can be extracted from the Division of Revenue Bill 2000. More details regarding these and other grants will be provided in a separate circular soon.

CONCLUSION

52. In conclusion, I wish to emphasise that the information called for is required to enable the Department of Finance to perform its responsibilities with regard to the co-ordination and maintenance of macro-economic stability in the country. It remains the responsibility of each Council to determine its priorities and to pro-actively manage its funds throughout the fiscal year, provided that the limits, as determined, are not exceeded.

53. This circular must be brought to the attention of your Council.

Yours faithfully

DEPUTY DIRECTOR-GENERAL: BUDGET OFFICE