NATIONAL TREASURY

MFMA Circular No. 14

Municipal Finance Management Act No. 56 of 2003

2005 Division of Revenue Bill and Municipal Budgets

The purpose of this circular is to provide guidance to municipalities on national priorities and budget allocations announced by the Minister of Finance in the 2005 Budget, which must be taken into account when preparing the 2005/06 municipal budget. This circular also informs municipalities on the legislative commitments arising as a result of the 2005 Division of Revenue Bill, read together with the Municipal Finance Management Act.

This circular should be brought to the attention of the mayor and tabled in the committee(s) responsible for the budget and IDP. Municipalities are required to table multi-year budgets in terms of section 16 of the MFMA, by 1 April 2005. Should any allocations not be included in the budget tabled in April then these should be updated and included, prior to adoption of the final budget for 2005/06. A copy of the tabled budget and adopted budget must be forwarded to National Treasury immediately. This circular should be read in conjunction with the earlier MFMA circulars. Further information will be provided soon on budget documentation, in-year and end-of-year reporting.

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National Budget Highlights

The 2005 National Budget allocates R58,3 billion to municipalities over the next three years, or an additional R5,4 billion over the 2004 Budget baseline allocation. The substantial increase in the local government share is mainly targeted towards provision of free basic services and the extension of services to areas not presently serviced.

The division of nationally raised revenue between the three spheres of government is based on the functional responsibilities and fiscal capacity of each sphere of government, as well as on past and new policy priorities. Out of a total of R417,8 billion available for the 2005/06 Budget, local government receives R17,2 billion. Provinces receive R209,3 billion (primarily for the non-revenue raising functions of school education, social grants and health services), and national government receives R136,2 billion, and R53,1 billion for debt servicing. The Bill

therefore allocates approximately 5 percent of national available resources after debt servicing to local government in 2005/06, compared to 58 per cent for provincial government and 37 per cent for national government.

National allocations are an important source of revenue for municipalities comprising around 14,7% of total local government budgets for 2004/05. The largest allocation for local government is the equitable share allocation of R9,6 billion, which funds the delivery of basic municipal services. The rest of the allocation of R7,5 billion is for conditional grants, mainly the municipal infrastructure grant, targeting infrastructure for water, electricity, sanitation, refuse removal and roads. It also includes an allocation of R1,2 billion for the eradication of the bucket system and replacement with an alternative sanitation system.

A major review of the local government fiscal framework commenced in 2004 with the first part of this review completed in time for the 2005 Budget, including the introduction of a new equitable share grant formula and the phasing out of RSC levies. This review will continue for next years budget, in order to take into account the impact of the restructuring of the electricity distribution industry and the introduction of the new property rating and valuation system (Local Government: Municipal Property Rates Act).

A copy of the 2005 Division of Revenue Bill was emailed to all municipalities on 1 March 2005 and a hard copy of the Budget Review posted to all municipalities. Municipalities are encouraged to distribute the Bill (as approved by the National Assembly), together with Annexure E and chapter 7 of the Budget Review. Once the Bill has been passed by the NCOP and signed into law by the President, a copy of the Act will be emailed to all municipalities and made available on the National Treasury website www.treasury.gov.za/mfma located under MFMA Circular No 14**.**

Municipalities are also reminded to take into account provincial budgets for 2005. These budgets include details of allocations to each municipality for inclusion into the municipalities coming budget. These documents are available on the provincial treasury website or by contacting the relevant provincial treasury direct.

National Transfers to Local Government

National transfers to local government are divided into three major categories, namely:
1. The Equitable Share Grant (together with the water operating grant)
2. Infrastructure conditional grants; and
3. Capacity-Building and Restructuring conditional grants

The total national allocations to local government increase from a revised allocation of R14,8 billion (2004/05) to R17,2 billion (2005/06), R19,7 billion (2006/07) and R21,5 billion (2007/08). This share of revenue raised nationally for local government increases from 4,6% (2004/05) to 5,0% in 2007/08.

All national grants to the local sphere are published per municipality with the 2005 Division of Revenue Bill, for each of the next three years. This is to enable municipalities to prepare and table comprehensive three-year budgets for the coming 2005/06 municipal budget, which in turn allows municipalities to plan more effectively in implementing and executing projects and programmes. The allocations are also provided for the municipal financial year (1 July to 30 June), which is the figure that municipalities should use for their budgets (refer to “municipal year allocations” column).

Note that the allocations in the 2005 Division of Revenue Bill update the figures published in the 2004 Division of Revenue Act, which also include allocations for 2005/06 and 2006/07 ("baseline allocations").

Co operative Relations between Category B and C Municipalities

The equitable share formula generally allocates funds per municipality, metropolitan (category A) local (category B) and districts (category C) municipalities. The formula makes allowance for variations in functions performed between the category B & C municipalities (local and district) with allocations directed to the municipality that carries out that function. For example, though most local municipalities carry out the water function, where such a function is instead assigned to the district municipality, the equitable share formula is used to further break up the allocation into a water component from the local so that it can be transferred direct to the district municipality. It needs to be emphasized that the formula for any allocation is merely indicative, and should generally not be regarded as determining the amount to be spent per function. This is because each municipality may have different needs or backlogs, even though each municipality is required to provide a set of basic services to all residents and customers within that municipality.

Where a district municipality performs a function that would generally be performed by a local municipality, it is incumbent on the district to explicitly reflect resource allocations to that local municipality, and for it to consult and seek approval for projects from the relevant local municipality, and generally transfer funds to it so that it can perform its functions directly. The district municipality is required to build the capacity of weak local municipalities to perform their functions, rather than taking over such functions. Spending on all projects undertaken by a district municipality within that local municipality should be reported on a monthly and quarterly basis to the local municipality. The district must also ensure that expenditure within each local area reflects the allocation that would have gone to that municipality directly in terms of the equitable share or MIG formula.

District municipalities required to allocate funds to local municipalities must provide three-year allocations to each local municipality, in accordance with section 37 of the MFMA and section 24 of the 2005 Division of Revenue Bill. This must be completed by 15 March this year and by 1 March in all future years.

In cases where a municipality performs a function on behalf of another (i.e. the district municipality may act as an agent and provide a service assigned to a local municipality), then both parties should also have a formal Service Level Agreement that clarifies roles, responsibilities and standards of service for such function, and the transfer of any funds between both municipalities for such functions. Refer to the section below on External Service Level Agreements for more information.

1. *Equitable Share Grant*

The unconditional equitable share allocation is the largest and most significant national allocation, in accordance with section 214 of the Constitution, and includes a water operating grant. The biggest reform to the local government grants system in 2005/06 is the adoption of a new local government equitable share formula, which will be phased in over the medium term with full implementation in 2007/08. By introducing a revenue-raising component the new formula addresses concerns about the varying fiscal raising capacities of municipalities. The new equitable share formula is explained in more detail under Annexure E to the 2005 Division of Revenue Bill.

The total equitable share grant will increase by R3,7 billion over the next three years rising from R7,7 billion (2004/05) to R11,4 billion (2007/08). This is in support of the accelerated implementation of free basic services to poor households. All municipalities should continue to prioritise the provision of free basic services to poor households, including better targeting and performance reporting.

The *water service operating subsidy* is closely related to the equitable share grant, although it is conditional and is used to fund over 300 water schemes in municipalities. The grant will increase from R949 million (2004/05) to R1 040 million (2007/08). The Department of Water Affairs and Forestry (DWAF), which has administered a number of these schemes in poorer areas prior to 1994, is in the process of transferring these schemes to the relevant municipalities over the next three years. Subsidies currently going to DWAF will be redirected to municipalities as these transfers occur.

2. *Municipal Infrastructure Grant (MIG)*

The MIG complements the equitable share allocations to give effect to national objectives to:

- expand the delivery of basic services to all households, including the delivery of free basic services to poor households and other poverty alleviating objectives, and;
- stimulate local economic development and job creation over the medium term.

Municipalities are also required to use their capital budgets to promote labour-based infrastructure methods (Expanded Public Works Programme) for projects where this is appropriate. The MIG is a schedule 4 grant in terms of the Bill and allows for more flexibility.

The MIG does <u>not</u> fund specific projects, and national and provincial departments are forbidden from approving projects as this is solely the municipality's power and responsibility and non-compliance with this should be reported to National Treasury. The MIG grant is designed to complement the capital budget of a municipality, rather than funding specific projects. Reporting on MIG therefore focuses on reporting on the <u>entire capital budget</u> of a municipality, as it is not meaningful for any municipality to split their capital budget into a MIG and non-MIG components.

The formula for the MIG grant is the same as last year except for a rescaling of the sectoral weights to facilitate the incorporation of the Integrated National Electrification Programme in 2006/07. A ring-fenced allocation of R1,2 billion over the three years has been introduced for the eradication of the bucket sanitation system. No provision has been made for the SMIF component (for innovation and regional projects) in 2006/07 and 2007/08. Municipalities seeking access to these funds are required to submit applications to Department of Provincial and Local Government.

All municipalities that have been categorised as high and medium capacity (for the implementation of the MFMA) will receive their MIG grants directly, as long as they comply with section 14 of the 2005 Division of Revenue Bill (on tabling of a three-year budget as part of the 2005/06 budget), and adherence to section 37(2) (submitting a detailed three-year capital plan by October 2005 for the 2007/08 and 2008/09 budget). The district municipalities have a responsibility to ensure that low capacity municipalities are supported and will be able to comply in the medium term, and will have to also comply with section 24.

Section 37(2) enables municipalities to receive the MIG grant provided that they prepare sector plans showing how backlogs are being addressed relating to the key sectors such as electricity, water, sanitation, refuse removal, roads and transport. These plans must be

submitted to the national and provincial departments (via the national or provincial treasuries) in order to facilitate co-ordination in service delivery, in accordance with the objective of co-operative governance. The sector plans for electricity will be supplied to the DME, whilst those for water and sanitation will be made available to DWAF etc. Hence municipalities must as part of such co-operative governance, take into account any comments received on their capital budgets, and create the basis for relevant consultation with national and provincial government (in accordance with IDPs, provincial growth development plans, national spatial framework plans, etc). However, municipalities will make the final decisions on its projects and do not require the approval of any national or provincial department for such projects.

The implementation of the Municipal Infrastructure Grant (MIG) commenced in 2004/05 and consolidates all infrastructure grants from national to the local government sphere. The total allocation for the MIG is R5,4 billion (2005/06), R7,5 billion (2006/07) and R8,3 billion (2007/08). It should be noted that the MIG allocation also includes an allocation of R1,2 billion to eliminate the bucket system of sanitation.

The government has also announced further supplementary allocations between all three spheres of government, but from which many municipalities will benefit, including,

- R3 billion for community infrastructure, which has not yet been allocated, but a significant portion is expected to be allocated to municipalities via the MIG, and a further
- R3 billion for public transport infrastructure, which has not yet been allocated, but a significant portion is expected to be allocated to municipalities with stadiums to host the 2010 Soccer World Cup.

To be eligible for direct transfers for these new allocations, municipalities must prepare credible community infrastructure plans in townships and new housing sites, and public transport plans for World Cup bidding cities. Further information on the above funds will be circulated later.

3. *Capacity Building and Restructuring Grant*

The capacity building grants were set up to assist municipalities in building management, planning, technical and financial management skills and capacity for effective service delivery, with the major portion of grants flowing directly to municipalities. These grants total R749 million for the 2005 MTEF and will, subject to a review, be ultimately phased into the equitable share grant after the end of the MTEF. The following programmes are being supported from this grant, namely,

- Financial Management Grant;
- Municipal Systems Improvement Programme, and;
- Restructuring Grant.

Division of Revenue Provisions

In addition to the highlights provided elsewhere in this circular, attention is drawn to further provisions and responsibilities contained throughout the Division of Revenue Bill that impact on municipalities, and are summarised below. All attempts have been made to align the Bill with the other local government legislation.

- Section 9 deals with allocations to public entities for the provision of a municipal service or function – requires service level agreements to be signed by specific dates,

regular reporting between the parties and national treasury, withholding of funds if the parties fail to comply with this section

- Section 14 deals with MIG allocations – describes the transfer mechanisms, requires multi year infrastructure plans and capital budgets
- Section 16 deals with capacity building allocations – consistent with the framework contained in appendix E2
- Section 18 deals with water services operating and transfer subsidies – transfer of water assets and staffing matters
- Section 21 deals with receiving officer in respect of schedule 4 allocation – monthly, quarterly performance reports, and annual plans on outputs
- Section 22 deals with reporting – aligns the reporting requirement with section 71 of MFMA and sets out exceptional cases when funds are stopped or withheld
- Section 24 deals with co operative governance – between category B and C municipalities, sharing of plans, addresses duplication of functions and agreement on operational costs and collection of revenue
- Section 27 deals with annual financial statements and annual reports for 2005/06 - preparation of annual performance management reports for all municipalities in terms of Municipal Systems Act, and aspects of the audit of allocations
- Section 30 deals with internal audit units – requires that national, provincial and local accounting officers regularly report to its audit committee on compliance of the Act
- Section 34 deals with the stopping of allocations – stop the transfer of any allocation on grounds of persistent non compliance of the Act
- Section 37 deals with budgets – draft three year capital plans to be submitted to National Treasury for outer years
- Section 38 deals with unauthorized and irregular expenditure – aligns the provision with the MFMA
- Section 40 deals with transfers to low capacity municipalities – may determine that an allocation or a portion of the allocation be redirected to the category C or the relevant province, for purpose of proper administration, and
- Section 42 deals with the liability of costs incurred in violation of principles of co operative governance – requires effort to settle disputes out of court, costs incurred will be regarded as fruitful and wasteful expenditure and be recovered from the person who caused the organ of state not to comply.

It is important that municipalities comply with the above provisions, as non-compliance with the 2005 Division of Revenue Act may lead to a withholding or stopping of funds to a municipality. It is also important that municipalities comply with the MFMA.

Changes to the Fiscal Framework

Reform of Regional Services Council (RSC) Levies

The Minister of Finance announced in his Budget Speech that the RSC levy will be phased out on 30 June 2006. This is because the RSC and JSB levies are poorly designed and inefficient. National government intends to replace the RSC levy with another tax or grant, after further consultations with affected municipalities. It is the intention to table new legislation with any replacement taxes by the end of 2005. Alternative sources of revenue in the form of a tax or grant are being explored as replacements for revenue currently collected

from RSC levies. Municipalities must however use the next year to prepare for the phasing out of the RSC levy and the phasing in of an alternative.

Consequently, in the transition period and in respect to the 2005/06 budget, municipalities are advised to budget for similar levels of the RSC income over the three years, with an increment in line with the inflation projections. The budget forecasts for 2006/07 and 2007/08 will need to be reviewed when the reforms are finalised. Further transitional mechanisms will be dealt with during the latter part of 2005 and early 2006.

Furthermore, as was signaled in the 2005 National Budget, municipalities are urged to take into account the impact on holding companies when considering imposing regional establishment levies on historical dividends received by holding companies. The collection of RSC levies payable on dividends beyond a reasonable period would result in undue hardship on a number of levy payers (holding companies) and will not fall within the spirit of any sound credit control and debt collection policy. The RSC Act is to be amended to limit retrospective collection of RSC levies in these instances.

VAT Treatment of Grants

With effect from 1 April 2005, all grants to municipalities transferred from national government that are intended for taxable supplies will be zero-rated (input credits may be claimed). Where grants are to be used for non-taxable supplies such grants will be exempted (input credits may not be claimed). All enquiries in this regard should be address to SARS head office for clarification. We will bring any SARS circulars in this respect to the attention of municipalities.

External Service Level Agreements

The delivery of free basic services in areas serviced by Eskom and water boards remains the political responsibility of the relevant municipality, which is also required to fund such services from its equitable share allocation. In spite of the obligation to sign service delivery agreements in terms of previous Division of Revenue Acts and the Municipal Systems Act, most municipalities have failed to prioritise this responsibility for delivery in areas previously served by public entities like Eskom or water boards.

The 2005 Division of Revenue Act provides for funds to be withheld from municipalities failing to finalise such agreements. These agreements are required for category A municipalities by 30 June 2005, 30 November 2005 for all category B municipalities with budgets in excess of R1 billion, and 30 June 2006 for all other category B and C municipalities. Municipalities are cautioned to take this obligation seriously if they do not want part of their equitable share deducted for the provision of such services, as such funds will be transferred to the relevant public entity directly if the municipality is responsible for failing to sign such an agreement. Such role for the municipality is consistent with the service authority role of municipalities, and need not require any changes to the service provider role of a public entity.

However, it is important that in all instances a written *Service Level Agreement* exists between both parties (municipality and service provider). The agreement must clarify the standards of service to be provided by the other party and, importantly, how funds (either own funds or from the equitable share) will be transferred between both. Municipalities should strive to transfer funds timeously and efficiently to ensure that service provision is not compromised. A draft service level agreement is being developed by National Treasury to be signed between municipalities and public entities – this is to prevent a repeat of past

practices which rely totally on expensive and time-consuming legal approaches at the cost of co-operative governance.

Housing, Urban Regeneration and Economic Development

One of the challenges facing many municipalities is to work with provinces in ensuring housing for poor communities. Satisfying the demand for affordable, adequate housing remains a problem, particularly in urban municipalities as a result of accelerating migration from rural to urban areas and the establishment of many informal settlements. A new strategy for the development of sustainable human settlements has been adopted by national government to broaden the range of housing options for poor communities, with an immediate focus on upgrading informal settlements. Further impetus will also be given to the building and construction boom by the urban renewal tax incentive and accelerated investment in low-income housing and municipal infrastructure projects.

Many urban municipalities are prepared to take over the housing function within their municipality, hence section 17 of the 2005 Division of Revenue Bill provides the basis to accelerate the pace of accreditation of such municipalities that want to apply for such accreditation in terms of the Housing Act. The Bill ensures that all provincial housing departments must facilitate such accreditation from 1 April 2005, and ensure that their process must be completed within six months of receiving the application. A copy of the application should be submitted to National Treasury for information.

Macro Economic Trends and Growth Rates

Summary of Growth Rates

	2005/06	2006/07	2007/08
Inflation forecast (CPIX)	5,1	5,0	5,1
GDP Growth	3.9	3,7	4,2
Guideline Growth Limits	5,5	5,0	5,0

Over the medium term, the inflation rate is expected to remain in the target range of 3 to 6 per cent. The **inflation forecast** (CPIX) for 2005, 2006 and 2007 is 5,1%, 5% and 5,1% respectively. Real **GDP growth** for 2005, 2006 and 2007 is expected to be 3,9%, 3,7% and 4,2%, respectively. Individual municipalities will experience different rates of growth due to local factors, however, municipalities should be mindful of the macro economic impact of rapid increases in tariffs and charges. Hence, it is recommended that increases in tariffs and charges remain within the inflation band of between 3 and 6 percent. Municipalities must aim to ensure that revenue projections are accurate, realistic and collectable.

The **guideline growth limits** for municipal budgets for 2005/06, 2006/07 and 2007/08 are 5.5 per cent, 5 per cent and 5 per cent, respectively. This is a guideline, for self-generated revenue sources. It excludes the increased national allocations provided for the purposes of expanding infrastructure and providing basic services to more households. Any increases in municipal rates and tariffs above the guideline growth limits must be fully motivated and explained to the local and business communities. Note that municipalities are obliged to ensure that their budgets are balanced, and all expenditure is fully funded.

The new property rates legislation should NOT be seen as an opportunity to significantly increase the rates-burden on ratepayers. Given that the government is committed to low inflation targets (and hence administered prices), it will be necessary for municipalities to adjust their rates lower to take account of higher property values (for site and building).

Municipalities should be mindful of the overall tax burden and are cautioned against extending property taxes in a manner that may impact negatively on residential, business, agricultural, mining and industrial sectors. Where there is any intent to impose new taxes or extend existing tax instruments municipalities should, prior to implementation of such taxes, prepare an impact analysis for consultation with the community and submit this to the National Treasury.

Implementation of the new property rates legislation will require municipalities to review their entire rating system. Municipalities are strongly advised to consult with national government before finalising their rating schedules in terms of the new Act.

An assessment of the impact of the new property rates legislation on public infrastructure and state-owned properties, particularly those offering local services such as schools, police stations, magistrates courts and public medical facilities will be undertaken. Municipalities are encouraged to be mindful of the broader implications when imposing taxes on public infrastructure, as such action may lead to perverse outcomes that may prove to be more detrimental to the long-term interests of the municipality.

Municipalities are urged to ensure that national economic, tax and fiscal policy objectives are not undermined through excessive municipal charges. The National Treasury will monitor excessive tariff increases over the medium term and will institute appropriate measures, if required. Municipalities are also reminded that section 28(6) of the MFMA prohibits increases in taxes and tariffs during the financial year (i.e. after budget approval) except in terms of a financial recovery plan.

To achieve national objectives, municipalities should also strive to alter the composition of their budgets by spending more on capital and basic services and less on personnel and administration, and improve the quality of spending. Municipalities are expected to maintain a clear focus on expanding infrastructure investments to encourage economic growth potential, adding impetus to the national priorities for improved spending in this area. On the operating side, it is important to continue to strive to achieve efficiency and productivity gains whilst being mindful of the implication that rapid growth in salaries and allowances will mean for service delivery.

Conclusion

When preparing the annual budget, the mayor of a municipality must take into account the national budget, the relevant provincial budget, the national governments fiscal and macro economic policy, the annual Division of Revenue Act and any agreements reached in the Budget Forum. This is in addition to consultation with the community and other stakeholders, including district and all local municipalities within the district.

Municipalities are expected to table credible and sustainable budgets. These multi year budgets should be consistent with the form required in terms of the MFMA and supported by the budget related policies. In this regard, we emphasis the need to ensure that revenue projections are realistic and achievable, allocations from other sources are consistent with the Division of Revenue Act, provincial and district budgets, tariffs are raised taking into account affordability levels of the community, the backlogs in infrastructure are being addressed, whilst maintaining a balance between new and rehabilitation of assets, sufficient provision is made for working capital reserve, administrative overheads are minimized and overdrafts are managed downwards over the next financial year. We also remind councils to ensure that the IDP is revised and linked to resource allocations in the budget.

This circular highlights the key national priorities and provides guidance to municipalities and entities in framing the 2005/06 budget. We remind all municipalities to ensure that they forward a copy of the tabled budget and related policies, together with the appropriate return forms to National Treasury immediately after tabling in Council.

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