

# Introduction

## Introduction

The evolution of a stable and well-functioning intergovernmental fiscal system has been one of the notable successes of South Africa's first decade of democracy. In 1994, South Africa had fragmented administrations designed to spend public resources and deliver services along racial lines. Ten years on, there is a unitary state, nine sound provincial governments and 284 municipalities, whose consolidation and institutional capacity-building are well under way.

The Constitution assigns service delivery responsibilities to the three spheres of government, with the sub-national spheres playing a pivotal role in the delivery of basic services, particularly to the poor. This document assesses the performance of the provincial and local spheres of government in service delivery. It starts with a synopsis of the financial performance of the provincial and local government spheres, and proceeds with an analysis of key provincial functions: like school education, health, social development, agriculture, roads and transport, and housing. It concludes by discussing water and sanitation and electricity, which are mainly provided by local government and are key in the implementation of indigency policies.

*Sub-national governments are key to the delivery of basic and social services*

To provide the context, this introduction outlines key features of the intergovernmental system and fiscal arrangements, highlights key observations in this review and summarises budget reforms of the last seven years.

## The intergovernmental system

South Africa has a unitary system of government, but with strong decentralised features. Some functions are performed exclusively by one sphere of government, but most functions are shared (concurrent) between spheres, mainly in terms of policy-making, legislation, implementation, monitoring and performance assessment.

The big shared functions between national and provincial governments include school education, health services, social security and welfare services, housing and agriculture. National government is largely responsible for providing leadership, formulating policy, determining the regulatory framework (including setting minimum norms and standards), and monitoring overall implementation. Provinces are mainly responsible for the implementation, in accordance with the nationally determined framework. Thus it is provincial departments that have large budgets (for implementing services), while the related national department has a relatively small share.

*There are concurrent functions between national and provincial governments*

*National government's exclusive functions absorb most of the national government budget*

National government's exclusive functions include national defence, the criminal justice system (safety and security, courts), higher education, water and energy (electricity) resources, and administrative functions (home affairs, and the collection of national taxes). These exclusive functions absorb almost the entire national government budget. Provinces' exclusive functions include provincial roads, ambulance services, and provincial planning, among others.

*Municipalities deliver basic services like water, electricity, refuse removal...*

Municipalities are also responsible for both concurrent and exclusive functions, like the provision of water, electricity, refuse removal, municipal infrastructure and emergency services.

*The intergovernmental system applies the constitutional principle of 'co-operative governance'*

The Constitution entrenches 'co-operative governance' but does not specify how this is to be achieved. To increase the efficacy of service delivery, the intergovernmental system is dependent on the proper co-ordination of policy, budgeting, planning, implementation and reporting between the affected spheres, and at technical, executive and legislative levels within a sphere. All spheres of government have to face the challenge of aligning their policy and implementation processes. The following intergovernmental forums all play an important role in shaping policy and decisions on resource allocation:

- Extended Cabinet and the President's Co-ordination Council bring together the national executive, nine premiers and the chairperson of the South African Local Government Association (SALGA) for consultation on the fiscal framework and division of revenue on which medium-term expenditure framework (MTEF) budgets are based.
- The Budget Council and Budget Forum are established in terms of the Intergovernmental Fiscal Relations Act (1997). The Minister of Finance and members of the executive councils who are responsible for finance in each of the provinces constitute the Budget Council. This is the body in which the national and provincial governments consult on: any fiscal, budgetary or financial matter affecting provinces; legislation that has financial implications for provinces; and financial management and monitoring of provinces. The Budget Forum is made up of the Budget Council and local government representatives, and plays a key role in local government fiscal and financial matters.
- MinMECs, which are sectoral policy forums of the ministers and their provincial counterparts.
- Joint MinMECs between selected sectors and the Budget Council.
- There are also several intergovernmental forums, comprising senior officials, which provide technical support to the political forums.

*Key principles underpin the intergovernmental system*

The continuing evolution of the intergovernmental system will always be enriched by clarity and debate about some of its underlying principles. On the basis of the Constitution, various policy documents, legislation and the analysis here, the following could be a point of departure for this debate:

- *Accountability and autonomy:* All governments in the three spheres are distinctive and accountable in their own right, with specific constitutionally defined powers and responsibilities. Each

is accountable to its legislature or council only, and empowered to set its own priorities. The power of national and provincial governments to intervene in other spheres is confined to where a sphere fails an executive obligation.

- *Good governance:* At the heart of good governance is the accountability of political representatives to the electorate and transparent reporting arrangements within and between spheres. This is achieved through: the electoral process; due reporting to national parliament, provincial legislatures and municipal councils; and an effective flow of information. While political executives are responsible for policy and outcomes, accounting officers are responsible for implementation and outputs.
- *Redistribution:* All three spheres have important roles to play in redistribution, but because inequalities are spread across the national spatial economy, the redistribution of resources is primarily a national function. The equitable share formula therefore relies heavily on poverty-related criteria, and the various conditional transfers to provincial and local government focus on the poor.
- *Broadened access to services:* The Constitution and current government policy prioritise service delivery to all South Africans. The responsible spheres are expected to broaden access to services at affordable costs to consumers, designing appropriate levels of service to meet consumer needs, exploring innovative and efficient modes of delivery, and leveraging public and private resources to acquire capital for investment.
- *Revenue-sharing:* The fiscal system takes into account fiscal capacity and the functions assigned to each sphere, with each empowered to determine its own budgets, collect revenue and spend funds. Provinces and municipalities are funded through own revenue, equitable share allocations and conditional and unconditional grants. The grant system must be simple and comprehensive and not compensate sub-national governments, which fail to collect the revenue due to them.
- *Vertical division:* In determining allocations to each sphere, trade-offs are involved between spheres. For this reason, the budget allocation process should be comprehensive, driven by political priorities, and cover all aspects of governance and service delivery. Separate and ad hoc requests for funds fragment budget allocation and undermine the political prioritisation process.
- *Responsibility over budgets:* Each government has the right to determine its own budget, and the responsibility to comply with it. To reduce moral hazard and ensure fairness, national government will not bail out provinces or municipalities that mismanage budgets, nor will it provide guarantees for loans.

## **Intergovernmental fiscal relations**

*The revenue-sharing model takes the fiscal capacities and expenditure assignments of each sphere of government into account*

The Constitution creates three spheres of government with different revenue-raising capacities. These capacities are complemented by intergovernmental transfers to ensure that each sphere has sufficient funds to discharge its expenditure responsibilities. Given the provincial imbalances in income and resource distribution, South Africa's fiscal system is based on a revenue-sharing model, with seven of the nine provinces receiving more funds than they raise, by way of national taxes. Similarly, except for the major urban municipalities, most municipalities are also highly dependent on national transfers, though less so than the provinces.

*The Intergovernmental Fiscal Relations Act shapes the intergovernmental fiscal system*

The Intergovernmental Fiscal Relations Act provides the framework in which revenue-sharing between the three spheres of government must take place. The Financial and Fiscal Commission (FFC), an independent constitutional body, gives advice on the division of revenue process and makes recommendations accordingly. Government must, when tabling the national budget, show how the division of revenue for that year takes into account the recommendations of the FFC. Government's response is captured annually in the explanatory memorandum to that year's Division of Revenue Bill and this fulfils the requirement set out in section 10(5) of the Intergovernmental Fiscal Relations Act.

## **Provincial and local government finances**

Table 1.1 provides the fiscal framework for the 2004 national budget published in the *2004 Budget Review*. The total consolidated national government budget (including debt service costs) for 2004/05 is R368,9 billion. This comprises R327,0 billion in revenue (mainly corporate and personal income tax, value-added tax (VAT), and fuel and excise levies) and borrowing amounting to R41,9 billion, translating to a 3,1 per cent deficit. Before allocating the funds between the three spheres, R50,4 billion is set aside for debt service costs, and R2,5 billion as a contingency reserve. The reserve is for unforeseeable and unavoidable expenditure, emergencies, and also for expenditure items that are not yet included in departmental allocations.

**Table 1.1 Main budget expenditure, 2000/01 to 2006/07**

R million	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
	Outcome			Revised	Medium-term estimates		
National departments	73 178	87 705	99 091	110 494	120 597	131 047	139 677
Provinces	108 899	121 099	136 925	161 476	181 130	199 704	216 344
<i>Equitable share</i>	98 398	107 460	123 457	144 743	159 971	173 852	186 392
<i>Conditional grants</i>	10 501	13 638	13 468	16 733	21 158	25 853	29 953
Local government	5 536	6 520	8 706	12 390	14 245	15 916	17 091
<i>Equitable share</i>	2 415	3 184	4 187	6 350	7 678	8 643	9 365
<i>Conditional grants</i>	3 121	3 336	4 519	6 039	6 568	7 272	7 726
<b>Total allocations</b>	<b>187 613</b>	<b>215 324</b>	<b>244 721</b>	<b>284 359</b>	<b>315 972</b>	<b>346 667</b>	<b>373 112</b>
<i>Percentage increase</i>	10,1%	14,8%	13,7%	16,2%	11,1%	9,7%	7,6%
Contingency reserve	–	–	–	–	2 500	4 000	8 000
<b>Non-interest expenditure</b>	<b>187 613</b>	<b>215 324</b>	<b>244 721</b>	<b>284 359</b>	<b>318 472</b>	<b>350 668</b>	<b>381 113</b>
State debt cost	46 321	47 581	46 808	47 326	50 432	53 986	57 945
<b>Main budget expenditure</b>	<b>233 934</b>	<b>262 905</b>	<b>291 529</b>	<b>331 685</b>	<b>368 904</b>	<b>404 654</b>	<b>439 058</b>
<i>Percentage increase</i>	8,9%	12,4%	10,9%	13,8%	11,2%	9,7%	8,5%
<b>Percentage shares</b>							
National departments	39,0%	40,7%	40,5%	38,9%	38,2%	37,8%	37,4%
Provinces	58,0%	56,2%	56,0%	56,8%	57,3%	57,6%	58,0%
Local government	3,0%	3,0%	3,6%	4,4%	4,5%	4,6%	4,6%

Source: 2004 Budget Review

The vertical division of revenue reflects that national government's role is mainly policy formulation, with provincial and local governments delivering basic and social services, which are largely population driven. The more people in a province or municipality, the more pressure on their budgets, the larger their share of nationally raised revenue.

*There is a relationship between the vertical division of revenue and the functions of each sphere of government*

Expenditure on provincial governments' budgets makes up the largest share of total government expenditure, around 57,3 per cent in 2004/05. This, however, is about to change, with the imminent shift of the social security function to the national sphere. A sizable amount of expenditure will shift with the function. Nevertheless, provinces will continue to play a key role in the delivery of social services, including school education, health (which includes academic and regional hospitals, as well as primary health care), other welfare services, housing and roads. As these functions have limited potential for cost recovery, provinces are largely dependent on transfers from nationally raised revenue.

*Provincial sphere's budget makes up the largest share of total government non-interest spending*

Provincial budgets totaled R186,5 billion in 2004/05, comprising R181,1 billion in national transfers and R5,4 billion in own revenue. The equitable share transfer<sup>1</sup> is R160,0 billion or 88,3 per cent of national transfers while conditional transfers are R21,2 billion or 11,7 per cent of national transfers.

*National transfers finance 97,1 per cent of provincial expenditure*

<sup>1</sup> The equitable share transfer is unconditional and provinces can allocate it at their discretion.

*Local government equitable share is used to equalise for varying municipal fiscal capacities*

Local government generally has more fiscal capacity than provinces, but this varies across municipalities. On average, own revenue finances 90 per cent of municipal expenditure. The remaining 10 per cent is financed by national transfers, mainly through the local government equitable share (53,9 per cent) and conditional grants (46,1 per cent). Property taxes, turnover/payroll regional levies on businesses, user charges (particularly on water, sanitation, electricity and refuse removal) form the bulk of municipal own revenue. However, the efficacy of own revenue collection in some municipalities remains low, often resulting in deficits at the end of the financial year. The deviations between budgeted and actual revenue in the local government sphere are a concern.

*There is a need to improve the efficacy of current municipal revenue sources*

The Municipal Property Rating Act (2004) has the potential to increase the tax base for municipalities. Municipalities, however, will have to proceed with caution when reviewing their property rates, as exorbitant property rates may result in higher levels of disobedience, resulting in turn in a further erosion of their current tax base. The main focus continues to be on reforming the design of current taxes, modernising billing and collection systems, and improving allocative and expenditure efficiency.

*The MFM Act provides for the modernising of budgeting and financial management*

The Municipal Finance Management Act sets the legal basis for modernising budgeting and financial management practices. The Act forms an integral part of the broader local government reform agenda. By placing their finances on a sustainable footing and enhancing accountability, the Act aims to enable municipalities to deliver services to all their residents and clients.

## **Some key pointers**

Based on the trends observed in this review, a number of pointers and lessons become clear:

*Community development and sustainability are still a major issue*

- The building of sustainable communities remains a major issue. While government has contributed to more than 1,6 million housing opportunities since 1994, and provided many social and basic services, the sustainability of some of these communities is still in question.

*The right incentives are necessary for minimising dependency*

- Budget choices must balance effective subsidisation of the poor with creating an enabling environment for sustainable growth and development. It is important to design incentives and benefits that minimise the risk of permanent dependency. The fiscal system must reward institutions and individuals that take responsibility, while addressing real poverty-related needs.

*Performance assessment is a priority*

- There is a need to assess the performance of all critical sectors in the provision of public services in order to improve service delivery. A host of performance and non-financial indicators must be developed to be able to undertake such assessments.

*Local and provincial governments require dedicated capacity-building*

- Both local and provincial governments require dedicated capacity-building support, particularly to strengthen their financial management. The Public Finance Management Act (1999)

(PFMA) and the Municipal Finance Management Act introduce fundamentally new approaches, but their success depends on the ability of the respective spheres and departments to implement them.

- The challenges that confront provinces and municipalities underscore the importance of a well-considered and properly sequenced approach to decentralisation and clearly defined roles and responsibilities. These spheres will perform better if their roles are clearly defined and they are accountable and empowered, but not stretched beyond their capacity. When changes are introduced and new requirements set, the inevitable trade-offs involved and fiscal implications must be carefully considered. *Clarifying the roles and responsibilities of each sphere of government*
- The marked lack of non-financial information and common methodologies for comparisons remain a concern. Where there is information, it is not readily available, indicating that many managers do not fully use the data at their disposal. This information is critical, not only in performance management but also in budget planning, particularly in the design of the equitable share formula to transfer funds to sub-national governments. *Non-financial indicators must improve*

## Budget reforms

Notable reforms have been implemented over the last seven years, including:

- Three-year budgets, which are now being extended fully to local government, including the three-year allocations per municipality, have been published, starting in 2003 with the Division of Revenue Bill. *Multi-year budgets have been extended to municipalities*
- In-year monitoring and reporting on actual spending trends have been legislated and institutionalised through the PFMA, including reporting on conditional grant transfers. There is, however, slow progress in performance monitoring. *Financial monitoring has been institutionalised*
- Strategic plans, revised budget formats and annual reports have been institutionalised, with the aim of strengthening the link between these documents as instruments, which executives can use to account for public expenditures appropriated by Parliament and legislatures. *The link between planning, budgeting and reporting needs to be strengthened*

Going forward, key reforms include:

- Financial management and budget reforms, which are at present being implemented by national and provincial departments, will be extended to the local government sphere, under the auspices of the Municipal Finance Management Act. In this respect, key constitutional amendments to section 139 on stronger intervention mechanisms will apply to municipalities in a financial crisis or emergency. *The MFM Act provides the foundation for budget reforms at local government level*
- In future service delivery measures and indicators will be improved and, together with performance information, will be published on quarterly basis to complement financial information. *Performance measures need special attention*

- Supply chains will be reformed to modernise government procurement practices.

## **Chapter overview**

The 11 chapters of this document provide overviews of trends and analyses of key policy issues and fiscal challenges:

- This introduction covers broad trends in the sectors covered and the main features of the intergovernmental system.
- Chapter 2 provides information on the 2004 provincial MTEF budgets, and also reviews provincial budgets and actual revenue since 2000/01. It shows that the 2004 budgets reinforce the real growth in provincial budgets and expenditure over the past four years. The chapter also notes that the composition of provincial expenditure is changing, with rising shares for non-compensation of employees expenditure. This is being fuelled mainly by: strong growth in social security grant spending; capital expenditure on construction and rehabilitation of public facilities and assets, such as school buildings, hospitals and roads; and rising spending on housing and critical items like textbooks and medicines.
- Chapter 3 outlines trends in local government budgets, providing consolidated information on the 2003-04 budgets.
- Chapters 4, 5 and 6 deal with the key social services sectors: education, health and social development. Provinces play an important implementation role in these sectors, with the policy role residing with national government. The chapters show that the share of social services in total provincial spending is stable at around 82 per cent. However, within social services, the share of social development grows to about 28 per cent in 2006/07, reflecting the impact of the phasing in of the child support extension grant. Each sector's spending grows in real terms.
- Chapter 7 covers agriculture and land. It notes that a substantial share of provincial agriculture expenditure goes to personnel, leaving limited amounts for agricultural extension and other inputs and services. It also notes the rapid progress made on land restitution and the increase in post settlement support under the umbrella of the Comprehensive Agricultural Support Programme.
- Chapters 8 and 9 deal with infrastructure spending, for roads and housing.
- Chapters 10 and 11 cover water and electricity, which are largely shared between local and national governments. Key issues relate to extending these services to all residents and providing free basic services to very poor households. Both chapters examine the price-setting processes in these sectors. The chapter on electricity assesses the impact of the restructuring of the electricity distribution sector on municipalities.



## **Conclusion**

This review underscores that South Africa's intergovernmental system is maturing. With intergovernmental institutions of governance firmly in place, provinces and local governments are better placed to speed up future delivery of critical pro-poor services on a sustainable basis.

Government is currently in the process of reviewing the intergovernmental grants system and their formulae for the 2005 Budget. This process will take account of the functions performed and the fiscal capacity of the three spheres of government. In this regard, government is set to promote greater consistency in its redistribution objectives and in getting the appropriate balance between national grants and cross-subsidisation. One of the major challenges is to improve the quality of both delivery and how it is measured. The present wave of budget reforms seeks to improve efficiency in all components of the intergovernmental system through greater emphasis on expenditure planning, budget execution, reporting on performance and value for money.

