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Introduction

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A remarkable success of South Africa's democracy is the creation and nurturing of an intergovernmental system founded on the constitutional principle of co-operative governance. What has emerged from the former apartheid republic, with its four provinces, three separate administrations under a tri-cameral system, four 'independent' homelands and six self-governing territories, is a stable and well-functioning intergovernmental system. This consists of nine provinces and 284 municipalities, which were rationalised down from 843 in 2000 after re-demarcation.

The functions of post-1994 provinces are different from what they were in the apartheid era

The change has profound implications for the design and functioning of the intergovernmental fiscal system. Constitutionally, the provinces exist as governments with legislative and executive branches that are accountable to their electorates. This is very different from the pre-1994 provinces, which functioned purely as administrations.

Provincial and local governments are key to service delivery

While the Constitution assigns service delivery responsibilities to all three spheres, provinces and municipalities play a key role in implementing pro-poor programmes. It is crucial that they continually improve their service delivery capacity to achieve government's developmental goals.

This year sees separate reviews for provinces and local government

Unlike before, this year the *Review* focuses mainly on the performance of provincial governments in service delivery. As the scope of policies and service delivery matters related to municipalities has grown substantially over the years, a detailed review of local government budgets and expenditure will be published next year.

The *Provincial Budgets and Expenditure Review: 2001/02 – 2007/08* begins by giving an overview of the architecture of South Africa's intergovernmental system, the next part of this chapter. It then presents an analysis of school education, health, social development, agriculture, housing and roads and transport. This is followed by a discussion of cross-cutting spending areas, like personnel, and concludes by providing a consolidated picture of revenue and expenditure trends in provinces for the period 2001/02 through 2007/08.

The South African intergovernmental system

The South African system of government is designed so that certain functions are exclusive (performed by one sphere only), while others are concurrent (shared between different spheres). The Constitution divides functions among the three spheres of government and clearly distinguishes between exclusive and concurrent responsibilities.

Provinces are key implementers of policy in school education, health, social development, housing, roads and agriculture

Concurrent functions include policy-making, legislation, implementation, monitoring and performance assessment. Functions such as school education, health services, social welfare services, housing and agriculture are shared between national and provincial governments. For these functions, national government is largely responsible for providing leadership, formulating policy, determining the regulatory framework including setting minimum norms and standards, and monitoring overall implementation by provincial governments. Provinces are responsible mainly for implementation in line with the nationally determined framework. Provincial departments therefore have large budgets for implementing government programmes, while the national departments have a relatively small share for their functions.

Exclusive functions for provinces include provincial roads, ambulance services and provincial planning

Each sphere of government has specific exclusive functions. For national government, these include national defence, the criminal justice system (safety and security, courts), higher education, water and energy (electricity) resources and administrative functions (home affairs, collection of national taxes). These absorb a large proportion of national government's budget. Exclusive functions for provinces include provincial roads, ambulance services and provincial planning.

National government is now exclusively responsible for social security grants

A major change in the current intergovernmental arrangements is the overall administration of the social security grants function. The function has shifted from being a concurrent function to an exclusive national government function. This is discussed in detail in Chapter 4, which covers social development.

A number of intergovernmental forums play an important role in co-operative governance

The intergovernmental system depends largely on well co-ordinated policy, planning, budgeting, implementation and reporting. This is necessary both within spheres and between spheres and is effected at the technical, executive and legislative levels. The following intergovernmental forums play an important role in co-operative governance and in shaping national and provincial policy and resource allocation decisions:

- Extended Cabinet: This is made up of the national cabinet, premiers of provinces and the chairperson of the South African Local Government Association (SALGA.) It is the highest co-operative governance mechanism, advising the national cabinet when it finalises the fiscal framework and division of revenue, on which MTEF budgets are based.
- The President's Co-ordination Council: This is chaired by the President and comprises the nine provincial premiers, the chairperson of SALGA, and the national ministers responsible for cross-cutting functions such as provincial and local government affairs, public service and administration and finance. Other national ministers may be invited to participate.
- The Budget Council: This is established under the Intergovernmental Fiscal Relations Act (1997). The Minister of Finance and the members of the executive councils (MECs) responsible for finance in each of the provinces make up this body. The national and provincial spheres consult on any fiscal, budgetary or financial matter affecting provinces as well as any legislation that has financial implications for provinces.
- MinMECs: These are sectoral policy forums made up of the national ministers responsible for concurrent functions and their provincial counterparts.
- Joint MinMECs: These are sectoral meetings between selected sector MinMECs and the Budget Council.
- Several intergovernmental forums: These consist of senior officials which provide technical support to the political forums.

The following key principles underpin the intergovernmental system:

Key principles underpin the intergovernmental system

- *Accountability and autonomy:* Each sphere has specific constitutionally defined powers and responsibilities, is accountable to its legislature or council, and is empowered to set its own priorities. The power of national government to intervene in provincial and local government matters, and provincial governments to intervene in local government matters, depends on whether the relevant sphere fails to carry out an executive obligation.
- *Good governance:* Accountability of political representatives to the electorate and transparent reporting arrangements within and between spheres is at the heart of the intergovernmental system. While political executives are responsible for policy and outcomes, the head officials, functioning as accounting officers, are responsible for implementation and outputs.
- *Redistribution:* The three spheres all have important roles to play in redistribution, but because inequalities exist across the country, the redistribution of resources is primarily a national function. Where provinces and municipalities undertake redistribution, the challenge is to do this in line with their fiscal capacity and not to

undermine economic activity and their financial viability. Redistribution among the three spheres is achieved through the process of the vertical division of revenue. Redistribution among provinces and municipalities is effected through their respective equitable share formulae.

- *Vertical division:* Determining allocations to each sphere inevitably involves trade-offs through a comprehensive budget allocation process, driven by political priorities, and which covers all aspects of governance and service delivery. Separate and *ad hoc* requests for funds fragment budget allocation and undermine the political process of prioritisation.
- *Revenue-sharing:* The fiscal system takes into account the fiscal capacity and functions assigned to each sphere. Provinces and municipalities are funded through own revenue collected, 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 revenue due.
- *Broadened access to services:* The Constitution and current government policy prioritises service delivery to all South Africans. The responsible spheres are expected to broaden access to services at affordable costs to consumers, design appropriate levels of service to meet customer needs, explore innovative and efficient modes of delivery, and leverage public and private resources to acquire capital for investment.
- *Responsibility over budgets:* Each sphere of 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 their funds, nor provide guarantees for loans.

Intergovernmental fiscal relations

Each sphere of government has different revenue-raising capacities. This leads to fiscal imbalances among the different spheres. Intergovernmental transfers from nationally raised revenue are used to address these imbalances. Provinces rely on national transfers to enable them to meet their expenditure responsibilities. National transfers make up 97 per cent of total provincial revenue. At the same time, income and resource distribution imbalances that exist between provinces are addressed through a revenue-sharing model.

The Financial and Fiscal Commission oversees the vertical and horizontal division of revenue process

The Intergovernmental Fiscal Relations Act (1997) provides the framework in which revenue is shared between the three spheres of government. The Financial and Fiscal Commission (FFC), an independent constitutional body, oversees the division of revenue process. It also makes recommendations to government for the vertical division of revenue among the three spheres of government and the horizontal division of revenue between provinces and municipalities. When tabling the national budget, government must show how the division of revenue for that year takes the FFC's recommendations into account. Government's response is captured annually in the explanatory memorandum to the Division of Revenue Bill, which meets the requirement set out in section 10(5) of the Intergovernmental Fiscal Relations Act (1997).

Milestones in the evolution of the system

The design of South Africa's intergovernmental system is informed by the Constitution, which, among other things:

- establishes the three spheres of government as distinct, autonomous and interdependent
- assigns powers and functions to the three spheres
- prescribes revenue-sharing arrangements that are supposed to be equitable and transparent.

The first Division of Revenue Act (1998) gave expression to a range of constitutional provisions for South Africa's intergovernmental fiscal system

Immediately after the first democratic elections in April 1994, the executive and legislative arms of the nine provinces started to operate. Fiscally, however, provinces only started to have distinct existence after 1997/98. In 1998, the first formal Division of Revenue Act, which is required in terms of section 214 of the Constitution, was passed. It was accompanied by a memorandum, which explained how government had taken into account each of the factors set out in section 214(2)(a to j) for determining the division of revenue between the three spheres. The memorandum also gave a detailed explanation of the new provincial equitable share formula. That year was a watershed in the creation of the intergovernmental system that was to evolve further, particularly between 2001 and 2004. The conditional grants that have become a key feature of the intergovernmental fiscal transfer system were also introduced then.

Medium-term multi-year budgets replaced incremental budgets in 1998

In 1998, one-year incremental budgeting gave way to the first Medium Term Expenditure Framework (MTEF). This was preceded by a thorough review of spending and service delivery trends in selected sectors, like education and health, and some cross-cutting areas of spending, like personnel. At the same time, the Medium Term Budget Policy Statement (MTBPS) was introduced. This is a pre-budget policy statement, which gets released about four months before the budgets are tabled. Through the MTBPS and three-year rolling budgets, government indicates how it intends using public resources to give expression to its policies. The two mechanisms, now permanent features of the system, allow for early engagement in a debate on the budget before it is formally passed by Parliament.

The financial troubles in some provinces between 1996 and 1998 led to a moratorium on borrowing, with section 100(1)(a) of the Constitution imposed on four provinces

At around the same time, at the Budget Council, a major intergovernmental agreement on a moratorium on borrowing was reached between provinces and national government. The Constitution and the Borrowing Powers of Provincial Governments Act (1996) govern provincial borrowing. In terms of the legal framework, provinces are permitted to borrow only for bridging finance purposes (to cover cash shortfalls within a financial year) and to fund capital expenditure. The moratorium on borrowing was agreed on in the context of the financial difficulties being experienced in Eastern Cape, KwaZulu-Natal and Free State provinces. At the time, provinces had collectively realised a deficit of about R5,6 billion or over 5 per cent of their total revenue. As part of the financial recovery plan, section 100(1)(a) of the Constitution was also imposed on the three provinces, and subsequently on Mpumalanga in 2001. The plan resulted in an excellent recovery in provincial finances, which saw provinces posting a collective surplus of R0,5 billion in 1998/99. Since then, provincial finances have been more sound and sustainable.

The 1999 Budget Council lekgotla laid the foundation for the intergovernmental system to evolve further

In 1999, at its annual lekgotla, the Budget Council adopted a medium-term vision for developing the intergovernmental system for provinces and how they relate to national government.

Notable agreements included that:

- the policy choices in the short and medium term should not foreclose options for further evolution of the intergovernmental system
- service delivery indicators should be introduced and made an integral part of budgeting to reinforce 'value for money' in public finance management
- a regulatory framework for provincial borrowing with clear rules would be developed
- conditional grants and their administration should be reviewed, and
- new own revenue sources should be explored for provinces within the provisions set out in the Constitution.

The Provincial Tax Regulation Process Act was promulgated in 2001

After this lekgotla, the Provincial Tax Regulation Process Act (2001) was promulgated. The Act sets out a framework for provinces to introduce new taxes. A province contemplating a new tax submits a detailed tax proposal developed according to the guidelines that have been agreed to with the Minister of Finance. After examining the proposal and taking account of the recommendations of the Financial and Fiscal Commission, the Minister approves or disapproves the requested tax. Once a particular tax has been approved, it then becomes listed as a generally approved provincial tax. To introduce it, other provinces need only to pass legislation to that effect. So far, only Western Cape has submitted an application for a new tax, in the form of a fuel levy. This is currently being considered.

In relation to borrowing, again at its annual lekgotla in 2004, the Budget Council agreed that the moratorium imposed on borrowing would be lifted. However, provincial borrowing would have to adhere to the following guidelines:

In 2004, the moratorium on borrowing was lifted and tight guidelines were introduced

- All borrowing would be linked to specific infrastructure programmes or projects, which would be considered on their merits
- To the extent that the Development Bank of Southern Africa can provide technical assistance and offer competitive rates, it would be the main lender in the initial years
- Provinces would not encumber any specific revenue stream for any funds borrowed, and
- The total amount of funds each province is allowed to borrow would be determined by its capacity to raise its own revenue, as well as the amount of funding it receives in the form of national infrastructure grants to provinces.

To date, no province has borrowed under the recently agreed framework.

Provincial government finances

Table 1.1 provides the fiscal framework for the 2005 National Budget published in the *2005 Budget Review*. The vertical division of revenue reflects national government's policy role, and provincial and local governments' implementation role in service delivery. It is determined by the functions of each sphere, target population, inputs required for policy implementation and the fiscal capacities of each sphere.

At 57,7 per cent in 2005/06, the provincial governments' budget makes up the largest share of total government expenditure and reflects this sphere's key role in the delivery of social services, including school education, health (academic and regional hospitals, as well as primary health care), social welfare services, housing and roads.

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

Provincial budgets totalled R215,2 billion in 2005/06, comprising national transfers of R209,3 billion (97,3 per cent of total provincial revenue) and own revenue of R5,9 billion. Provinces also budgeted for a surplus of R1,4 billion in 2005/06. The equitable share transfer, which is unconditional, with provinces having discretion on how it is allocated, is R134,7 billion or 64,4 per cent of national transfers. Conditional transfers are R74,6 billion or 35,6 per cent of national transfers.

National transfers finance 97,3 per cent of provincial expenditure

Table 1.1 Main budget expenditure, 2001/02 to 2007/08

R million	2001/02	2002/03 Outcome	2003/04	2004/05 Revised estimate	2005/06	2006/07 Medium-term estimates	2007/08
State debt cost	47 581	46 808	46 313	48 901	53 125	56 603	59 381
Non-interest expenditure	215 324	244 721	282 349	321 212	364 694	399 790	435 513
Percentage increase	*14,8%*	*13,7%*	*15,4%*	*13,8%*	*12,9%*	*9,1%*	*8,0%*
Total expenditure	**262 905**	**291 529**	**328 662**	**370 113**	**417 819**	**456 393**	**494 894**
Percentage increase	*12,4%*	*10,9%*	*12,7%*	*12,6%*	*12,9%*	*9,2%*	*8,4%*
Contingency reserve	–	–	–	–	2 000	4 000	8 000
Division of available funds							
National departments	**87 705**	**99 091**	**108 459**	**121 101**	**136 262**	**146 800**	**157 817**
Provinces [1]	**121 099**	**136 873**	**161 494**	**185 354**	**209 273**	**229 282**	**248 236**
Local government [1]	**6 520**	**8 759**	**12 396**	**14 757**	**17 159**	**19 708**	**21 461**
Total	**215 324**	**244 722**	**282 349**	**321 212**	**362 694**	**395 789**	**427 513**
Percentage shares							
National departments	40,7%	40,5%	38,4%	37,7%	37,6%	37,1%	36,9%
Provinces	56,2%	55,9%	57,2%	57,7%	57,7%	57,9%	58,1%
Local government	3,0%	3,6%	4,4%	4,6%	4,7%	5,0%	5,0%

1. Includes conditional grants.

Chapter overview

The nine chapters provide overviews of trends and analyses of key policy issues and fiscal challenges:

- This *Introduction* covers the main features of the intergovernmental system and introduces the sectors covered in this *Review.*
- *Chapters 2, 3 and 4* deal with the key social services sectors: education, health and social development. Provinces play a key delivery role in these sectors, while national government takes responsibility for the policy function. Overall, the chapters show that while the share of these services in total provincial spending is stable at around 82 per cent, within social services the share of social development grows to 34,3 per cent in 2007/08. Each sector's spending does, however, grow in real terms.
- *Chapter 5* introduces government's new vision for housing delivery and highlights alternative approaches to housing which seek to create sustainable communities.
- *Chapter 6* covers agriculture and land. The chapter identifies critical interventions required by provinces to reduce their share of personnel expenditure to provide vital services for supporting and developing commercial and subsistence farmers. It looks at the impressive and rapid progress made in land restitution. The chapter highlights the steps taken to provide agricultural support to beneficiaries of the land reform programme.

- *Chapter 7* deals with roads and transport. Although budgets for such infrastructure are increasing, they still exceed the spending capacity of these departments. The chapter emphasises the need for more effective intergovernmental co-ordination. It also examines public transport and road safety.
- *Chapter 8* looks at provincial personnel matters. These include employment trends, particularly in the social services sector, and the distribution of senior management personnel across provinces.
- *Chapter 9* provides information on the 2005 provincial MTEF budgets, and also reviews provincial budgets and actual revenue since 2001/02. It shows that the 2005 budgets reinforce the real growth in provincial budgets and expenditure, which started in the last four years.

An Annexure setting out provincial government financial information is attached at the back of the *Review*.

Some key pointers

Some observations emerging from the sector chapters point to the following:

- *The need to improve infrastructure delivery in provinces.* While provincial capital spending has grown sharply over the past few years, delivery mechanisms have not been matching these growing trends. There is thus a need to institutionalise good practices in provincial infrastructure planning, budgeting and implementation. In addition, a framework is needed for planning, financing and executing big economic infrastructure projects that have great spill-over effects for more than one sphere of government.

Planning, budgeting and execution of infrastructure projects need to be refined

- *Building sustainable communities is still a major issue.* While government has contributed to more than 1,8 million houses since 1994, and provided many social and basic services, the sustainability of some communities is questionable.

Community development and sustainability are priorities

- *Poor budget planning and spending capacity continue to slow down service delivery.* Provincial budgets often show clear intent to address backlogs and poverty alleviation, but poor budget planning and spending capacity often means that these intentions are not realised. This is particularly true of poorer provinces.

Not all intentions lead to the desired outcomes

- *The re-emergence of sizeable unallocated funding in provincial budgets is a concern.* These funds have been given various names in different provinces, such as poverty relief funds or economic development funds. They often undermine the integrity of the budget process as they break the link between priority setting, the vertical division of revenue and budgets. In many instances they lead to major underspending.

There are sizeable unallocated funds in provincial budgets

Performance assessment is necessary for improving service delivery

- *Performance assessment*: there is a need to assess the performance of all critical sectors in the provision of public services to improve service delivery. Performance indicators must be developed for undertaking this kind of assessment.

Non-financial indicators must improve

- *The marked lack of non-financial information and little common methodology for comparisons continues to be a problem.* Where information is available, it is not readily available, suggesting that many managers do not fully use such data. This information is critical, not only for performance management but also for budget planning, particularly in the design of the equitable share formula to transfer funds to sub-national governments.

Conclusion

This *Review* shows South Africa has a well-functioning intergovernmental fiscal system designed to ensure the efficient use of resources in delivering public services, particularly to the poor. It also notes that while there has been good progress in stabilising provincial finances, more work lies ahead for improving the quality of service delivery.