4. INTERGOVERNMENTAL FINANCE

INTERGOVERNMENTAL BUDGETING[1]

The Constitution establishes national, provincial and local government as autonomous spheres which are "distinctive, interdependent and interrelated." It identifies functional areas of concurrent and exclusive competence. In order to give effect to the requirements of the Constitution, budgetary procedures and other institutional arrangements have undergone dramatic changes. Budget-making is the responsibility of all three spheres of Government.

Revenue sharing

The Constitution requires that nationally raised revenues be divided equitably between the three spheres of government, and that the provincial share be divided equitably between the nine provinces. In addition to their equitable shares, provinces and local government also receive grants from the national share. National norms and standards may apply to provincial spending out of the equitable share, and grant funds may be subject to conditions. These allocations to the spheres must take into account the recommendations of the Financial and Fiscal Commission (FFC) and criteria detailed in section 214(2) of the Constitution.

Revenue sharing is necessitated by the constitutional assignment of revenue-raising and expenditure responsibility. Most of the revenue is raised nationally. Although the provinces have significant expenditure requirements, they have only limited revenue sources. The equitable division of national revenues between the three spheres of government gives each the funds to provide the services and perform the functions assigned to it under the Constitution, given each sphere's ability to raise its own revenues to pay for these activities.

Objective formulae

The provincial and local government equitable shares are further divided according to objective formulae after the recommendations of the FFC have been taken into account. The provincial formula allocates funds between the provinces according to their demographic and economic profiles, taking account of the services – primarily health, welfare and school education – for which provinces are responsible. The local government formula is designed to enable municipalities to deliver a package of basic services to low income

[1] The Intergovernmental Fiscal Relations Act requires a memorandum explaining the division of national revenues between national, provincial and local government. That memorandum is included as Annexure E.

households at affordable cost. Both formulae have a strong equity component, recognising the special needs of poorer areas.

Consultation and legislation

Intergovernmental budgeting is evolving to meet the requirements of the Constitution and the demands of transformation. The role of intergovernmental forums and task teams established to coordinate national financial planning, fiscal policy and the decentralised decision-making process has been strengthened. This active consultative process gives effect to the Constitution's call for cooperative governance and remains the key to the success of the intergovernmental financial system. Multi-year budgeting was introduced in 1997 in the national and provincial spheres to improve the integrity of spending plans by establishing a budgetary framework that calls for assessing in advance the medium-term financial implications of policies and programmes. Local governments will apply multi-year budgeting from the 1999/2000 financial year. Legislation was enacted in 1997 consistent with constitutional requirements, giving more form and substance to the intergovernmental budget process. Further legislation is anticipated in the coming year.

CO-OPERATIVE GOVERNANCE AND BUDGETING

Intergovernmental consultation

One of the key successes of the 1998 budget process was the extent to which it gave effect to the principle of cooperative governance under the Constitution. Numerous consultations took place with the provincial and local spheres of government through forums and meetings before the final budget allocations were made. The process of budgeting for 1998/99 started in April 1997.

Lekgotla

For the provinces, the consultation began with a two-day lekgotla (strategic planning session) of the Minister of Finance and his provincial counterparts as well as national and provincial treasury officials. The lekgotla adopted a strategic approach to provincial budgeting, accepting the medium term expenditure framework (MTEF) as the basis of provincial budget planning. A revised equitable shares formula was adopted for purposes of calculating the initial indicative allocations to provinces. The process of implementation began after Cabinet accepted these proposals. At least ten meetings of the Minister and his provincial colleagues were held in 1997 and 1998 prior to Budget Day, in addition to the numerous technical meetings and bilaterals between officials of national and provincial departments.

SALGA

The 1998 Budget is also the first to cater for an equitable share to local government. The Minister held two meetings in 1997 with the South African Local Government Association (SALGA), the organisation representing organised local government. In February 1998, a meeting of the Budget Forum, comprising the Minister of Finance, SALGA and provincial finance MECs was held to discuss the local government equitable share.

Intergovernmental Forum

The Intergovernmental Forum which includes Premiers, Cabinet members, provincial MECs and SALGA was consulted. Cabinet also included Premiers in a meeting to discuss provincial MTEF allocations. In other cases, meetings of Ministers and provincial MECs were held jointly with Finance and other departments, including the Departments of Education, Health, Welfare and Local Government, to coordinate budget allocations with policy goals. Throughout the entire process, consultations also took place with the FFC.

While the consultation that has taken place far exceeds that required by the Constitution, it must be pointed out that all intergovernmental forums are advisory bodies and can only make recommendations. The national Cabinet decides on the final allocations between the three spheres of government and presents these in the form of the Budget for parliamentary approval.

Realistic budgets

Government has adopted an approach aimed at improving the integrity of the fiscal process and promoting realistic budgets at all levels. Under the new system, each of the provinces and municipalities will draw up their own budgets, after taking into account allocations from national government, own revenue and authorised borrowings, and other transfers. Each government in every sphere is expected to live within its enacted budget consistent with the understanding that budgets are law.

Finance legislation

Cooperative governance has been given effect through the enactment of legislation required by chapter 13 and other sections of the Constitution.

Financial and Fiscal Commission Act

The Financial and Fiscal Commission Act gives purpose to the requirements relating to the FFC under section 220 of the Constitution. The FFC is an advisory body, accountable to Parliament, that makes recommendations and gives advice on financial and fiscal matters to organs of the state in the three spheres of government.

The FFC was originally established in terms of the interim Constitution and has contributed significantly to the development of the intergovernmental system. Its recommendations for the division of resources between the three spheres of government form the basis of the current allocations. More recently, the FFC has made recommendations regarding the establishment of the local government equitable share.

Intergovernmental Fiscal Relations Act

The Intergovernmental Fiscal Relations Act, which took effect on 1 January 1998, establishes a formal process for considering intergovernmental budget issues. The Act is designed to facilitate and regulate a process of consultation to promote a budget-making process that is fair.

The Act gives effect to section 214 of the Constitution by setting out the process to arrive at the equitable share of revenue raised nationally for the national, provincial and local spheres of government. This includes the equitable division of the provincial share of that revenue among the provinces and any other allocation that may be made to provinces and local government.

Under the Act, the budget process begins with the FFC making recommendations on these allocations 10 months before the start of the financial year. The Minister of Finance is then required to consult with the provinces, local government and the FFC concerning these proposals. The Act establishes the Budget Council and Budget Forum to facilitate consultation with provinces and local government, respectively. These consultative bodies discuss a wide range of fiscal, budgetary, legislative and financial matters.

The Act requires the Minister to table the Division of Revenue Bill at the time of the Budget, specifying the allocations to each sphere and the conditions that may apply to any of these allocations. In addition, the Division of Revenue Bill is to be accompanied by a memorandum that explains any assumptions and formulae used in arriving at the allocations as well as how they incorporate constitutional requirements and the FFC's recommendations.

The 1999 Budget will be the first budget guided fully by the requirements of the Intergovernmental Fiscal Relations Act. Preparation of the 1998 Budget, which began in April 1997, followed a slightly different process from the one outlined in the Act, as the Act was only passed in November 1997.

Treasury Control Bill

The coming parliamentary session will consider a new Treasury Control Bill. This bill, which has yet to be finalised and approved by Cabinet, is aimed at improving financial management within the public sector as a whole. It will apply to all spheres of government. The Bill will provide for the establishment of the National Treasury to determine and monitor the implementation of treasury norms and standards regarding the use of public funds.

Amongst other provisions, the Treasury Control Bill will give the Treasury the responsibility to:

- design and enforce an optimal system of cash management;
- regulate, amongst other things, the tabling of estimates of expenditure;
- set standards for financial reporting and accountability; and
- tighten the rules that allow for the shifting of funds within votes.

Other legislation

While the Government accepts that expenditure accountability should in principle be matched by taxation powers, it is aware of the potentially disruptive effect subnational taxation powers may have on national macroeconomic policies. Following a decision of the Budget Council, the Commission of Inquiry Into Certain Aspects of the Tax Structure of South Africa (Katz Commission) is preparing a report on the tax powers of provinces in order that legislation regarding provincial taxation powers, as required by the Constitution, can be formulated.

New challenges

As expected, the new intergovernmental budgeting system throws up new challenges and problems. These include the development of an information and reporting system to promote more effective financial management, co-ordination of budgeting and policy-making, and the need to build capacity, particularly at the sub-national sphere of government.

Many of the problems arising in 1997/98 can be attributed to the weak management systems which are not geared for a decentralised system, and a lack of capacity, particularly in the poorer provinces and municipalities. There was also considerable uncertainty arising from the implementation of the new Constitution, the shifting of functions between spheres and the evolution of the intergovernmental financial system in general. These issues are being addressed in the cooperative structures established in terms of the Intergovernmental Fiscal Relations Act.

RESOURCES AVAILABLE

Vertical division

Sharing of resources

The total pool of resources to be shared by the national, provincial and local spheres of government over the coming three financial years is based on projections of how the economy will perform over the medium-term.

Although the emphasis in the Constitution falls on the sharing of nationally raised revenues, government also borrows to meet its expenditure requirements. The budget deficit is therefore taken into account when the resources are divided between the three spheres. Further, mandatory obligations including debt service costs and standing appropriations are set aside before the division is made, as is a reserve to cope with the uncertainties that confront medium-term planning. Thus the total divided is revenue plus the deficit, less debt service costs, standing appropriations and a reserve.

Distinctive functional responsibilities

The *vertical division* or sharing of funds between the three spheres of government allocates funds so that each sphere of government is able to provide the services and perform the functions assigned to it under the Constitution. Provinces spend approximately 85 per cent of their budgets on three functions – primary and secondary education, health and welfare – while the delivery of services such as defence, police and foreign affairs are the responsibility of the national government. Local government is responsible for the provision of municipal infrastructure and the provision of electricity and water reticulation, sanitation services and refuse removal.

The allocations also take into account each sphere's ability to raise its own revenues. Local government, which is largely self-supporting, gets a much smaller share than the provinces, which presently have limited sources of own revenue available to them.

An extensive process was followed in arriving at these numbers. National and provincial governments first received indicative allocations for the 1998/99 to 2000/01 period in May 1997, nearly eleven months before the start of the financial year. The implications of the allocations were reviewed and analysed as part of the MTEF process and discussed in intergovernmental forums. Account was taken of the FFC's recommendations, including those related to local government.

The equitable shares for 1998/99 contained in the Division of Revenue Bill and the MTEF allocations for the subsequent two years are summarised in Table 4.1. The provincial equitable share has to be further divided between the nine provinces, while the local government share has to be allocated to approximately 850 municipalities.

Table 4.1 Division of resources between the spheres

R million	1998/99	1999/00	2000/01
National share	78 457	84 608	91 722
of which:			
*National departments**	*69 434*	*76 885*	*84 077*
Identified conditional grants to provinces	*9 023*	*7 723*	*7 644*
Provincial equitable share	79 117	81 642	86 684
Local government equitable share	1 024	2 316	2 542
Debt service and standing appropriations	42 570	45 050	48 060
Contingency reserve	1 000	3 000	7 000
Total	202 169	216 616	236 008
less: recovery from pension funds	*-870*	*-920*	*-960*
Total expenditure	**201 299**	**215 696**	**235 048**
Addendum:			
National departments, excluding estimated provincial share of improvements in conditions of service	67 131	71 563	75 856
Provincial share, plus identified conditional grants and estimated improvements in conditions of service	90 443	94 687	102 550

** Includes conditional grants to local government, allocations such as improvements in conditions of service and other grants where the provincial or local government shares have not yet been finalised and funds to be transferred on an agency basis.*

Conditional and unconditional grants

In addition to their equitable shares, the Constitution provides for transfers to provinces and local government out of the national equitable share of revenue. These grants can be assigned for particular purposes. This differs from the equitable share allocation, over which the provinces and local government have discretion.

Grants from the national share are intended to ensure that cross border services are properly financed and that national priorities are appropriately reflected in provincial and local government budgets. Where particular services are of a specialised nature and serve a wider constituency than a single province or municipality, there is a case for national government support, in the form of a grant which will usually be conditional. Conditional grants should reflect agreement between the national government and a province or local government.

Conditional grants to provinces, as detailed in Table 4.2, in 1998/99 include:

- R4 434 million to support various health-related programmes, including R3 021 million for central hospitals in four provinces, R1 060 million to support medical training, R300 million for hospital construction in the Eastern Cape and KwaZulu-Natal and R 53 million to promote tertiary health services in provinces lacking such facilities.

- R2 800 million supplementary allocation to provinces, conditional on the enactment of credible budgets conforming to national legislation and treasury norms and standards;
- R1 132 million for supporting local government, composed of R951 million to fund provinces with so-called R293 (former bantustan) towns and R181 million to deal with municipalities experiencing transitional difficulties as a result of the phasing in of the new local government equitable share formula. Both of these grants are for one year only, and will become part of the equitable share to local government in 1999/00;
- R657 million for RDP-related programmes, of which R526 million is for the primary school nutrition programme; and
- A portion of the R400 million set aside on the budgets of the Departments on State Expenditure, Education and Welfare to address management and administrative needs. The provincial share of these funds will be determined later in the year.

Table 4.2 Provincial allocations for 1998/99

R million	Equitable share	Conditional Grants				Total
		Supplementary Allocation	Health Services*	Local Government**	Other	
Eastern Cape	14 073	503	148	173	119	15 016
Free State	5 432	189	308	39	36	6 003
Gauteng	11 701	408	1 910	27	49	14 095
KwaZulu-Natal	15 508	562	729	592	238	17 628
Mpumalanga	5 213	192	21	45	36	5 507
Northern Cape	1 964	64	21	6	9	2 064
Northern Province	10 424	378	21	135	108	11 066
North west	6 837	236	21	86	36	7 216
Western Cape	7 965	270	1 202	30	26	9 492
Unallocated	0	0	53	0	0	53
Total	**79 117**	**2 800**	**4 434**	**1 132**	**657**	**88 140**

Note: The total excludes improvements in conditions of service and other conditional grants where the provincial allocation has not yet been finalised. It also excludes payments for services rendered on an agency basis on behalf of national government.

**Includes R200 million that will be voted as part of the supplementary estimate.*

*** Includes R951 million allocated to R293 towns in Eastern Cape, Free State, KwaZulu-Natal, Mpumalanga, Northern Province and North West and R181 million to the provinces for allocation to local authorities to adjust to the new local government equitable share formula. These amounts will form part of the equitable share for local government from 1999/2000*

The total of R88 140 million above includes identified conditional grants. If the estimated provincial share of improvements in conditions of service were included in the provincial budgets, the total would be R90 430 million. These figures are presented in detail in Table 6.3 in chapter 6. The actual amount to be allocated to each province for improvements in condition of service will be determined later in the year and voted as part of each province's adjustments estimate. Other funds will also flow to the provinces from the national share, but some of the amounts, such as the R2 880 million allocated to provincial housing authorities, are not appropriated as part of the provincial budgets.

Apart from its equitable share and the indirect funding of R1 132 million from provincial government, local government will receive R583 million in 1998/99 for the consolidated municipal infrastructure programme. Further capital grants of R716 million will be made from the vote of the Department of Water Affairs and Forestry. Other grants include R1 189 million for bus subsidies, R419 million for urban renewal, R130 million for settlement of outstanding debts, and at least R79 million of other subsidies from various national departments.

Own Revenue

The Constitution provides for certain provincial and municipal tax powers in terms of sections 228 and 229. The national government intends to regulate these powers in order to ensure that provincial and municipal tax measures do not undermine macroeconomic policy objectives.

Once Katz Commission has submitted its report on provincial tax matters, Government will prepare firm proposals and table the necessary legislation. The Departments of Finance and Constitutional Development have agreed on a process to reform the revenue sources of local government. The emphasis is currently on improving the collection of revenue derived from existing sources.

Currently, provincial own revenue, collected primarily from user charges such as motor licences and hospital fees, accounts for less than five per cent of their total budget.

Municipalities generate revenue equivalent to approximately 90 per cent of their budgeted expenditure. In 1997/98 local government tax revenue amounted to R10,1 billion, while gross revenue from user charges was R20,4 billion. Property taxes, user fees and regional services council levies are the principal municipal revenue sources.

Provincial and municipal borrowing

The Constitution allows provinces and municipalities to borrow for capital and bridging finance, subject to regulation by national government. The Borrowing Powers of Provincial Governments Act of 1996, regulates provincial borrowing, while the Local Government Transition Act (LGTA) does so for local government.

Provincial borrowing

Although the Budget Council agreed that provinces would not borrow in the 1997/98 and 1998/99 financial years, a number of provinces utilised overdrafts with commercial banks to address cash flow shortages. The concern arises that provinces may end up using private credit facilities for more than bridging purposes. The Budget Council intends to review the Borrowing Powers of Provincial Governments Act and to develop a framework to regulate this practice in line with the Constitution.

Municipal borrowing

In contrast, municipalities have been allowed to borrow for capital expenditure, given the significant extent of their revenue. Municipalities are not allowed to borrow to fund their operational budgets, except for bridging finance. Budgeted municipal borrowing for the 1997/98 financial year amounts to approximately 15 per cent of total budgeted expenditure. Most of this borrowing is from the Development Bank of Southern Africa and short term loans.

Private sector involvement in municipal lending remains limited. Amongst other factors, municipal defaults and improper financial management have contributed to the reluctance of the private sector to participate in financing local government. The Department of Finance has commissioned an investigation to focus on the borrowing powers of municipalities and their relationship with creditors. The investigation will culminate in the drafting of policy and a regulatory framework that will clarify the overall municipal borrowing environment and the role of concessional loan financing. This process is intended to facilitate the emergence of a stable and active market for municipal debt.

In the meantime, regulation to govern municipal borrowing in the interim will shortly be gazetted in terms of the Local Government Transition Act.

PROVINCIAL SHARES AND BUDGET ISSUES

Provincial horizontal division

Provincial shares

The division of the provincial equitable share between the nine provinces is known as the *horizontal division.* It is calculated using a formula that directs funds to provinces based on their demographic and economic profiles. The provincial equitable shares formula draws on the recommendations of the FFC, and has been updated to reflect new census data and other information. The full details of the formula are discussed in Annexure E.

The revenue sharing formula represents a break from historical funding patterns, redistributing resources to ensure funds are available to support the equitable provision of provincial services. The formula includes specific components to take account of the demand for services such as education, health and welfare. The education component, for instance, reflects the number of school-age children and the number of those actually enrolled. Similarly, the welfare component is based on the proportion of the population eligible for social security benefits, such as the elderly who qualify for old-age pensions and children up to age six, who are eligible for the new child welfare grant.

These elements of the equitable division formula are neither indicative budgets, nor conditional allocations to the provinces. Provinces budget for these functions within their overall available resources, informed by their own prioritisation of spending within the context of national policies. This ensures that each province has both the budgetary responsibility and the flexibility to provide basic services and perform the functions allocated to it under the Constitution.

Redistribution

The revenue sharing formula yields a distribution across the provinces that differs from the current distribution of funds. Government has agreed that the new shares will be phased in over five years – that is, by 2002/03. As Table 4.3 illustrates, in moving from the current shares to the target shares, Gauteng, KwaZulu-Natal and Mpumalanga gain in relative terms.

Table 4.3 Impact of equitable shares formula

	Budget shares 1997/98	Target shares 2002/03	Percent change
Eastern Cape	17,9%	16,9%	-5,6%
Free State	6,9%	6,6%	-4,5%
Gauteng	14,8%	16,2%	9,2%
KwaZulu-Natal	19,1%	20,3%	6,3%
Mpumalanga	6,3%	7,6%	19,6%
Northern Cape	2,6%	2,3%	-11,9%
Northern Province	13,6%	12,5%	-8,5%
North West	8,7%	8,2%	-6,2%
Western Cape	10,1%	9,6%	-4,9%
Total	**100,0%**	**100,0%**	

Note: The "equitable shares" exclude other unconditional and conditional grants to the provinces from the national share.

Per capita shares

Figure 4.1 below illustrates the equitable allocations on a per capita basis (using current population estimates), excluding conditional grants, in 1997/98 and 2002/03, expressed as percentages above or below the national average.

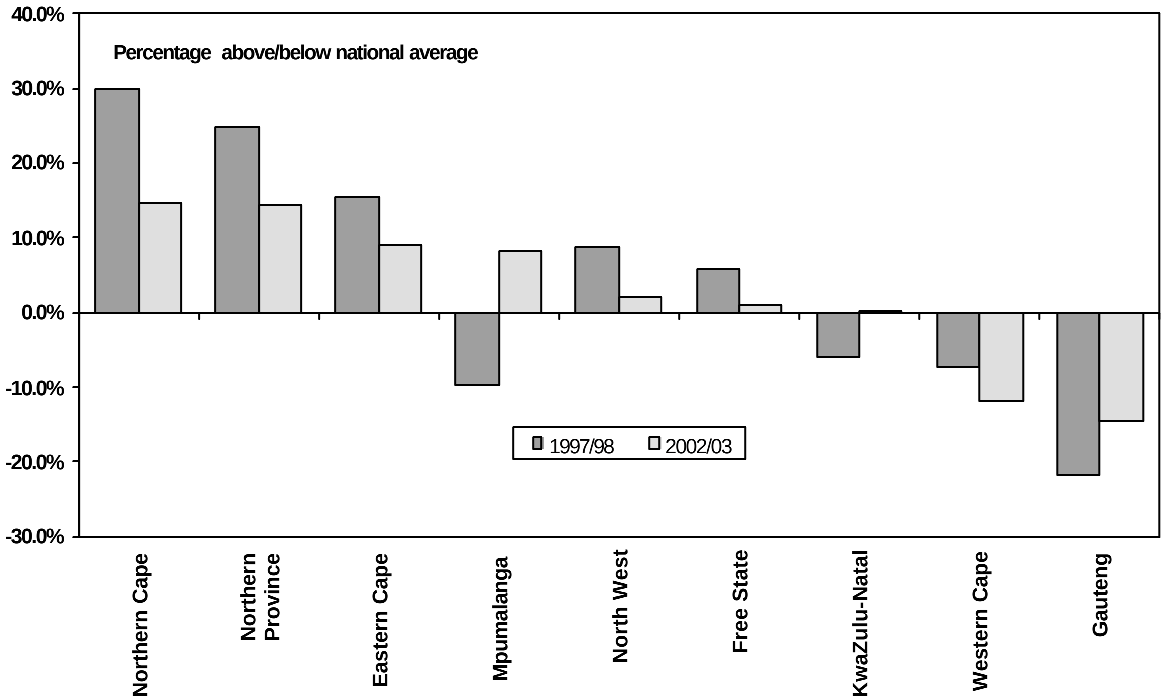
Provinces currently above the national average include Northern Cape, Northern Province, Eastern Cape, North West and Free State and those below are Western Cape, Gauteng, Mpumalanga and KwaZulu-Natal. The former three provinces benefit from the equitable shares formula, and thus will increase their share as the formula is phased in.

The equitable distributions between provinces incorporate:

- a poverty-related weighting in the social security and basic components of the formula;

- a bias in favour of the school-going population in the education component;
- a bias in favour of people without private medical insurance in the health component;
- a weighting in favour of women, children and the elderly in the health and social welfare shares; and
- an increased share of the total population in Gauteng and the Western Cape, following the preliminary results of the 1996 census.

Figure 4.1: Equitable shares distribution



When compared to the national average, the per capita shares reflect the different characteristics of the provinces. The more developed provinces – Gauteng and Western Cape – receive less than the national average, reflecting the redistribution of national resources to the poorer, rural provinces. The high share of the Northern Cape reflects the fixed costs of delivering services to a small, widely dispersed population.

Expenditure control

New responsibilities and challenges

The new intergovernmental fiscal system is radically different from the old system of function committees, by which the various national departments controlled allocations to the provincial line departments. Provinces now budget for themselves with provincial Executive Councils and legislatures allocating and voting funds according to their priorities, formed within the context of national legislation and policies.

CAUSES OF PROVINCIAL OVER-EXPENDITURE IN 1997/98

Over-expenditure by the provinces has been a matter of concern for several months. The Department of State Expenditure's system for monitoring provincial expenditure identified these trends early in the 1997/98 financial year. Task teams comprised of national and provincial treasuries and spending departments have met numerous times to review and analyse provincial expenditure.

When information about actual provincial expenditure in 1996/97 became available, it was clear that many of the 1997/98 provincial budgets were unrealistic. There was an upsurge in recurrent expenditure during 1996/97 as backlogs in health and education services began to be addressed, particularly through the employment and improved remuneration of teachers and health personnel. This increase was not fully accommodated in the 1996/97 budgets. They were dealt with by end-of-the-year Treasury Committee allocations, nationally funded rollovers, the reallocation of funds within provincial budgets and provincial cash reserves. However, as a result of a budget cycle that encouraged budgeting by reference to the previous year's budget – as opposed to actual expenditure – this increase in 1996/97 expenditure was not reflected in the 1997/98 budgets. Consequently, while the 1997/98 budgets appeared to accommodate modest increases on a budget-to-budget basis, they actually required unrealistic reductions when compared to actual 1996/97 expenditure.

In addition to this base year problem, the FFC has argued that provinces engaged in certain "budget games". It is possible that some provinces under-budgeted in key areas such as education, health and welfare in anticipation that the national government would make up any shortfalls. Based on the experience of previous years, a bailout by the national government was expected. But the nature of the intergovernmental system has changed, demanding that each province live within its budget. The national government is resolved to stand by these rules.

It must be recognised, however, that national departments are largely responsible for the development of policy, which is then implemented in provinces. When national departments fail to take full account of the cost implications of their policies, and do not provide additional funds to implement new responsibilities, then provinces can find themselves with unfunded mandates. This mismatch between funding and policy responsibility appears to have contributed to provincial expenditure pressures.

Although unfunded mandates are a serious concern, the underlying structural issues are much broader. Policy and jurisdictional uncertainties, as well as the level of discretion provinces have in implementing national policies, also confound the management of provincial budgets. Provinces feel they have little room in their budgets to reprioritise. Personnel costs and social security benefits account for 80 per cent of provincial expenditure, yet changes in salaries and the numbers of social security beneficiaries are largely beyond the control of the provinces. On the other hand, provinces have frequently failed to implement policies in those areas where they do have discretion. In many cases, limits on numbers of employees or administrative costs have not been enforced.

Government recognises that there is a lack of management capacity in the provinces, particularly in the area of financial management. The Department of Public Service and Administration has detailed the extent of this problem. It is clear that weak provincial financial and other management systems have resulted in inadequate expenditure controls, an increasing fraud problem, administrative overstaffing, lack of oversight to prevent unnecessary expenditure and inordinate delays in proceeding with needed reforms. The lack of management capacity has no doubt increased the perception within provinces that problems are insurmountable.

The 1997/98 Adjustment Estimate included R1 500 million to address over-expenditure in the most financially distressed provinces. The funds will be available subject to stringent conditions requiring the provinces to address the underlying causes of their financial dilemma.

Against this background the Departments of Finance and State Expenditure have participated in finalising the 1998/99 provincial budgets and the Budget Council has agreed on a range of expenditure monitoring and control procedures for the new year. The base year problem has been addressed, the 1998/99 budgets are more sustainable and there is greater appreciation at national level for the problems caused by unfunded mandates.

Note: Refer to box on Provincial Spending in 1997/98 in Chapter 3

The evolution of the new system has been accompanied by several difficulties. The Constitution, which decentralises budgeting, and structures policy making along sectoral lines, has caused an incongruous separation between programming and funding. In addition, many of the elementary systems of any treasury function, accurate financial management information and effective expenditure control procedures, are often absent. These teething problems are not unique to South Africa. But the difficult task of implementing a new fiscal framework – with new institutions, rules and policy priorities – is compounded by the structural problems left by the past.

Welfare budgets have come under pressure as a result of backlogs and an increasing number of beneficiaries, and education budgets from the upward pressure on personnel costs resulting from both the increase in the number of teachers and a realignment of teachers' salaries. Identifying and addressing these problems have been priorities for the Budget Council, the Departments of Finance and State Expenditure, and provincial treasuries.

Improved monitoring

With improved data and the further consolidation of financial management systems, national government's ability to assist in the monitoring of provincial activities has been enhanced. In 1997/98, all nine provinces and the national departments were for the first time put on the same, centralised personnel management system, known as PERSAL. Provinces still rely on different financial management systems for non-personnel expenditure. However, consolidation of personnel management information now affords both provinces and national government access to consistent and timely data on personnel pay trends.

Relying primarily on this information from PERSAL, the Department of State Expenditure has developed an early warning system for monitoring provincial budgets. During 1997 cooperative task teams of national and provincial treasury officials were created to assess expenditure trends, building on the early warning indicators.

One of the outcomes of this process has been a clarification of the roles and responsibilities of the relevant players in the intergovernmental system. Provinces gained a clearer understanding of the relative priority of the various policies promulgated by national departments.

On the other hand, national departments learned about the budget and other practical constraints that the provinces face in trying to implement these policies. Continued consultation and cooperation of national and provincial departments, and between treasuries and other departments, are the essential foundations for arriving at sustainable solutions.

Multi-year budgeting

MTEF

The introduction of the MTEF represents an important step forward in the evolution of intergovernmental financial relations. By initiating a process of three-year rolling budgets, the MTEF aims to introduce greater certainty and forward planning to the expenditure allocation process.

COOPERATIVE INTERGOVERNMENTAL TASK TEAMS

Task teams led by the national Departments of Finance and State Expenditure worked intensively with provincial treasuries during the last half of 1997 and 1998. At times, the task teams were expanded to include representatives of the national and provincial departments of Education, Health and Welfare. Most meetings were held on a bilateral basis. There were also several meetings where all the provinces participated, thereby allowing for a sharing across provinces of policy ideas and concerns.

The work of the task teams reflects a practical application of the principles of cooperative government as detailed in the Constitution. Section 41 calls on the different spheres of government to inform each other and consult on matters of common interest. Section 125(3) states that the national government "must assist provinces to develop the administrative capacity required for the effective exercise of their powers and performance of their functions."

The task teams were informed by another cooperative effort initiated through the MTEF. Sectoral MTEF work teams comprised of national and provincial officials examined on education, health and welfare programmes, developing expenditure projection models and analysing the expenditure implications of existing and new policies. An MTEF sectoral team reviewing personnel policies also identified the wage bill as a key source of pressure on provincial budgets. The sectoral teams found that the initial MTEF budgets submitted by the provinces had insufficient funds allocated to the major social services, given policy and personnel commitments.

In response to these findings, the task teams led by the Departments of Finance and State Expenditure expanded their work to include assisting the provinces revise their MTEF budgets. The teams developed criteria for assessing the credibility of provincial budgets, including whether adequate funds had been allocated to education, health and welfare given anticipated actual expenditure in 1997/98. The national and provincial education, health and welfare departments joined in this process. The task teams' work offered advice to the provinces' executive councils and legislatures, who must make final decisions regarding provinces' budgets.

Based in part on the work of the task teams, the 1998 Budget includes a R2,8 billion conditional grant to provinces. These funds are divided between the provinces based on the equitable shares formulae, but will be available to a province only if it enacts a credible budget consistent with the task team principles that adequate funds must be provided for education personnel, health personnel and welfare grants. Other conditions include requiring provinces to take adequate steps to improve the collection of own revenue, apply generally recognised financial management practices, and comply with intergovernmental financial legislation and agreements reached in the Budget Council.

For the first time, national departments such as education, health and welfare, who play a leading role on the policy terrain, have a sense of the resource envelope in the provinces and the expenditure growth rates that are sustainable in the various functions. This knowledge will enable those national departments whose policies impact on the provinces, to adapt their policies and prioritise their programmes within the context of realistic budget constraints. As detailed in chapter 5, the MTEF spending plans provide Executive Councils and legislatures and people in provinces the opportunity to evaluate medium-term budget allocations in the context of Government's policy priorities.

An MTEF would not be complete without provincial participation. Sectoral teams established as part of the MTEF process were organised to review spending on education, health and welfare. These teams included officials of the relevant national and provincial line departments and the national and provincial treasuries.

Sectoral work teams

The sectoral work teams played an important role in facilitating cooperation between national and provincial line departments and between national and provincial treasuries. In addition to the detailed analyses of sectoral issues that emerged from the teams, they identified shortfalls in provincial budgets for the MTEF period. Special attention was paid to reconciling the demands of national policies with provincial budget allocations. By comparing initial estimates of expenditure for the next three years, prepared on the basis of the 1997/98 budgets, with actual spending trends, the work teams contributed to improved understanding, both nationally and provincially, of the financial implications of existing Government policies.

Subsequently, task teams led by the Departments of Finance and State Expenditure became integrally involved in working with the provinces to define the parameters for drawing up sustainable budgets for 1998/99 and beyond. The Supplementary Allocation of R2 800 million for provinces, placed on the vote of the Department of Finance, will be disbursed on condition that provinces prepare budgets that accommodate all statutory and contractual expenditure in the first instance. This process constrains provincial budget games whereby provinces budget short on essential expenditure, commit the discretionary parts of their budgets, and hope for bail outs.

Capacity building

Sound financial management in the provinces has become a top priority. The 1998 Budget provides for:

- R100 million on the vote of the Department of State Expenditure for financial management development;
- R200 million on the vote of the Department of Education for the education management and quality improvement; and
- R100 million on the vote of the Department of Welfare for information systems development.

These funds will be utilised to establish effective treasury control over expenditure in the provinces, to improve the running of schools and education departments, and to root out theft and corruption in the welfare system.

LOCAL GOVERNMENT SHARES AND OTHER ALLOCATIONS

Capital transfers

Aside from capital grants for rural water infrastructure, capital transfers were rationalised and restructured into the consolidated municipal infrastructure programme in 1996, and phased in during 1997.

The consolidated municipal infrastructure programme, under the Department of Constitutional Development, provides grant funding for the installation, upgrading and rehabilitation of municipal internal bulk and connector infrastructure, while the rural water infrastructure grant which falls under the Department of Water Affairs and Forestry funds community water and sanitation projects. These grants are budgeted to be R1 302 million in 1998/99.

Previous operating transfer arrangements

Up until the end of the 1997 financial year, operating transfers to municipalities were made by means of intergovernmental grants from provincial budgets, agency payments and implicit subsidies from national and provincial departments. Investigation by the Department of Finance revealed that the grant system used in the past was inconsistent, inequitable, unpredictable and was not based on objective policy criteria.

New Proposals

In order to address these problems and to conform to the new equitable share for local government provided for in section 214 of the Constitution, national government will introduce a transparent, formula-based system of operating transfers to municipalities during the 1998/99 municipal financial year starting on 1 July 1998. This approach is expected to be phased in over a period of five years. The new system of intergovernmental transfers addresses both the total share of revenue for local government and the division of this revenue between municipalities.

Key principles

The key principles underlying the new system of intergovernmental transfers are:

- *Equity*

Because funds are transferred to municipalities in a uniform, transparent and rational manner according to a formula, all municipalities will be treated equitably, and therefore will be assisted to deliver a package of basic services to all low-income households at affordable cost.

- *Efficiency*

The new transfer system will promote allocative efficiency by promoting competition between municipalities on the basis of their fiscal performance, rather than on their tax bases.

- *Spillover effects*

Services provided by one municipality that produce a positive externality for a neighbouring municipality will be catered for in the new transfer system.

- *Facilitating democracy*

In order for municipalities to fulfil their functional, political and administrative responsibilities towards their residents, they require a minimum level of institutional and administrative infrastructure.

Types of Transfer

The objective of the basic transfer to municipalities is to ensure that all municipalities are able to deliver a basic package of services to all poor households in their jurisdiction at affordable cost. The funding will also provide for the development of adequate administrative capacity to ensure democracy and good administration.

There will also be a transfer to assist municipalities to provide essential infrastructure for services that create significant positive economic spillovers for residents of other municipalities. For the foreseeable future this infrastructure will continue to be funded from regional service council levies.

1998/99 local government budgets

Total transfers to local government, including those spent by national and provincial government on municipal services but excluding agency payments, will total approximately R4 107 million in 1998/99. Of this amount, R2 805 million will be for operating transfers (an increase of R164 million over 1997/98) and R1 302 million for capital transfers (a decrease of approximately R504 million compared to 1997/98). The decrease in capital transfers is primarily due to extraordinary high rollovers from 1996/97 into 1997/98, which significantly distorted the 1997/98 figure, and the phasing out of the bulk and connector infrastructure grants and the extended municipal infrastructure programmme, and their rationalisation into the consolidated municipal infrastructure programme.

Municipalities are not permitted to run deficits on their operational budgets. In formulating their budgets they are expected to take account of their own revenue, transfers from national and provincial government and any borrowing for capital up to limits allowed by national legislation.

Growth limits for 1998/99

For macroeconomic and fiscal reasons, municipalities have to ensure that their budgets fall within limits set by the Minister of Finance. For the 1997/98 financial year an 8 percent growth rate was determined for both the operating and capital expenditure of all municipalities. The guideline growth rate for such expenditure by local government for the 1998/99 financial year is 6 per cent. Capital expenditure funded by grants and subsidies from the consolidated municipal infrastructure programme and various other national government programmes is excluded from this limit.

1997/98 local government budgets

For the 1997/98 local government financial year, municipal budgets recorded an increase of 9 per cent to R52 300 million, including capital expenditure of R15 000 million. Loans amounting to approximately 54 per cent of planned capital expenditure were budgeted in 1997/98 (55 per cent in 1996/97).[2]

Revenue sources

The main sources of revenue to municipalities in 1997/98 were gross income from electricity, water and sewerage charges of R20 400 million,

[2] These figures differ from the South Reserve Bank figures in Table 3.7, which excludes revenue from utility services.

intergovernmental grants, subsidies and other revenue of R16 100 million, property rates of R7 300 million, and regional services levies of R2 800 million.

The net revenue from electricity, water and sewerage charges is significantly less than the gross figure reflected in the table above, as expenditure on bulk purchases is expected to amount to R11 600 million. In addition, salary and administration costs for these sectors are included in the total local government salary and administration costs estimates, making it impossible to determine the net income from these user charges.

Transfers

Transfers to local government totalled R4 447 million for the 1997/98 financial year excluding roll-overs and agency payments.

Expenditure

Apart from the projected R11 600 million expenditure on bulk purchases, expenditure on salaries and allowances of R12 000 million, administration and general expenditure of R14 900 million and R5 300 million for interest and the redemption of loans, are projected for the year. Excessive increases in administrative and personnel expenditure and weak financial administration characterised many budgets, squeezing the capacity of local government to deliver on RDP objectives.

One of the challenges facing local government is to stabilise its financial situation and improve its financial management practices to ensure that budgeted figures are realised. Local authorities frequently find it difficult to realise their revenue projections due to inadequate provision for non-payment for services.

Project Viability

National government continued to monitor the financial state of municipalities through its “project viability” programme, which was initiated in 1996 to monitor the short-term liquidity of municipalities and to measure the success of the Masakhane campaign.

As at September 1997, outstanding debt owed to municipalities for rates and service charges for all municipalities stood at R9 279 million. A joint meeting with provincial MECs, chaired by the Ministers of Finance and Constitutional Development, approved a national intervention framework to rectify this situation.

Resulting from the above, a ten person task team was appointed in Johannesburg to restructure the municipal budget, to place the city on a firmer financial footing.

Municipal debt

The Department of Finance revised its methodology to estimate the current level of municipal debt, leading to a revision downwards of the estimated debt figures published in the 1997 Budget Review. The Department intends to publish two surveys per year on municipal debt levels.

For the quarter ended June 1997, municipal debt amounted to R24 600 million. This represents an increase of 7 per cent (R1 600 million) compared with the figure for the quarter ending in March 1997.

4.6 CONCLUSION

Sorting out roles and responsibilities in the intergovernmental system has been one of the biggest challenges of 1997/98, and will no doubt continue to be a major concern as this system evolves.

The arrangements for the sharing of resources between the national, provincial and local spheres of government will evolve further in future years. The current year's formula will serve as the starting point for calculating the revenue division in future years, but it is likely that adjustments will also be made to the framework as new information becomes available.

Government recognises, however, that stability in the overall intergovernmental financial framework is a pre-condition for sound financial planning and responsible government. Legislation enacted during the past year establishes the necessary forums for effective consultation between the national government and provinces.