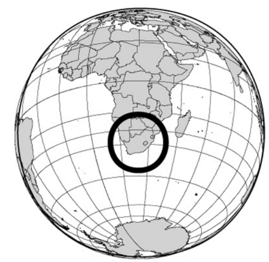
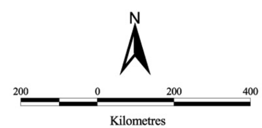
Republic of South Africa

Capital: Pretoria
Population: 43.5 Million
(2002 est.)

Boundaries and place names are representative only and do not imply official endorsement.





Sources: CIA World Factbook; ESRI Ltd;
Times Atlas of the World: UN Cartographic Dept.

Republic of South Africa

BONGANI KHUMALO
AND RENOSI MOKATE

The Constitution establishes South Africa as a constitutional republic founded on the principles of democracy. There are a number of political parties that are represented in all spheres of the government – national, provincial, and local. Some political parties emerge only during election periods and disappear thereafter. The political landscape is dominated by the African National Congress (ANC), which holds a more than two-thirds majority in the National Assembly. The ANC also controls all of the provincial legislatures and most metropolitan municipalities.

The system of government in South Africa is generally stable, with a clear separation of powers between the executive, the legislature, and the judiciary. However, given that the decentralized system of government has only been in existence for ten years, some aspects of it are still evolving. This is particularly true with respect to the assignment of powers and functions among the three spheres of government and the exercise of those powers where they are concurrent. The government has made significant strides in enacting enabling legislation, which is required for the exercise of powers and functions. However, implementation of such legislation has presented its own challenges. For example, there is uneven distribution of technical and institutional capacity between national, provincial, and local governments in the area of housing. Although the enabling legislation for the exercise of powers in this concurrent area exists in the form of the National Housing Act, implementation in the form of delivery of houses to those that need them has not progressed smoothly.

Provincial government executives are appointed by the premiers who, in turn, are appointed by the president. In the local government sphere, councils are elected by the people and the mayors are elected by the councillors. In all the subnational governments, the majority party has a significant say in the choice of mayor through executive structures.

The Constitution establishes an independent legislature, judiciary, and executive. The executive, which can be loosely referred to as the government at all spheres, is held accountable to the electorate through the relevant legislatures. The National Assembly and the National Council of Provinces are at the national level, the nine legislatures are at the provincial level, and the councils are at the local level. All these legislative institutions have a role in monitoring and ensuring that the government is held accountable to the people through their own institutions, which ensure citizen participation. Over and above these institutions, the Constitution establishes other institutions such as the Human Rights Commission, the Gender Commission, the Constitutional Court, and so on, all of which ensure that the government is held accountable for any violations of the Constitution. All these statutory bodies are independent.

These independent institutions also receive complaints from the general public regardless of race, gender, colour, or creed, and they can influence the activities of the government. For example, where the government fails to deliver on the provisions in the Bill of Rights (Chapter 2 of the Constitution), aggrieved parties can and have challenged the government in the Constitutional Court, where judgments can and have been made for the complainants. The Human Rights Commission has also received complaints from aggrieved parties and made pronouncements in their favour. The media in South Africa are free and, as such, provide a key avenue for keeping the government under scrutiny. Several government corruption scandals that have ended up being investigated were initially exposed by the media.

South Africa has a population of 44.8 million people and a surface area of 1.2 million square kilometres. It has a racially and ethnically diverse society. Its gross domestic product (GDP) was $212.8 billion in 2004, and its per capita gross national income was $3,630. South Africa has a stable macroeconomic environment characterized by moderate growth rates, low inflation, and low interest rates.

THE INTERGOVERNMENTAL FISCAL RELATIONS SYSTEM IN SOUTH AFRICA

The intergovernmental fiscal framework inherited from the apartheid era was one in which the various provinces differed markedly in their economic endowments and administrative capacity. In 1994, following protracted negotiations between the liberation movements and the apartheid government and a series of compromises on both sides, South Africa settled on a democratic, fiscally decentralized, unitary state. The system consisted of nine provinces and more than one thousand municipalities that, in 2000, were reduced to 284. With respect to provinces, the fiscal

Table 1
Basic political and geographic indicators

Official name: South Africa
Population: 47.4 million people

Area (square kilometres):	Western Cape = 129,370 sq. km.
	Eastern Cape = 169,580 sq. km.
	KwaZulu-Natal = 92,100 sq. km.
	Northern Cape = 361,83o sq. km.
	Free State = 129,480 sq. km.
	North West = 116,320 sq. km.
	Gauteng = 17,010 sq. km.
	Mpumalanga = 79,490 sq. km.
	Limpopo = 123,910 sq. km.

Total Area = 219,090 sq. km.

GDP per capita in rands (year): R32,483
Constitution: 1996, constitutional democracy
Orders (spheres) of government: National, provincial, and local
Constitutional status of local government: Autonomous sphere
Official languages: English, Afrikaans, IsiZulu, Sesotho, Setswana, isiXhosa, siSwati, isiNdebele, Xitsonga, Tshivenda, and Sesotho sa Leboa
Number and types of constituent units: Nine provinces

Population, area, and per capita GDP in South African rands of the largest constituent unit
Northern Cape

902,300 people
361,830 sq. km.
GDP per capita R32,870

Population, area, and per capita GDP in South African rands of the smallest constituent unit
Gauteng

9,415,231 people
17,010 sq. km.
GDP per capita R43,923
Exchange rate = .73

decentralization process could be characterized as mainly involving the decentralization of service responsibilities, with limited revenue-raising capacity. Allowing provinces to choose applicable tax rates and tax bases could result in tax competition that would interfere with trade, investment, or migration across provincial boundaries, thus reinforcing economic disparities and potentially creating a highly skewed distribution of wealth and economic activity. In addition, the weak administrative capacity (and institutions) inherited by most of the provinces, especially those that inherited the apartheid legacy of the homelands, and self-governing states meant that disadvantaged provinces would be ineffective in optimizing and maximizing any expanded revenue-raising powers granted by the Constitution. The issue of revenue assignment is discussed in more detail below.

Provinces neither impose nor collect levies on broad-based taxes such as corporate income and profits, personal income, consumption, and trade. Most of the taxes available to provinces are narrow-based and relate to fees levied on motor vehicle licences, gambling, liquor, hospital fees, and tourism. However, the Constitution grants provinces the power, subject to national legislation and national economic policy objectives, to impose other taxes, such as a surcharge on personal income tax and a fuel levy.

By comparison, an interesting feature of South Africa's intergovernmental fiscal system is the degree to which local governments, especially the larger municipalities, have been given revenue-raising powers. This feature provides the country with a mechanism to develop a much more efficient intergovernmental fiscal system than can other lower-income developing countries with similar fiscal systems. Similar to the White Local Authorities (WLAs) under apartheid, the major sources of revenue for local government include taxes, user charges, and private-sector equity in infrastructure provided by local authorities. Although in the aggregate, local government in South Africa raises a substantial amount of own revenue (90 percent of expenditure needs are financed from own revenue), the situation changes drastically when municipalities are viewed individually. For example, some metropolitan municipalities finance as much as 98 percent of their expenditure needs from own revenues, while some small rural municipalities may depend entirely on transfers in the form of equitable share transfers, conditional transfers, and grants from other spheres and institutions.[1]

EXPENDITURE AND REVENUE-RAISING RESPONSIBILITIES

Macroeconomic policy management in South Africa is the function of national government. Financial and fiscal matters of the state are stipulated in Chapter 13 of the Constitution. This chapter establishes the key institutions and roles for dealing with macroeconomic management. The National Treasury, through the minister of finance, has the role of determining and implementing the country's fiscal policy. An independent central bank, the South African Reserve Bank (SARB), has the role of determining and implementing the monetary policy of the country through constant consultation with the minister of finance. The National Treasury, through Parliament, has set the key parameters within which monetary policy is exercised, while the Reserve Bank is responsible for determining the instruments for effecting that policy. South Africa follows an inflation-targeting policy, with the current target for the consumer price index (excluding mortgage rates) set at 3 percent to 6 percent, and it has a floating exchange rate policy. The governor and deputy governors of SARB are appointed by the president of the country after consultation with the SARB board of directors and the minister of finance.

In 1994, South Africa was in an undesirable fiscal condition, with a budget deficit close to 10 percent, inflation hovering around 20 percent, and debt service costs at 4.7 percent of GDP. The priority of Nelson Mandela's government was, thus, to get macroeconomic policy right. This was achieved with significant success through the implementation of a tight fiscal program. The government adopted its national Growth, Employment and Redistribution (GEAR) macroeconomic strategy through extensive consultation with organized labour and business. The stance adopted by the government was that of macroeconomic stabilization, and it has been under implementation for over five years. The main achievements of this strategy have generally been seen in terms of a substantial reduction in the budget deficit to under 2 percent in 2005 (from the 1994 level of over 10 percent), stable inflation at under 6 percent (from around 20 percent in 1994), reduced debt service cost at 3.5 percent in 2005 (from a high of 5.6 percent in 1997), and general stability in subnational budgets.[2]

However, due to the austerity measures that accompanied the strategy of government investment, infrastructure especially suffered. Investment in social services did not grow as quickly as some sections of society expected. Therefore, while access to social services greatly improved, this was achieved mainly through efficiency gains rather than increased investment. The success of the government's GEAR strategy has been tempered by lack of adequate growth in employment. Unemployment currently stands at about 26 percent.

As has already been indicated, macroeconomic policy management is the exclusive function of the national government, and, under times of fiscal austerity, subnational governments must follow the direction of the national government. The impact of the austerity measures in the early years of GEAR was to enforce the same measures at the subnational government levels.

Over the past five years, rapid reforms in the fiscal arena have strengthened tax administration and improved tax buoyancy and public expenditure management. This development has allowed the government to embark on new investments and the rehabilitation of infrastructure as well as to accelerate investment in basic services.

A comprehensive budget reform process has been carried out alongside the overhaul of the intergovernmental system. Key reforms have included the introduction of three-year budgeting. This has introduced certainty on transfers to subnational governments and allows for decentralized budgeting as captured within the Medium Term Expenditure Framework (MTEF) and the Medium Term Budget Policy Statement (MTPBS). It has also transformed a "bean-counting" treasury into a treasury with strong policy assessment capacity, modernized financial management through the Public Finance Management Act and the Municipal Finance Management Act, removed bail-outs/guarantees for provincial municipal debt and the possibility of ad hoc allocations during the financial year, and finally enhanced the development of clear fiscal frameworks for provincial and local governments. The results have been seen in improvements on expenditure management at both the provincial and local government levels.

However, on the revenue side, much work still needs to be done, especially around the issue of revenue forecasting. As the National Treasury has noted, inaccurate revenue forecasting – either in the form of over- or underestimation of receipts – could result in the expansion of unnecessary borrowing or in the inadequate allocation of funds. This could hamper the implementation of crucial socio-economic programs.[3]

Despite budget reforms and the overhaul of the Intergovernmental Fiscal Relations (IGFR) system, many challenges remain. The following sections identify key weaknesses in four dimensions of the IGFR system in South Africa – expenditure assignment, revenue assignment, intergovernmental transfers, and fiscal management – some of which have persisted despite policy reforms. In turn, such weaknesses pose significant challenges for effectiveness and efficiency in the delivery of constitutionally mandated basic services as well as for the transparency and accountability of the IGFR system as a whole. These weaknesses are explored in greater detail below.

Expenditure Assignment

According to public finance theory, a crucial element of fiscal decentralization requires that a clear and concise set of functions, responsibilities, and services be provided by the jurisdiction with control over the minimum geographic area that would internalize the benefits and costs arising from the provision of such services (and other functions). The current assignment of expenditure functions in South Africa, which is closely aligned with the above theory, aims to achieve three main objectives – efficient resource allocation via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and macroeconomic stability and growth.

Expenditure functions that have a national dimension (justice, defence, correctional services, foreign affairs, and tertiary education) as well as macroeconomic and redistributional implications are the primary responsibility of the national government. These expenditures account for around 39 percent of total budgeted expenditure. By contrast, provincial governments account for about 55 percent of total budgeted expenditure but generate less than 6 percent in revenue.[4] Most of the expenditure

Table 2
Legislative responsibility and actual provision of services by different spheres of government

Legislative responsibility (de jure)	*Public service*	*Actual allocation of function (de facto)*
National/provincial	Administration of indigenous forests	Provincial/local
National/provincial	Social security and welfare	National/provincial
National/provincial	Agriculture	Provincial
National	Health	National/provincial/local
National	Correctional services	National
National	Defence	National
National	Justice and constitutional development	National
National	Safety and security	National
National	Water affairs and forestry	National
National	Trade and industry	National
National	Transport	National
National	Minerals and energy	National
National	Foreign affairs	National
National	Home affairs	National
National/provincial	Casinos, racing, gambling and wagering, excluding lotteries and sports pools	Provincial
National/provincial	Vehicle licensing	Provincial
Provincial	Ambulance services	Local
National/provincial	Education	National/provincial
Provincial	Libraries other than national libraries	Local
Provincial	Liquor licences	National
National	Museums other than national museums	National
Provincial	Provincial planning	Provincial
Provincial	Provincial recreation and amenities	Provincial
Provincial	Provincial sport	Provincial

Table 2
Legislative responsibility and actual provision of services by different spheres of government (*Continued*)

Legislative responsibility (de jure)	*Public service*	*Actual allocation of function (de facto)*
Provincial	Provincial roads and traffic	Provincial
Provincial	Veterinary services, excluding regulation of the profession	Provincial
National/provincial/local	Air pollution	Local
National/provincial/local	Building regulations	National/provincial/local
National/provincial/local	Child care facilities	Local
Local	Electricity and gas reticulation	Local
National/provincial/local	Firefighting services	Local
National/provincial/local	Local tourism	Local
National/provincial/local	Municipal airports	Local
National/provincial/local	Municipal planning	Local
National/provincial/local	Municipal health services	Local
National/provincial/local	Municipal public transport	Local
National/provincial/local	Stormwater management systems in built-up areas	Local
National/provincial/local	Water and sanitation services limited to potable water supply systems and domestic waste-water and sewage disposal systems	Local
Provincial/local	Beaches and amusement facilities	Local
Provincial/local	Billboards and the display of advertisements in public places	Local
Provincial/local	Cemeteries, funeral parlours, and crematoria	Local
Provincial/local	Municipal parks and recreation	Local
Provincial/local	Municipal roads	Local
Provincial/local	Street lighting	Local
Provincial/local	Traffic and parking	Local
Provincial/local	Refuse removal, refuse dumps and solid waste disposal	Local

responsibilities are derived from Schedule 4 of the Constitution, which stipulates that provincial governments are responsible for primary and secondary education, health and welfare services, provincial roads, and local economic development. Local governments account for just over 4 percent of total budgeted revenues and are tasked with the delivery of key basic municipal services such as housing, water, electricity, and sanitation.[5]

Despite the fact that the Constitution sets out clear responsibilities and a solid framework, some matters related to the assignment of expenditure functions continue to remain unresolved. These are the persistent potential for unfunded mandates, a lack of clear delineation of responsibilities when functions are transferred to other spheres of government, and the lack of a detailed and comprehensive framework for the assignment of powers and functions. Unfunded mandates refer to situations in which subnational governments are legally mandated in terms of the Constitution or by policy pronouncement to undertake specific functions but do not receive funds from nationally raised revenues in order to fulfill these functions. This scenario is highlighted in cases where the framework underlying the provision of particular services requires provincial and local governments to implement nationally determined minimum-service standards. However, the funding for the delivery of such services fails to reflect the cost of the service standards, forcing subnational authorities to divert scarce own-revenue funds to meet the standards set.

A clear classification of responsibilities for some functions shared by the different spheres of government is still required. For example, some roads have yet to be classified either as district or local roads. Until such classification is finalized, these kinds of roads may end up not being maintained, a scenario that could hinder improved access to socio-economic infrastructure. Closely linked to the classification issue is the lack of clarity on the nature of transfer of functions – whether assignment, delegation, or agency agreement. Where this occurs, planning and budgeting for service delivery becomes difficult as each type of assignment has its own implications.

Although a draft policy framework for assigning powers and functions to the local government sphere has been developed, the proposals contained in the framework are not comprehensive. They fail to cover all legislation originating in national line function departments. For instance, in the health sector, the national government has yet to specify the range of activities that comprise the environmental health services that should be provided by local authorities. This lack of specificity has necessitated laborious negotiations between local municipalities and their respective district municipalities regarding which entity should bear responsibility for providing environmental health. Another drawback of the draft framework is that it applies only to functions assigned to local governments and excludes shifts/transfers of functions from the national sphere to the provincial

Table 3
Direct expenditures by function and level of government

Function	*Federal (%)*	*State or provincial (%)*	*Local (%)*	*All (%)*
Defence	100	0	0	100
Debt servicing	100	0	0	100
General administration	44	0	56	100
Law and order	100	0		100
Economic services	100	0		100
Social services				100
health	78.3	21.7	0	100
education	66.1	33.9	0	100
Social development	74.5	25.5	0	100
Subsidies	0	0	0	100
Total				100
Local public services*	0	0	0	100

* Local public services include: primary and preschool education, secondary education, public health, hospitals, urban highways, urban transportation, drinking water and sewerage, waste collection, electric power supply, fire protection, public order and safety, police.

sphere. In the absence of an appropriate framework, subnational governments either initiate legislation to fill gaps or develop policies that could place increased future demands on the country's treasury.

Revenue Assignment

Despite improvements in revenue-sharing arrangements since 1994, there still remain marked differences in revenue-generating capacity across the three spheres of government. The differences stem largely from the structure and assignment of taxation powers allocated by the Constitution to the spheres of government. South Africa's revenue system is based on ensuring fiscal uniformity, harmony, and efficiency. However, the assignment of revenue functions involves lower fiscal autonomy for subnational governments. All broad-based taxes (mainly personal income, corporate, and consumption taxes) are assigned to the national government, while narrow-based/minor taxes (such as motor vehicle licence fees, hospital user fees, and gambling taxes) are assigned to provincial authorities. In comparison, municipalities have greater revenue powers than do provinces as they are assigned property rates and turnover and utility user charges.[66] The collection of most revenue in South Africa is carried out by the South African Revenue Service. Currently, the Revenue Service only collects revenue for the national government, although there is nothing that stops provinces and municipalities from entering into agency arrangements with it so that it can collect on their behalf as well.

The exercise of subnational revenue-raising powers can only be implemented subject to the enactment of enabling legislation by the national government. The enactment of this legislation in South Africa has taken quite a while, although it has happened. The Property Rates Act is currently being phased in and is envisaged to take a period of seven years before it is fully phased in. The Municipal Fiscal Powers and Functions Bill is still being developed, as required in Section 229 of the Constitution, while the Provincial Tax Regulation Process Act only came into effect in 2001. All these pieces of legislation give certain discretion to the national minister of finance and, to some extent, local government with respect to the exercise of revenue-raising powers by subnational governments.

In general, South Africa's intergovernmental fiscal relations are characterized by relative centralization on the revenue side and highly decentralized expenditure responsibilities. Although expenditure on the delivery of social services constitutes about 89 percent of total provincial spending, these services generate very little in terms of revenue. Unable to raise adequate revenue from their assigned taxes, in order to achieve their constitutional mandate, the provinces have come to rely heavily on intergovernmental transfers (or grants), which make up 95 percent of the total revenue utilized at the provincial level.

While subnational governments argue that narrow-based taxes limit their capacity to increase revenue, efficient administration and collection of revenue, especially by provincial governments, remains a significant problem. In most provinces, the major revenue-generating departments – public works, economic affairs, education, health, and transport – lack dedicated and staffed internal revenue collection units. The establishment of dedicated revenue collection units is critical for ensuring that fees for services are adjusted in a timely manner, that due revenues are collected, and that projections or forecasts of revenues are provided to enhance the budgeting abilities of provincial treasuries. Over the past decade, most provinces have rarely adjusted fees and tariffs unless pressured by the national government, and they have continued to collect less revenue.

The inability of provinces to maximize collection of own revenue has reinforced the dependence of the provinces on transfers from the national government, an outcome that affects expenditure in two important ways. First, it imposes a constraint on the provinces' ability to change their expenditure patterns. Thus, the volume of expenditure incurred by each

Table 4
Tax assignment for various orders of government

	Determination of			Shares in revenue (%)			
	Base	*Rate*	*Tax collection and administration*	*National*	*Province*	*Local*	*All orders*
National							
Direct taxes 1. Taxes on Income, profit, and capital gains 2. Payroll taxes 3. Taxes on property Indirect taxes 1. Value-added taxes 2. Excise duties 3. Taxes on international trade and transactions Other revenues 1. Stamp duties and fees.	Taxes under direct taxes and indirect taxes are assigned according to 1996 Constitution.	100% determined by the national sphere 100% determined by national sphere	Taxes collected and administered by the South African Revenue Service (SARS)	80.8	1.1	18.1	100
State or provincial							
Tax Revenue 1. Casino Taxes 2. Horse Racing Taxes 3. Liqour Licenses 4. Motor vehicle licenses Non-tax revenue 1. Sale of non-capital goods 2. Transfers received 3. Fines, penalties, and forfeits 4. Interest income 5. Sale of capital assets 6. Other financial transactions	Tax bases are in line with Section 228 of the 1996 Constitution	1. Review of applicable rates carried out by relevant departments/ provincial treasuries and submitted to the minister of finance for approval. 2. Regarding non-tax revenue, applicable rates and prices wholly determined by provincial authorities	Relevant line departments in conjunction with the Provincial Treasury.				

Table 4
Tax assignment for various orders of government (*Continued*)

	Determination of			*Shares in revenue (%)*			
	Base	*Rate*	*Tax collection and administration*	*National*	*Province*	*Local*	*All orders*
Local							
Revenue 1. Regional levies 2. Property rates 3. User fees (levied on electricity, water, and refuse removal services) 4. Subsidies and grants	In line with municipal fiscal powers and functions outlined in Section 229 of the 1996 Constitution	With the exception of subsidies and grants (intergovernmental transfers) and allocations from nationally raised revenues, rates on other tax sources 100% determined by local government authorities. However in certain instances, determination of rates on property is done in accordance with the Property Tax Act (2004)	Income collected by revenue departments in specific municipalities.				

province depends on the volume of transfers. Second, this dependence means that the national government has significant influence on equity considerations in spending through the structure of the provincial equitable share formula. Encouraging provinces to raise more of their revenue needs could result in provinces' being better able to alter spending in line with their local circumstances and priorities.

Therefore, it is important that the implementation of the Provincial Tax Regulation Process Act, 2001, considers various ways in which the assignment of revenue powers could incorporate appropriate incentives for provinces to raise more of their own revenues and that it direct such revenues towards expenditure programs that support sustainable local economic growth and development. The act was passed as a necessary legislation to enable provinces to exercise their revenue-raising powers, as detailed in

Section 228 of the Constitution. Although most of the provinces have not used the act, recent moves by the Western Cape province to impose a fuel tax and the recent decision by the minister of finance to rescind the regional services levies accruing to local governments have significant implications for both local and provincial fiscal sustainability. These implications make the case that reform of tax assignment at the subnational level is all the more necessary. The regional services levy was a tax levied on the payroll bill of business entities.

Intergovernmental Transfers

Intergovernmental transfers (grants) within South Africa's IGFR fall within two main categories: general purpose grants and specific purpose (conditional) grants. Given that the expenditure responsibilities of the provincial and local governments are extensive but their revenue-raising abilities are minimal, general purpose transfers are intended to reduce fiscal imbalances arising from these asymmetric revenue-raising capacity and expenditure functions. Specific purpose grants are intended to correct interjurisdictional spillovers, meet national redistribution objectives, and achieve specific national priorities and policies concerning services provided by subnational spheres of government.[7] Provinces and local governments receive general purpose grants through the provincial equitable share (PES) and the local equitable share (LES), respectively. Both PES and LES are formula-driven and utilize factors such as population, poverty, and household income and expenditure in determining the per capita share accruing to each province or municipality.[8] Furthermore, the Constitution specifies the criteria that must be taken into account in allocating the equitable share to the three spheres of government. These criteria are listed in Section 214 (2) [a-j] of the Constitution of the Republic of South Africa. General purpose grants can be spent at the discretion of subnational governments.

Since 2000, specific purpose grant allocations to subnational governments, which are allocated on an ad hoc and discretionary basis, have represented a growing share of transfers (see Figures 2 and 3). Over the 2001/02 to 2007/08 fiscal years, growth in conditional grants allocated to local governments averaged over 23 percent compared with the equitable share's average growth of 22 percent. In the case of provinces, and over the same period, growth in conditional grant allocations averaged just over 14 percent compared with the 11 percent recorded for equitable transfers. To a large extent, the increasing importance of conditional transfers reflects the proactive policy stance of the national government and the unsustainable expenditure assignments to subnational governments.

Despite their intended objectives, a number of problems hinder the effective implementation of conditional grant-funded programs. Most notably, the grant system is characterized by a high number of conditional grants, many of which are allocated on an ad hoc and discretionary basis.[9] The ad hoc and discretionary nature of allocations in turn creates unintended, negative consequences. First, aims and objectives tend to be duplicated, and this exerts an unnecessary administrative burden on implementing subnational governments. Second, many grants are poorly designed: they lack clear purpose and either lack measurable outputs or have outputs or conditions that are unreasonable. Third, the ad hoc and discretionary nature of grants makes the transfer system less transparent, an outcome that makes monitoring difficult and that undermines coordination between policy and budgeting. It also enhances budget game playing and confusion regarding accountability.

In addition to the above problems, some research studies have highlighted poor financial and project management skills, a shortage of staff, and inadequate facilities as hindering the smooth spending of conditional grants.[10] Despite the teething problems identified with conditional grants, their use in the South African IGFR system continues to grow. This growth is largely driven by the introduction of new basic services programs, notably, those geared towards HIV/AIDS prevention and treatment, school nutrition, and adult basic education programs as well as infrastructure and institutional capacity-building grants. Conditional grants have also been used to provide for services that are clearly needed (e.g., early childhood education), but where the institutional framework for delivery either needs to be transformed or is not adequately understood and where the cost structure for providing the service needs to be clarified.

FISCAL EQUITY, EFFICIENCY CONCERNS, AND INTERGOVERNMENTAL FISCAL TRANSFERS

South Africa adopted a formula-based approach to the equitable division of nationally collected revenue. This approach was proposed by the Financial and Fiscal Commission (FFC) and takes into account the expenditure needs of subnational governments as determined by the government in general. The FFC is an independent body established under Chapter 13 of the Constitution. Its main function is to make recommendations on the equitable division of nationally raised revenue among the three spheres of government (vertical division) and across provinces and municipalities (horizontal division). The Constitution requires that, before an Act of Parliament affecting the equitable shares is tabled, the minister of finance must indicate how the recommendations of the commission have been taken into account.

The process for the division of revenue starts with the FFC making recommendations that are subjected to consultations and public hearings with the national and provincial legislatures and organized local government. From the government side, these recommendations fit into the process through the Budget Council and Budget Forum. The Intergovernmental Fiscal Relations Act, 1997, established these forums, which consist of the national minister of finance and his nine provincial counterparts (the Budget Council). The Budget Council and organized local government constitute the Budget Forum. These two then make recommendations to the Minister's Committee on the Budget, which, in effect, is a subcommittee of the Cabinet chaired by the minister of finance and makes recommendations to the Cabinet on the final budget allocations. Once the division of revenue is finalized, a Division of Revenue Bill must be tabled to be passed by Parliament. The bill contains memoranda explaining all the formulas used to determine the allocations, which FFC recommendations have been accepted, and whether any have not been accepted and, if not, why not. The payment schedule for transfers is also included. In general, the FFC's recommendations have been accepted by the government. The reason for this is that the FFC has steered clear of making recommendations on actual allocations and, rather, has focused on the principles that should guide the determination of allocations. Its recommendations have also been based on thorough and sound research and analysis, taking into account best practices on IGFR matters.

An interesting aspect of the system as it has evolved is that, while the horizontal division is formula-driven, the vertical division is determined through a political process based on the government's priorities for the medium-term expenditure cycle. The pool of revenue available for sharing among the provinces (and municipalities) is thus predetermined. In the last couple of years, some quarters have raised concerns about the objectivity of the vertical division, especially with respect to the transparency of the issues surrounding the vertical division. The Select Committee on Finance of the National Council of Provinces (NCOP) has asked the FFC to comment on the vertical division. This is in spite of the fact that, in its response to the commission's very first recommendations, the government adopted an approach that implied that the vertical division was a political process and could not be determined through a formula. Whether such an approach might compromise the government's power to determine and resource its priorities is still subject to intense debate.

Once the vertical division has been established, the next step is the horizontal equitable division of revenue among the nine provinces and 284 municipalities. This is followed by other allocations in the form of conditional and unconditional grants to the provinces and municipalities. The intergovernmental fiscal relations system in South Africa is structured in such a way that subnational governments (provincial and local) are mandated to deliver most basic social services. Although in terms of revenue powers, the fiscal autonomy of the provinces is very limited, this is not the situation with local government. Thus, vertical and horizontal imbalances exist due to the nature of the assignment of revenue sources and the vast variation in fiscal capacity, especially in the local government sphere. Generally, subnational governments are empowered to determine their own resource allocation decisions in the context of the government's broad, medium-term, strategic objectives.

Currently, a number of conditional grants flow to provinces and municipalities. Some of these are block grants, while others are specific purpose grants.[11] Generally, conditional grants have been problematic, and a comprehensive review of these grants is currently under way to find out whether they follow an appropriate framework/design. The review is being carried out by both the FFC and the National Treasury (the two institutions are working independently on this review).

The vertical division of revenue among the three spheres of government involves a policy decision that reflects the priorities of the government over an MTEF period.[12] The horizontal division of revenue is formula based and takes into account demographic patterns and broad indicators of need. The provincial equitable share formula is specified as follows: $A = E + H + B + P + EA + I$, where A is the allocation per province, E is the weighted share of the province's school-age population, H is the share of the population of the province without medical aid, B is the share of population for the province, P is the weighted provincial share of population living in poverty, EA is the share of the province in economic activity, and I is an amount allocated equally across provinces for governance costs.

The local government's equitable share formula takes into account basic municipal services, the number of poor households, the fiscal capacity of a municipality, and an allocation for the cost of governance based on the number of poor households in the municipality. The formula is driven by the demographic patterns in the country and captures the need to finance the constitutionally assigned functions of subnational governments.

In general, significant fiscal disparities are driven to a large extent, but not exclusively, by differences in costs and capacity in the production and delivery of public services. These are a matter of policy concern, and mechanisms are being investigated to address them. Recently, there have been comprehensive reviews of the fiscal frameworks of both the provincial and local government levels together with the relevant revenue allocation formulas. The reviews were conducted independently by the National Treasury and the FFC. The outcome of both reviews was that the recommendations of the FFC that were limited to the data that are used for different components in the PES and the structure for the LES were all accepted, although the implementation will be phased in as the relevant data become available. With respect to the LES, the structure that has been adopted is a component-based structure that mirrors that of the PES.

Table 5
Vertical fiscal gaps

	Total revenue collected in millions of rands	*Total revenue available, including net transfers for that level of government in millions of rands*	*Expenditures in millions of rands*
National	369,869		283,113
Subnational			
state/provincial	5,663	205,367	204,869
Local	72,900	8,100	86,000
All orders			

In general, the revenue-sharing mechanism ensures that the fiscal gap between revenue and expenditure responsibilities for sub-national governments is reduced. The formula also addresses horizontal disparities within the spheres. However, the South African approach is not an equalization approach but, rather, an equitable sharing of nationally raised revenue.

FINANCING CAPITAL INVESTMENT

It is the government's goal to expand investment and spending on capital to boost economic growth and employment creation and to improve service delivery. The critical question is the assignment of responsibilities between different role players. In particular, the question concerns defining the role that government needs to play in terms of financing capital expenditure. In terms of funding, the government is driven by spending priorities and functional responsibilities that each sphere of government has to meet, taking into account policy changes. This is done through intergovernmental transfers. In the last five years the government has embarked on a program to accelerate investment in infrastructure. The program incorporates what is known as the extended public works program, which requires that infrastructure projects incorporate employment generation by utilizing local people through labour-intensive methods. The beneficiaries must include women and other disadvantaged groups. The extended public works program extends beyond infrastructure programs as it includes other activities, such as home-based care for HIV/AIDS sufferers and so on.

A question that arises relates to how borrowing can be used to finance capital expenditures. In relation to this question, it can be argued that a sound revenue base among governments is crucial before they can start borrowing. The current situation in South Africa is one in which provincial governments have limited borrowing powers, although the Provincial Borrowing Powers of Provincial Government Act has been in place since 1996. Generally, provinces raise an insignificant amount of revenue relative to their expenditure needs. However, local governments raise a substantial amount of revenue relative to their expenditure needs and, therefore, exercise significant borrowing powers.

Increasingly, policy makers realize they need to distinguish among capital investments in the local sphere. Investment in new infrastructure and capital expenditure on maintenance need to be taken into account as discrete components. It is important to ensure that capital investment also takes account of maintenance needs for existing infrastructure. For example, there has been a significant focus on the establishment of new infrastructure to address the backlogs that were created under apartheid. There is a growing recognition that, as new infrastructure was created, not enough attention and resources were provided to maintain already existing infrastructure.

The lack of coordination in planning and implementing large capital investment projects is another matter of concern. For example, the rapid-rail project (Gautrain) is a provincial project, whereby the province of Gauteng will receive some funds from the national government for constructing the Gautrain. However, the implications of the project for the other spheres of government have not been addressed. For example, it will require local government to provide ancillary infrastructure such as feeder transportation and amenities at the stations. This unintended cost for local government has not been taken into account.

The government's role needs to focus on helping those municipalities that are not economically affluent and are therefore unable to raise project financing through the capital markets. It is generally acknowledged that the national government has an important role in terms of financing but that it should not be expected to entirely absorb financing as the specific province needs to take full responsibility. An additional question relates to whether there are mechanisms in place for provinces to consult with the national government before they initiate a large project that has significant national or regional implications. The government is in the process of establishing mechanisms that would guide the process on those issues, particularly as equitable share transfers do not cater to huge investment projects.

In conclusion, it is important to take into account the need to synchronize funds (expenditure versus revenue) with mechanisms to deal with municipalities that have structural problems. It is a fact that municipalities are the source of economic activities. Therefore, there may be a need to review the pool of funds that goes to municipalities in the form of the equitable share. For the provinces, there is a need to align provincial and national priorities on capital expenditure. Finally, there is a need to investigate whether the national government should develop alternative funding vehicles other than intergovernmental transfers and borrowing.

INSTITUTIONAL DIMENSION AND CORRUPTION

Appointments and Termination of Services

All spheres of government have the right to appoint their own personnel without a directive from another sphere. The hiring and firing of staff happens within the context of national legislation such as the Labor Relations Act, 1988, the Basic Conditions of Employment Act, and the Skills Development Act.

Secondment also exists in the system, taking the form of advisory teams in cases of glaring gaps in human resource capacity. Apart from this, at the very senior executive management level (e.g., deputy director generals and director generals/superintendents), secondment also takes place, particularly where there is a dearth of leadership.

Currently, there is a dualistic public service. National and provincial conditions of service are governed in terms of a single law and policy, while the local sphere has its own separate policy and laws regarding conditions of service. Generally, it is felt that municipal employees have access to relatively better conditions of service (remuneration and other allowances) than do employees in the national and provincial spheres. This is particularly true with respect to senior management at the local sphere (e.g., municipal managers).

Despite the dualistic approach, in general the conditions of employment and related matters in South Africa, both in the private and public sectors, are governed by the overarching labour legislation indicated above.

Autonomy at Each Level of Government

Each sphere of government is autonomous and, thus, retains an independent right to hire and fire staff. There is also a separation of powers between the judiciary, the executive, and the legislature.

Nevertheless, there is a systematic process that allows for intervention in one sphere by another and that is governed by law. Sections 100 and 139 of the Constitution enable the national and provincial spheres to intervene in the affairs and the administration of a province (and a municipality) where there is evidence of failure to deliver on mandates. It is important to note that this form of intervention is temporary in nature. However, legislation does permit the intervening sphere to rectify the situation, and, in the case of municipalities, measures may include firing or dissolving a council. This is done on a case-by-case basis, depending on the merits of each scenario.

What often emerges as a potential threat to autonomy, particularly of subnational government, is the issue of unfunded and underfunded mandates. In principle and law (the Division of Revenue Act), funds should follow function. However, in practice this principle is sometimes violated, especially in incidents where the higher sphere lacks trust and confidence in the subnational governments, particularly in their ability to plan, prioritize, and spend resources. It also results from a lack of clear policy frameworks on the assignment of powers and function, especially where such powers and functions are concurrent in nature. This can lead to a lot of frustration within the system. However, a framework for the efficient and effective assignment of powers and function is currently being developed, and it is anticipated that these problems will be dealt with in a more systematic and controlled manner than is found in the ad hoc and discretionary approach that has characterized the system thus far.

A matter related to unfunded mandates involves the fact that, quite often, municipalities have received qualified financial reports in cases where they have borne expenditure for functions that are not assigned to them by the Constitution. Similarly, there are challenges with respect to concurrent functions such as education and health. The national government sets policies, which are often input norms and not output based. Due to the lack of sufficient accuracy in the costing of services, this ultimately results in underfunded mandates. In this way, the autonomy of a subnational government to deliver services based on its own priorities may be largely compromised.

Corruption and the Use of Resources

The Public Finance Management Act (PFMA) and the Municipal Finance Management Act (MFMA) were introduced to repeal the Exchequer Act in order to modernize public financial management and to increase public accountability.

The PFMA has provided a solid background for a good MFMA. The MFMA is considered to be more solid and comprehensive in some areas where the PFMA is silent. The government has indicated a desire to strengthen the PFMA in areas that were not very tight, such as supply chain management. These two pieces of legislation apply to the financial management practices in the provincial and national governments (PFMA) and in local government (MFMA). They empower the authorities to hold public officials accountable, provide checks and balances in the utilization of public funds, and detail sanctions in case of violation of the law, including imprisonment for offences deemed to be very serious.

One of the outstanding pillars of South Africa's IGFR system is the auditor general, who audits government departments and bodies across all three spheres of government. However, the major weakness is that the auditor general's reports are often released a year after the incidents have taken place, thus providing an opportunity for correcting future encounters rather than for dealing with issues as they happen. The audits have also tended to focus too much on financial management issues and the accuracy of financial statements rather than on the overall performance of the government. In the future, however, the audit process will focus more on the performance of state institutions.

By law all government departments and agencies must have internal audit functions. These are aimed at assisting management in identifying weak management systems, which are potential areas for fraud and corruption, and developing corrective systems where risks appear. Significant attention is often given to fraudulent and corrupt activities in the government rather than in the private sector and multinational corporations. The government's other fraud and corruption strategies include toll-free numbers, bodies such as the Scorpions and the National Prosecuting Agency, Anti-Corruption Summits, the Whistle Blowers Act, and the encouragement of the development and implementation of fraud prevention plans.

Oversight

The Constitution establishes the Parliament, which serves an overarching oversight role on government activities and programs. The Parliament has sectoral committees that focus on specific areas (e.g., education, finance, etc.). The National Council of Provinces has committees that mirror those of the National Assembly. In some instances, joint committees are established to increase the effectiveness of the oversight role (e.g., the Joint Budget Committee). One issue that is clear is that a significant amount of work still needs to be done to ensure that legislatures and various committees are able to competently and robustly take departments to task in key areas of failure. This requires, among other things, that the committees be given adequate capacity to undertake rigorous independent research into the activities of the departments. Improving the oversight role of all the legislatures is an ongoing process.

CONCLUSION

South Africa's system of intergovernmental relations is still evolving as the country is still a young democracy. The clarity with which powers and functions are defined in the Constitution safeguards the country against arbitrary reallocations of functions. Nonetheless, there have been some shifts in functions over the past ten years, such as the reallocation of social security grants from the provincial governments to the national government and the reallocation of primary health care from local governments to provincial governments. A framework has been formulated for the effective assignment of functions, and it ensures that the assignment remains true to the spirit of the Constitution and that principles such as funding follows function are adhered to. Issues of public accountability, anti-corruption, and fraud prevention are important elements that are being inculcated within South Africa's democratic system.

NOTES

1 See South African National Treasury, *Intergovernmental Fiscal Review* (Pretoria: South African Government Printers, 2003).
2 See South African National Treasury, *Budget Review 2006* (Pretoria: South African Government Printers, 2006).
3 Ibid.
4 See Financial and Fiscal Commission, Annual Recommendations, Financial and Fiscal Commission, Midrand, 2002.
5 Ibid.
6 Municipalities derive most of their revenue from tariffs on utilities, in particular water and electricity. It is important to highlight that the electricity distribution industry in South Africa is undergoing reform. The reforms will involve a movement away from the current scenario, in which some municipalities distribute electricity to consumers, to a scenario in which an electricity distribution holding company – through regional electricity distributors – will be in charge. The amount of revenue available to originally distributing municipalities may be affected and, therefore, total revenues available to municipalities in the form of surpluses arising from the sale of electricity.
7 W. Oates, *Fiscal Federalism* (New York: Harcourt Brace Javanovich, 1972).
8 Detailed explanations of the revenue-sharing formulas are provided in Annex E of the Budget Review on an annual basis. The explanatory memorandum for these formulas also captures revisions to the input data that occur either as the result of a new census or new survey data, such as data on medical aid to the population with respect to health, data on school enrolments in the provinces, or new poverty data with respect to basic services for the local government.
9 According to the Division of Revenue Act (2005), provincial and local governments administered more than twenty-five grants during the 2005–06 fiscal year.
10 See, for example, A. Hickey, "Provinces Improve Spending on Conditional Grants for HIV/AIDS Health Programs," Budget Brief of the AIDS Budget Unit, Institute for Democracy in South Aftica, 2003.

11 The Division of Revenue Act (the legislation that deals with the allocation and equitable division of nationally collected revenue and is tabled annually with the budget) has very detailed schedules that present the frameworks for the various conditional grants to provinces and municipalities. These grants are classified into specific and general purpose grants and then listed in the appropriate schedules.

12 Main budget revenue includes all revenue less payments made to the revenue pool of the Southern African Customs Union. In 2005/06, this amounted to 12 billion rands. The Southern African Customs Union is the regional grouping that existed during the Apartheid era and includes Botswana, Namibia, Lesotho, and South Africa.