16 Fiscal decentralization in South Africa

A practitioner's perspective

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Introduction

This paper focuses on South Africa's implementation of a decentralized fiscal system since 1994, when South Africa's democratic government replaced the previous Apartheid administration.

As a developing country, the experience of South Africa promises to be relevant for other developing countries. Many papers on fiscal decentralization focus on the conventional arguments for, or against fiscal decentralization. Such analyses, while potentially appropriate for more developed countries, ignore the critical factors and choices facing developing countries. Incorrect and unsustainable strategies are, therefore, frequently attempted and when problems occur it is easy to blame poor capacity, lack of information or flawed implementation.

Building capacity and improving information are part of the daily requirements facing practitioners in developing countries, particularly in Africa. Developing countries do not enjoy the luxury of carefully sequencing the devolution of fiscal powers to subnational governments. Governments in developing countries are often forced to undertake critical political and economic reforms without sufficient capacity or information. Developing and implementing policy in this environment represents a major challenge made more difficult in the light of the ever-present pressure to deliver services to poor communities.

This paper provides an insight into the South African experience, and concludes with the general lessons learned in the implementation of a fiscally decentralized system in South Africa. The experience of the country's two spheres of subnational government (provincial and local) differs markedly. However, both emphasize the extent to which conventional economic arguments for or against fiscal decentralization pale into insignificance compared to problems caused by lack of sufficient capacity and absence of more modern budgeting and financial systems. The foremost lesson is that, irrespective of the degree of centralization or decentralization, basic budget and financial management reforms are critical elements for successful implementation of any system. While decentralization does have potential benefits, the selection of functions to decentralize is not obvious. Determining the correct balance of fiscal decentralization is more difficult, and does not automatically lead to more fiscal responsibility or better outcomes.

Background on decentralization[1]

The coming into power of the new democratic government led by Nelson Mandela in 1994 marked the end of Apartheid and, consequently, the policies of racial discrimination that denied the 88 percent black majority political rights, citizenship and economic benefits. Previously, white-ruled South Africa was divided into four provincial administrations (appointed by the national government) and local governments. Black South Africans were confined to live in "homelands" established in rural areas away from the main centers. Although supposedly independent, "homelands" were fiscally dependent on the Apartheid government, and their "governments" operated in effect as appointees of the Apartheid regime. The many black people living in urban townships in white South Africa were regarded as temporary residents, to be removed to the homelands once their labor was not required in white South Africa.

The budget of the Apartheid government focused spending on white residents, with very little expenditure directed towards education, health, housing and other basic needs of black residents. Poverty and unemployment were characteristic of life for most black South Africans.

The population of South Africa is over 43 million and is comprised of 33 million Africans, 4.5 million whites and 4.7 million Coloreds and Indians. South Africa is a middle-income country with a projected GDP of R876 billion ($110 billion) in 2000, a per capita income around $2,500 and inflation projected at 5.3 percent. What makes South Africa different from most middle-income countries is the extent of income inequality, which is also mirrored along racial lines. A poverty study in 1998 found that the poorest 40 percent of the population earn only 11 percent of income, while the wealthiest 10 percent of population earned 40 percent of income. The Gini-coefficient is 0.52.[2]

Political decentralization

South Africa has a unitary but decentralized system of government. It is not a federal system. The 1994 post-Apartheid system created three tiers ("spheres") of government: national, provincial and local.

Nine provinces replaced the previous four white provinces and nine black homelands, while the local governments largely integrated adjoining racially segregated black and white local areas. The new provinces were created in April 1994, only four months after their conception at the negotiation table and new integrated municipalities took effect in November 1995. There are 284 local municipalities.[3]

The national Parliament comprises two houses: a national assembly, and a national council of provinces representing provincial legislatures and organized local government. Provinces are accountable to provincial legislatures, and local governments to their councils.[4] The system of election at the national and provincial level is one of proportional representation, while the local level is a mix of directly elected and proportional representation.

Political imperatives to end Apartheid and prevent further civil strife dominated the 1993–94 transition. Fiscal decentralization to the provincial level was a political compromise between the main parties, part of the deal that allowed for a negotiated transition to democracy. Economic and fiscal considerations were secondary concerns to the political imperatives driving the negotiations. Decentralization to the local level was merely a continuation of the historical situation. The features of the new intergovernmental system, therefore, emanate from political, historical and constitutional factors, rather than fiscal considerations.

Powers and responsibilities

The Constitution assigns functions to the three spheres of government.[5] National and provincial governments are concurrently responsible for functions like school education, health, welfare and housing. In practice this means that the national government determines the policy, and provincial governments are responsible for implementation. Exclusive functions for provinces are not significant in budgetary terms, with the notable exception of provincial roads.

While the division of powers changed for national and provincial governments after 1994, the local government sphere was left with similar powers and functions as the previous white local authorities. Approximately two-thirds of local functions (in budgetary terms) involve user fee services like electricity, water and sanitation, while the remaining one-third involves the provision of public goods such as municipal and household infrastructure, streets, streetlights and garbage collection.

The South African constitution entrenches the important principle of *cooperative governance*. This obliges the three spheres of government to cooperate, and legally enforces negotiation, rather than litigation, to resolve political (and budgeting) problems between them. Numerous intergovernmental forums have been established as a result, including the Budget Council[6] and Budget Forum, which facilitate cooperation and consultation in the budget process.

Two aspects of decentralization in South Africa must be noted: First, the one million public servants employed by national and provincial governments comprise *one single public service* (with similar remuneration for similar rankings, irrespective of function[7]). Provinces employ the majority of public servants, at around 759,000. Municipal employees are not part of this public service, nor any uniform municipal service, but employees of their respective municipalities only. Second, there is a high level of unionization and collective bargaining. This reinforces the uniform nature of the public service, not only at the national and provincial level, but it also drives municipalities to converge towards similar conditions of service and salary structures.[8]

Fiscal decentralization in South Africa

Fiscal division of powers

As demonstrated in Table 16.1, South Africa's fiscal system is based on a *revenue-sharing* model, with provinces totally dependent on transfers from the national government, while municipalities are only marginally dependent.

The total national government budget in 2000 was R235 billion, comprising R213.4 billion in revenue (mainly corporate and personal income tax, VAT, fuel and excise levies), and borrowing amounting to R21.7 billion for a 2.4 percent deficit. The largest portion (R108 billion) is transferred to provinces, and about R6.8 billion to local governments (including grants-in-kind).

The actual spending budget of the national government is R73.7 billion, after excluding debt service and grants-in-kind to local government. The national government's main spending responsibilities are the criminal justice system (police, justice and prisons) and defence, which make up around 55 percent of its expenditure; higher education transfers (universities and technikons) 10 percent; transport including roads, rail, bus and other subsidies and public works, 5 percent each; revenue services (3 percent); and trade and

Table 16.1 Total budget and revenue sources of the three spheres of government in fiscal year 2000[a]

	Revenue generated (R bn)	*Borrowing (R bn)*	*Transfers from national (R bn)*	*Total budget (as appropriated)*	*Actual spending budget (excluding debt-servicing)(R bn)*
National	213.4	21.7	−112.2	122.9	73.7[b]
Provincial	3.6	0	108.4	112	112
Local[c]	55	8	3.8	66.8	69.8[d]
Total	272.0	29.7	0	301.7	255.6

Notes

a The fiscal year 2000 for national and provincial governments refers to the period 1 April 2000 to 31 March 2001. The municipal fiscal year is different, covering the period 1 July 2000 to 30 June 2001.

b The national government budget of R122.9 billion includes debt-servicing costs of R46.2 billion, and about R3 billion in grants-in-kind to local government.

c Local government figures are generally budget estimates, rather than actual expenditure. Actual expenditure figures will differ markedly from the budgeted estimates, given poor budgeting and financial management systems, and the exclusion of conditional grants and grants-in-kind in municipal budgets. If all grants and grants-in-kind are included, the local budget may increase to between R65 and R70 billion.

d Includes about R3 billion in grants-in-kind spent by national departments.

industry (3 percent). Smaller but significant budgets include water affairs (excluding all grants-in-kind), foreign affairs and home affairs (identity documents and passports). National education, health, welfare and housing departments focus on policy-making and monitoring rather than implementation, and so have small budgets, once grants to provinces and transfers to universities or technikons are excluded. The national government also has an oversight role oversight over public entities and government business enterprises.

Provincial governments are responsible for the implementation of the most important social services, including school education, health (including quarternary, academic and regional hospitals, as well as primary health care), welfare grants and services, housing and provincial roads (See table 16.2). Provincial budgets total R112 billion, comprising R108.4 billion of transfers from national, and R3.6 billion own revenue. Under the South African system, the R108 billion of transfers comprises an unconditional "equitable share"[9] of R96 billion, and R12 billion of conditional grants. The most significant own revenue sources are motor car license fees, casino and horseracing taxes and hospital fees.

Local governments are responsible for the provision of public goods and user services. The public goods comprise municipal infrastructure like access roads, streets, streetlights, garbage collection, sanitation and town planning. The key user-pay services are water and electricity. Local governments have taxation powers (property, regional levies), and generate income from the provision of services. Local governments raise R12.4 billion from these sources, and together with transfers of R6.8 billion from the national government, are estimated to jointly have budgets of R70 billion (if grants-in-kind are taken into account). The unconditional equitable share is just under R2 billion, while conditional grants and grants-in-kind comprise R5 billion.

In terms of actual spending of the R256 billion spent by the three spheres of government, the provinces spend the largest share (44 percent), national (29 percent) and the local sphere (27 percent).

Table 16.2 Expenditure functions of different spheres of government

	Major spending functions
National (R73.7 bn)	Protection services (R40.9 bn) • Criminal justice (police, prisons, justice) (R25.7 bn) • Defence and intelligence (R15.2 bn) Higher education (R7.1 bn) Transport (R4.1 bn) • National roads (R700 mn) • Bus subsidies (R1.5 bn) Public works (R3.8 bn) Water affairs (R2.9 bn) SA revenue services (R2.4 bn) Trade and industry (R2.2 bn) Labor (R2.1 bn) Foreign affairs (R1.3 bn) Home affairs (R1.3 bn) Other functions under R1 bn (R4.3 bn) • Arts, culture, science and technology • Agriculture (R719 mn) • Environment/Tourism • Land affairs • Minerals and energy • Communications Policy functions • Education (R476 mn) • Health (R478 mn) • Welfare (R348 mn) • Housing (R400 mn)
Provincial (R112 bn)	School education (R43.6 bn) Health (academic, hospitals, primary) (R26.4 bn) Welfare (social grants, services) (R21.5 bn) Housing (R3 bn) Provincial roads
Local (R69.8 bn)	Electricity reticulation (R14.5 bn) Water reticulation (R6.6 bn) Sanitation and wastewater (R1 bn) Garbage collection Municipal infrastructure (streets) Firefighting Municipal infrastructure

Taxation powers

Provinces cannot impose corporate income tax, VAT, excise levies or property taxes. Though they cannot impose a personal income tax, they may impose a surcharge on personal income tax and on the fuel levy. However, in terms of the Constitution, the right to impose a tax or surcharge is subject to national legislation and national economic policy objectives. To date, no province has exercised its taxation or surcharge powers.

As required under the Constitution, the forthcoming legislation[10] will establish a process to regulate the imposition of new provincial taxes. Under this regulatory process, national government will review each proposed provincial tax for consistency with the national economic and fiscal policy and ensure that it does not have adverse economic consequences for other provinces. If national government approves a provincial tax option, the tax would become part of an "allowed list" of taxes that any province could then impose once enacted by its provincial legislature. The approval process requires the national government to consult with the provinces (through the Budget Council) and with the constitutionally independent fiscal commission (the Financial and Fiscal Commission (FFC)). The allowed list will be in the form of legislation adopted by the national Parliament.

In general, provinces have accepted that the surcharge on the personal income tax is not feasible for the foreseeable future. Currently, options considered include a surcharge on the fuel levy and some smaller taxes. The introduction of any new taxes to provinces may require an adjustment in the revenue-sharing formula, to prevent poor provinces from losing out to richer provinces.

Provincial revenue has declined in both real and nominal terms since 1995–96. Therefore, the imposition of any new taxes is dependent on provinces improving their revenue collection from current tax sources (motor car licenses, gambling and hospital fees).

Further, given the success of the central revenue collection agency (South African Revenue Services), there is strong pressure for any significant taxes to be collected by this agency, rather than setting up new revenue services in provinces.

Local government has significantly more fiscal capacity than the provinces. Municipalities can raise property tax and turnover/payroll regional levies on businesses, as well as user charges (and a surcharge) on the provision of electricity and water (see Table 16.3). All of this revenue is collected by municipalities directly through their own collection agencies. However, local governments generally do not collect a significant portion of revenue due, resulting in deficits at the end of the financial year (as they budget on the expectation of collecting all their revenue). No additional taxes (except possibly for local betterment taxes) are planned for local government; the focus is on reforming the current design of local taxes and modernizing collection and billing systems. The budgeting system is also being modernized, and will be based on more realistic revenue projections.

Borrowing powers

The South African Constitution allows provincial and local governments to borrow for capital and bridging purposes only. Being new, provinces have not borrowed for capital, restricting their borrowing to bridging loans, largely in the form of overdrafts. They are expected to start borrowing for capital from 2002. Local governments have traditionally borrowed for capital investment. However, given the poor state of local government finances, and the uncertainty generated by the many policy changes since 1994, long-term borrowing has largely dried up. This is also because the previous system of national government guarantees was abandoned in 1994, and subnational governments were forced to borrow on their own merits.

Proposed legislation[11] to facilitate long-term borrowing for municipalities reinforces the approach of not providing central guarantees for subnational borrowing. This

Table 16.3 Taxation and user-charge revenue powers of the three spheres of government[a]

	Current taxes	*Current user charges*	*Potential taxes*
National[b]	Income tax (personal) (R86.4 bn) Income tax (corporate) (R26 bn) VAT (R54 bn) Fuel levy (R14.9 bn) Excise (R9.7 bn)		
Provincial	Gambling (R468 mn) Other (R540 mn)	Motor car licence fees (1.6 bn) Hospital fees (R395 mn)	Surcharge on personal income tax Surcharge on fuel levy Small taxes
Local	Property Tax (R10.1 bn) Regional levies (R3.9 bn)	Electricity/Water (R23,9 bn)[c]	Small betterment taxes

Notes

a The figures are indicative, to enable the reader to gauge the fiscal capacity of the three spheres. The figures for national are the most accurate, while that of local government the least accurate, being a guesstimate.

b Total tax revenue collected by the national government is estimated to be R208.4 bn in 2000. If total local and provincial tax is estimated at R13.4 bn, the total tax-to-GDP for the three spheres is estimated at around 25.3 percent, with subnational tax comprising around 6 percent of the total tax take of the three spheres.

c Note that this represents the budgeted gross income from the provision of electricity and water. The bulk purchase of electricity and water around R14 bn. If salaries/wages and administrative costs are taken into account, the net "surplus" from these services is significantly smaller, probably less than R1 billion.

legislation allows for a form of judicial intervention in the event of defaults, clarifying the rights of lenders.

To summarize, provinces and local governments have different fiscal capacities. Local governments have significantly more revenue-raising powers than provincial governments, raising over 90 percent of their own revenue, while provinces raise only 4 percent of their own revenue. Local governments have traditionally been allowed to borrow for both capital and bridging purposes, while provinces only borrow for bridging purposes. Provinces are, therefore, totally dependent on transfers, receiving R108.4 billion or 96.8 percent of their revenue, while local governments are less dependent, receiving R7 billion or around 10 percent of their total revenue.

Intergovernmental transfer system

Vertical division of revenue

Under the South African revenue-sharing system, nationally raised revenue is divided among the three spheres after national debt-servicing needs and a contingency reserve for emergencies are taken into account. This means that after deducting the R46.2 billion for debt-servicing in 2000, non-interest expenditure of R189 billion is available to be divided between the three spheres. Allocations are made for three years under the multi-year budgeting system in South Africa.

The Constitution requires ten factors be taken into account to help determine this division. This includes fiscal capacity and expenditure efficiency of the provincial and local spheres, their developmental needs and backlogs, and provision for emergency funding. Before proposing its final allocations to Parliament, the national Cabinet discusses its proposals with provinces and local government at the appropriate intergovernmental forums, the Budget Council and the Budget Forum.[12] It also takes into account any recommendations from the FFC. In addition, provincial premiers are invited to the Cabinet meeting where the final allocations between the three spheres is decided.

The consultations use as their starting point a *baseline allocation* (which includes the implicit percentage shares allocated to each of the three spheres) that reflects the three-year allocations from the last budget. As a result, it is only the additional resources that have to be allocated. This division between the three spheres reflects priorities determined by the national Cabinet after the above consultations. It is a *political judgment*, and depending on the program or sector prioritized, more resources are made available to the implementing sphere. Thus, if school education is identified as a new or higher priority, the provincial share increases over the baseline allocation from the current three-year allocation; if policing is a priority, the national government share is increased.

Given the high demands facing a developing country like South Africa and the need to prioritize, it is unlikely a formula-driven approach can be utilized to improve on this process for the vertical division among the three spheres. The political judgment approach does not make the budget process *ad-hoc*, given the baseline allocations (and the implicit baseline percentage share) of each sphere. The provincial and local spheres are (implicitly) guaranteed their baseline three-year allocations. Furthermore, Parliament (and particularly the second house, the National Council of Provinces) subjects such allocations and shares to rigorous scrutiny, where the FFC (and provincial and local) comments are also taken into account.

The political judgment, thus only involves allocations on the margin, and the additional allocations indicate the new priorities determined by the national executive. It is also not an unfettered political judgment, as the baseline percentage share between the three spheres is an important factor when such new priorities are taken into account. It would be incorrect, as well as unrealistic, to make the resource allocation process a mechanistic one determined by a formula. A formula-approach for the vertical division is not necessarily any more certain or less *ad-hoc*. For instance, a formula will be subject to annual changes as policy priorities change or better information becomes available.

In a developing country like South Africa, any formula is dependent on the information available, and will be subject to change as information is revised or improved. For example, in South Africa, given the number of informal settlements and high levels of illiteracy and poverty, census information is subject to changes from data corrections or new migrancy patterns. More complicated formulae attempting to capture the costs of providing basic services are more difficult to implement, not only because they require more sophisticated information, but also because they still require political judgment on the minimum *levels of service* to be prioritized. The higher the level of service, the higher the costs. Those functions with relatively high levels of service will in effect squeeze out those functions with lower levels of service. For this reason, the South African government has not accepted the proposed costed-norms approach of the FFC.[13]

It is the process to make these divisions that must be open and transparent, and allocations should be on three-year basis. Any sudden or major changes in allocations should be phased-in, reducing uncertainty and stabilizing the budget process.

Table 16.4 Division of revenue between the spheres of government[a]

Rand million	*2000/01 Budget*	*Revised estimates*	*2001/02 Budget*	*2002/03*	*2003/04*
				Medium-term estimate	
National allocation	75,212	74,414	84,287	89,955	95,432
Provincial allocation	106,037	108,736	117,386	126,563	135,221
Equitable share	*94,408*	*96,186*	*104,136*	*112,560*	*120,215*
Conditional grants	*11,629*	*12,551*	*13,250*	*14,003*	*15,006*
Local government allocation	3,713	5,712	6,506	7,155	7,849
Equitable share	*2,330*	*2,330*	*2,618*	*3,002*	*3,551*
Conditional grants	*1,383*	*3,382*	*3,888*	*4,153*	*4,298*
Allocated expenditure	184,962	188,863	208,179	223,672	238,502
Plus:					
Debt service costs	46,490	46,186	48,138	49,651	51,022
Contingency reserve	2,000		2,000	4,000	8,000
Total expenditure	233,453	235,048	258,318	277,323	297,524
Percentage of shared total	100	100	100	100	100
National allocation (%)	*40.7*	*39.4*	*40.5*	*40.2*	*40.0*
Provincial allocation (%)	*57.3*	*57.6*	*56.4*	*56.6*	*56.7*
Local government allocation (%)	*2.0*	*3.0*	*3.1*	*3.2*	*3.3*

Note
a Table 7.1 in Budget Review 2001.

Horizontal distribution

The *equitable share* is an unconditional grant to enable provinces and local governments to provide basic services and to perform any functions assigned to them (see Table 16.4). These allocations are not appropriated in the national budget, but only in the provincial/municipal budget, as they are regarded as a direct charge, legislated in the annual Division of Revenue Act.[14]

Once the provincial and local equitable share allocations are determined, a formula is used to effect the division between municipalities.

The *provincial formula*[15] utilizes seven factors. The heaviest weighting measures the need for education, health and welfare needs. In addition, the formula contains backlog and economic activity components. It favors the poorer provinces. Directed at basic services, the local formula[16] targets households at the lowest income level (less than R800 per month). This formula supports the more rural and very poor municipalities.

In addition to equitable share allocations, provinces and local governments also receive conditional grants from the national share. These grants are targeted first at the allocated functions (e.g. academic/highly specialized hospitals which provide services to residents of all provinces). They also support national priorities like housing, municipal infrastructure for poor households, and capital grants to address backlogs. Conditional grants are appropriated in both the national and provincial/municipal budgets, and are legislated in the annual Division of Revenue Act.

While the equitable share allocations have worked smoothly, there have been problems with conditional grants. Many of these lack a clear purpose and measurable objectives and are poorly designed. They tend to undermine the budget reform process and fragment the budget process. They undermine co-ordination between policy and budgeting, are not transparent, may lead to budget game-playing and create confusion about accountability. Some national departments regard them as a lever to force changes and/or attempt to micro-control such grants. Delays in decisions, including a failure to make three-year allocations for many such grants, results in non-transfers and under spending of some conditional grants.

A comprehensive budget process for determining all allocations is best suited to incorporating policy priorities. The challenge facing the budgeting process in South Africa is to ensure that the process to determine conditional grant allocations is part of a comprehensive budget process.

Experience and lessons from fiscal decentralization

Provincial experience

The new provincial administrations had little or no time to prepare for their establishment in 1994. Their initial years were difficult, as the new provinces struggled to merge fourteen different administrations into nine new ones. Since there was a centralized budget process before 1994, as provinces were mere administrations then, provinces had to develop the capacity to budget as the new, more decentralized, budget system began to be implemented.

Most provinces struggled initially, given the lack of expertise and information on spending prior to 1994. The implementation of new national policies to correct past injustices added further pressure. Policies to redress previous neglect and deprivation in education and health in black areas resulted in significant increases in the number of teachers and health personnel. The nationally negotiated wage agreement, together with the equalization of salaries between white and black officials at the higher "white" levels, dramatically increased the share of personnel expenditure.

Provincial treasuries, having been established in 1994, were initially not in a position to monitor or check the expenditure of departments from 1994 to 1997. The treasuries were dependent on the one-year input-driven budgeting system used at that time, and they lacked any in-year management system. There were long delays before financial statements were completed and in some cases, the books from previous years were simply never closed. As a result, the nature and extent of budget problems were not well understood.

Overspending, particularly in departments like education, health and welfare, was identified only late in 1997, during preparations for the 1998 budget. Such overspending did not lead to deficits in 1995 and 1996, as it was funded from unspent transfers meant for other priority programs (the Reconstruction and Development Programme (RDP)). During this time, the heads of departments frequently ignored their budgets, and provincial treasuries proved unable to curb spending. Provincial treasuries were forced to run large overdrafts in some cases, but generally failed to alert the national treasury about the severity and extent of their problems. The seriousness of the situation became clear only when banks were no longer willing to extend additional overdraft facilities to provinces, in particular the Eastern Cape and KwaZulu-Natal. Provinces ran an aggregate deficit of R5.5 billion in 1997, or about 5.8 percent of actual spending.

All provinces experienced similar over-spending, in large part due to implementing nationally determined policies. This included the nationally-negotiated salary agreement and new policies in the education, health and welfare sectors. Much of this problem was due to the lack of co-ordination between policy-making and budgeting, and the rapid creation of a decentralized system compounded this problem. The implementation of nationally agreed policies was not necessarily an unfunded mandate, however. Such policies (in education, health and welfare) were implemented with the full support of provincial line function departments who were also involved in developing the policies.

Sectoral collusion to secure more funds for a sector proved to be a far stronger factor in overspending than unfunded mandates. Intergovernmental forums[17] in education, health and welfare developed national policy without taking into account budgetary resources. Many departments adopted an aggressive policy to address backlogs in deprived black areas. The outcome in the welfare sector was successful in reducing poverty, as social pensions were extended to cover poor black pensioners. However, the policy was less successful in education and health, where the effect was to increase the cost of inputs (personnel expenditure) rather than improve outputs like better quality education or health services. For instance, differences in teacher–pupil ratios were reduced between black and white schools. But this did not always have the desired result of improving the quality of education in black schools. The increase in personnel expenditure squeezed out expenditure in non-personnel inputs like textbooks, undermining the attainment of the desired outputs. Similar problems existed in health where large pay increases made it impossible to buy needed medical equipment and drugs.

National government was forced to intervene, and impose stringent measures in provinces, such as spending controls, freezing employment, and cutbacks in non-social security expenditure. Provincial treasuries helped to implement such measures. A monthly reporting system was created and the national treasury assisted provinces in drawing up more realistic budgets for the financial year 1998.

The problem of a lack of co-ordination was resolved by the creation of joint intergovernmental forums, between the treasuries and that function. For example, a joint Minmec comprising the national Ministers of Finance and Education, together with their counterparts in provinces met at least twice a year to co-ordinate policy-making, budgeting and implementation. These structures are supported by a range of large and small technical forums of officials from national and provincial treasuries and line function departments.[18] These forums ensure that budgets and national policy are aligned, and that provincial departments adhere to their budgets. It also reduced the budget games played by such sectors.

The implementation of these simple but critical measures helped to turn around provincial finances dramatically, as they ran a R500 million surplus in 1998–99 compared to the R5.5 billion deficit a year earlier. Provinces stabilized their personnel expenditure and began shifting funds towards non-personnel budgets and payment of debts. The implementation of a multi-year budget from 1998 onwards, also helped provinces to prepare more realistic budgets. Provinces have run surpluses every year since 1998 to pay off their debt by the end of the financial year 2000. This has put them in a strong position to focus on the micro reforms necessary to improve the quality of spending in education and health and on increasing their budgets for infrastructure.

The importance of best practices and peer learning, as well as benchmarking, have also played a significant role in the turn-around of provincial finances. Following the best practices established in more innovative provinces proved to be invaluable in the

South African experience. The province of Gauteng, for example, focused on modernizing its approach to budgeting and financial management, providing a best practice for both provincial and national departments. Once the Gauteng provincial treasury had set up its three-year budgeting process and its financial systems, its officials were inundated by requests from other provincial treasuries to help implement reforms in their provinces. The Budget Council (and its technical meetings) provided a further forum to demonstrate such best practices to all provinces. Provincial treasuries worked closely together, and the role of peer learning has been a major factor in improving the performance of all provincial treasuries. This is a real benefit of fiscal decentralization, as it clearly allows for greater variety and innovation.

A further impetus for reform emerged through *benchmarking*. The publication by national government of the first *Intergovernmental Fiscal Review* in 1999 marked the culmination of attempts to benchmark the various provincial budgets, especially for the education, health and welfare sectors. The production of comparable statistics is dependent on the successful implementation of a uniform classification system (e.g. the new GFS, budget formats and a chart of accounts). Comparisons between provinces not only identified cost-drivers, but emphasized the need for further reforms in lagging provinces.

While the implementation of fiscal decentralization in provinces appears to be successful after initial problems, there are areas where progress has been slow or non-existent. Provincial governments so far have not succeeded in improving their revenue collection or to increase their revenue potential from current sources, neither have they take effective measures in dealing with excess staff. This can be attributed largely to the lack of agreement with the trade unions on a mechanism to retrench excess staff. The responsibility to secure such an agreement resides with the national government. The slow progress in these areas tended to undermine provincial budgets, as all projected revenue was not collected, or savings from staff reductions did not materialize.

Local government experience

It is harder to assess the progress (or the lack of it) in the state of local government finances. One reason for this is the archaic line-item (telephone directory type) budgeting system inherited in 1994, which did not promote in-year management of budgets. Budgets were not adhered to, making the budget information base inconsistent, lacking uniformity and of poor quality. Delays in preparation and submission of financial statements (as was the case with provinces) exacerbated this problem.

Though the fiscal capacity of the local sphere (in aggregate) is much stronger than that of the provincial sphere, there is great variance between municipalities. The major urban municipalities have strong revenue-generating powers, and are only marginally dependent on transfers from the national government. Many rural and smaller urban municipalities, however, have very weak fiscal capacity, and are strongly dependent on transfers from the national government. Many of the smaller municipalities were not financially viable, and have therefore been phased out under the new demarcation system implemented in November 2000. This new system created 284 new municipalities, with all the rural municipalities now consolidated with neighboring urban municipalities. Most of these municipalities are, however, very small in budgetary terms with budgets under R100 million. The twenty biggest municipalities make up about 80 percent of the aggregated local government budget, with the six metropolitan municipalities making up at least 50 percent.

The financial problems of municipalities can be largely attributed to poor budgeting systems and the failure to collect revenue. Apart from the poor design of municipal budgets, the budget process often lacks depth (it had no buy-in from politicians, as officials drove the process as a technical exercise) and fails to close the gap between ambitious plans and actual financial resources. The budgets also often over-estimate revenue (using an accrual system of estimating revenue), resulting in deficits, and poor accounting systems do not reveal how reserves are used to finance such deficits. Finally, municipalities have often not focused on revenue collection, instead attempting to secure more funds from the national government.

The challenge facing South Africa is to stabilize the finances of the new municipalities, as they will be carrying the burden accumulated from the previous unviable municipalities. They also inherited the poor budgeting and financial management system and mindset of officials steeped in such systems. But the biggest challenge facing municipalities is that of modernizing their organizational structures. Few municipalities run key services on a commercial basis or as distinct cost centers, resulting in poor management systems with great inefficiencies.

Although the bigger municipalities are in a better financial state, this has in some instances only come about after a major financial crisis. The largest municipality, Johannesburg, experienced a serious financial crisis in 1997, on a scale comparable with the New York City crisis of the mid-1970s. After national and provincial government intervention, Johannesburg put in place tough restructuring proposals[19] in an attempt to turnaround its finances. In the process, the municipality is piloting a modernization program, including the creation of utilities to run its services on a more business-like basis, privatizing non-core functions, introducing a multi-year budgeting system and a management-oriented financial reporting system to reflect information in a more transparent manner.

Reforms in local government budgeting and financing will be phased in over the next five to ten years. Such reforms will be accompanied by a modernization program in the way municipalities provide services like electricity and water. The national treasury is piloting many budgeting and financial management reforms (similar to those implemented in provinces) with seven of the larger municipalities. Once these are successfully implemented over the next two years, the reforms will be rolled-out to all other municipalities. The pilot approach is the only feasible way to roll out reform to so many municipalities. While it is supported by donor support, there is much potential to increase the scale of such support.

Devolution of functions

While some functions may be performed in any sphere of government, the South African experience indicates that some functions are difficult to perform in the national sphere. While defence, foreign affairs and higher education are clearly national functions, it is less clear where academic hospitals and welfare grants, currently in provinces, would be better performed. It is also not clear whether school education or health clinics are better performed at the provincial level rather than at the local level. Much depends on where such functions have traditionally been assigned and where implementing skills exist.

In the limited South African experience since 1994, some lessons are beginning to emerge, particularly for household and municipal infrastructure. Unlike many countries, the local sphere in South Africa is autonomous, and not under the control of the provincial or national government. But national departments have been able to intervene directly in municipal affairs through the use of grants-in-aid for the delivery of services to the poor. For example, water and sanitation services and infrastructure have been provided to rural areas by the national department responsible for water affairs. In addition, national government manages a conditional grant for municipal infrastructure. All these grants fund specific projects.

Although such measures were necessary in 1994 in order to ensure speedy delivery, national departments are too far removed from local areas to take account of local demand for services. The project-based approach resulted in a lack of attention to sustainability considerations (e.g. who is responsible for maintaining infrastructure and the collection of user fees for such services). It has also led to locational decisions that were not well coordinated with spatial and delivery plans of provincial or local governments (e.g. for the provision of schools, clinics or municipal infrastructure). Further, since such projects were not on the budgets of a municipality, no provision was made for the complementary services required to make the project successful. National government has shifted away from this approach, and will henceforth shift funds for such services to the responsible sphere of government. The municipal infrastructure fund is being consolidated with similar national programs (water infrastructure), and allocated between municipalities on a formula basis for a three-year period. The poor co-ordination between these infrastructure programs and the housing program is also to be addressed. It is likely that well capacitated local governments, like the six metros with good capacity, will be given more responsibility for the housing programs that are currently supervised by national and provincial government.

Poverty alleviation

Poverty alleviation is an important objective in developing countries. In South Africa, poverty-alleviation programmes like welfare grants, the provision of free basic water and electricity for poor households are implemented through the equitable share and conditional grant allocations to provinces and local government.

There has been much confusion amongst policy-makers in South Africa about the extent to which subnational governments are expected to redistribute from rich to poor households (or from urban to rural) from their own revenue raised. The approach adopted in South Africa suggests that while subnational governments must take some responsibility for redistribution, using their own taxes and tariff charges (where rich households should pay to subsidize poor households), this capacity is limited. The national tax system is far more effective in funding redistribution and poverty-alleviation, and the equitable share allocations should be adjusted as such programs are prioritized by the national government.

Financial management

A critical element in laying the basis for the modernization of the financial management system was the passage of the 1999 Public Finance Management Act. This Act clarified the division of responsibilities between the political head (Cabinet Minister) and head of department. The political head is responsible for policy and outcomes, while the head of department is responsible for implementation, and hence is also made the accounting-officer responsible for the spending of the department's budget.

The Act also spells out the responsibilities of the accounting-officer, and the deadlines for the submission of financial statements and annual reports. It also obligates the accounting officer to submit (and use!) monthly reports to the treasury and political head.

The underlying philosophy of the Act is to enable managers to manage, but to hold them more accountable. It requires the accounting officer to collect management information on a monthly basis and use such information.

This Act applies to national and provincial governments. Similar legislation has been tabled for local governments.

Why conventional arguments are not critical to analyzing fiscal decentralization in South Africa

The debate on decentralization must not be cast in extreme terms: that is, whether all powers and functions must be centralized or decentralized. No country fully fits into either of the two extremes. Though South Africa is not a federal country, it is characterized by a high degree of decentralization of powers and functions. Such decentralization is the result of historical factors and political negotiations during 1993 and 1994.

The evidence in South Africa suggests that appropriate decentralization does lead to better outcomes (or that inappropriate centralization leads to sub-optimal outcomes). However, determining the optimal assignment of functions between spheres is a complex process with no easy options. More difficult is determining whether, and when, to decentralize fiscal powers.

Decentralization should be ideally carefully phased in, taking into account capacity, but this is not always possible. In a developing country context, such capacity is often not immediately available. It cannot, therefore, be assumed that when it is available, it is at the national government level – an implicit assumption assumed by many when recommending a slow and ordered sequence of devolution.

It is, therefore, much too simple to attribute any problems in fiscal decentralization in South Africa to the poor design or lack of clarity in assignment of functions, or mismatch between revenue powers and expenditure responsibilities or to the rate or sequencing of the devolution of functions. It is too easy to blame problems on the lack of capacity or poor information. These are the everyday realities of a developing country, affecting every sphere of government, irrespective of the degree of fiscal decentralization.

An important lesson in South Africa is that decentralization is more likely to be successful if all allocations to perform such functions are properly budgeted for in subnational budgets. A problem with grants-in-kind is that they are often budgeted for at the national level, but are not taken into account in subnational budgets. This can undermine accountability and transparency at the subnational level, as it bypasses the subnational budget process and confuses accountability arrangements. This is particularly true where the subnational government is expected to take over the maintenance and operating costs of any asset built though a grant-in-kind.

It also does not automatically follow that shifting more revenue powers to match devolved expenditure functions will lead to more fiscal responsibility or better outcomes. In South Africa, the local government sphere has far more significant revenue-generating powers than the provincial sphere, yet municipalities appear more inclined to run deficits, often due to a continual failure to collect all revenue due.

Decentralization (or centralization) will not work if problems of capacity, budgeting, financial management, reporting, information and transparency are not addressed simultaneously. These are the fundamental building blocks of good and effective government. They are probably more critical in a decentralized context, because if these areas are not addressed, the problems surrounding assignment of functions and sequencing cannot be solved anyway.

Assignment of revenue and expenditure powers

The South African Constitution is detailed and the division of powers and functions is clearly defined. In terms of actual operation, the revenue-raising powers of each sphere are unambiguous, as is the case with expenditure powers.

There are, however, many dimensions to any function. Even where this is clearly defined in terms of practice, there are many areas where cooperation across spheres is necessary on a regular basis. For such sharing – for example, policymaking and implementation – some details always have to be worked out at the implementation stage. Though the South African system sounds easy to understand on paper – national departments make policy to ensure certain standards across the country, while provinces and municipalities implement to ensure local needs are met – it still proves difficult to implement, since it not only involves coordinating policy and budgets, but has also to take account of varying capacity in the different spheres.

The optimal assignment of functions and sequencing of devolution constantly evolves in a decentralized system. These relationships change and evolve even in developed countries (e.g. in the United States, the balance of power between the federal government and the states has shifted over time). To make matters worse, even where there is clarity on the division of powers and functions, regulatory powers of national governments or their agencies can impose additional (cost) burdens on subnational governments. Changes in sectoral policy (if determined nationally) may also introduce significant shocks to subnational governments.[20]

The South African system is clearly defined compared to most other countries. A lack of clear assignment can therefore not be a significant factor when analyzing fiscal decentralization in South Africa.

Matching of revenue and expenditure powers

The South African experience does not suggest that increasing the revenue capacity of subnational governments (by shifting the fiscal powers from the central government) will necessarily lead to more fiscal responsibility or a better outcome.

In terms of fiscal powers, the lesson in South Africa is that better fiscal matching by itself is no guarantee for better outcomes in terms of fiscal responsibility. The revenue-raising powers of provinces and local government differ, with local government having significantly more powers. In some instances (like the major metros) such revenue powers almost match expenditure responsibilities. But local governments are not more fiscally responsible than provincial governments.

It is not automatic that subnational governments with taxation and revenue-raising powers use such powers effectively. Subnational governments have proved to be more prone to spending than collecting revenue, and less inclined to avoiding deficits than national government, which is more sensitive to its credit-rating and international image. Until pressured by national government, provincial governments did not adjust fees for services on an annual basis, and continued to collect less revenue even in nominal terms. Subnational governments also do not generally adjust their budgets downward during the financial year to account for lower-than-budgeted revenues.

Comparisons between the province of Gauteng and its capital city Johannesburg are a case in point. One has revenues to match expenditure, the other does not; yet it is Gauteng that was better managed before the budget crisis affected Johannesburg in 1997. Both have large budgets, with Gauteng having a budget of R18 billion in 2000 and Johannesburg about R8 billion. When salaries and pension grants are excluded, Johannesburg and Gauteng have similar size discretionary budgets. Given their revenue powers, Johannesburg is not dependent on national transfers. It raised almost all its own revenue, while Gauteng province is totally dependent (94 percent of its budget) on national transfers. Yet Johannesburg proved to be fiscally irresponsible during 1994–97, not collecting a significant portion of its revenue, raiding all its reserves, and not curtailing its expenditure. National and provincial government intervened, and forced the city to acknowledge that it was in the midst of a serious financial crisis, and that it should not expect to be bailed-out by the national or provincial government. It took a further two years before the city took full ownership of its crisis, developing its own restructuring proposals to turn the city's finances around. The city is now proving to be a model for the reform of other municipalities in the country.

In contrast, the Gauteng province prided itself as a modernizer, and as a fiscally responsible government, from its creation in 1994. It helped demonstrate to national government, the adverse consequences of some of the new sectoral policies, including the impact of the first wage agreements. Although dependent on national transfers, it resisted the temptation to be bailed-out by national government, and instead focused on bringing overspending departments into line. National government did not have to persuade the provincial government to take tough measures to make its budget more credible, and improve its quality of financial management. The province took responsibility for its problems, and led other provinces in reforming its finances.

The risks associated with moral hazard can be contained if government adopts a strict no-bail-out approach, backed by a policy of not guaranteeing any subnational loans or deficits. However, this is easier said than done, and national government should have an intervention policy in place where tough sanctions apply against both political and departmental heads. Such intervention should occur only if all else has failed, and no co-operative process to address the problem is possible. A cooperative intervention is far more likely to succeed.[21]

It is important for revenue powers to be phased in carefully. Developing countries are under extreme pressure to limit their tax-to-GDP ratio if they want to attract investors.

Given the higher risk attributed to developing (or emerging) countries, they have to go much further than developed countries to demonstrate the credibility of their macroeconomic policies, and to prove that they can use their fiscal powers prudently. This calls for caution and a gradual approach in shifting taxation powers to subnational governments.

The initial lessons from South Africa indicate that subnational governments require both capacity and the political will to collect revenue due. It is also important when the tax base is small because of inequity in income, to ensure subnational governments resist the temptation to be selective in the collection of revenue (e.g. by concentrating only those paying their fees or taxes, and ignoring or forgiving those not paying).

Subnational governments have not demonstrated significant improvements in collecting all revenue due, or in increasing their revenue potential from current sources.

The approach adopted in South Africa is to ensure that rudimentary expenditure controls are in place before revenue powers can be expanded to any subnational government; it is difficult to know how much revenue to raise without knowing the amounts and objectives of funds spent. Secondly, it is important that such subnational governments are collecting their revenue from current sources.

Poor skills and capacity

In a developing country like South Africa, capacity and information are limited. An argument for sequencing of functions often assumes that national departments have such capacity in the first place. Where capacity is poor, it may be poor at both the local/provincial and national levels. Such capacity may exist, but not be properly distributed in terms of where it is required (e.g. urban areas are more likely to have skilled personnel than rural areas).

Certainly, there is more capacity in South Africa than in many other developing countries – but the capacity or skills are not always appropriate to the task at hand. Similarly, available capacity is hampered by lack of tools (e.g. information) or lack of clear policy direction.

The type of capacity that may exist in government may also not be appropriate for other reasons. In South Africa, many public servants were trained to deliver in developed (formerly white) areas, and are not skilled or be easily re-deployed to poor and deprived (black) areas, where the problems may be fundamentally different. The capacity to deal with poor and deprived (black) areas has had to be built up from almost nothing, making the challenge of immediate delivery a near-impossible task for any government.

Building the appropriate capacity must also be seen as part of a dynamic process, part of a development strategy. Appropriate capacity is unlikely to arise in a vacuum, but will develop only when and where there is a demand for it – in other words, when a function is assigned to the national or subnational government, it starts to develop capacity.

A major problem for developing countries is the migration of highly developed skills to developed countries (e.g. doctors, nurses, IT, chartered accountants, managers and professionals). Where skilled staff leave the public sector, they do not necessarily do so for the domestic private sector, but to emigrate out of the country. Constant changes in top management is a further problem – for example, one education department has had five heads of department in as many years – this is a sure recipe for failure. Attracting and retaining skills is critical to building sustainable capacity in the public sector.

Decentralization strategy must take capacity into account, but it may not be a critical factor in deciding whether to decentralize or not in the short-term. In any case, government can reduce disruption if it has a clear view of existing capacity when taking steps to devolve functions. There are trade-offs; government needs to address short-term problems with capacity at hand, but then make sure more appropriate capacity is being developed for long-term challenges. This requires pragmatic assessment of existing capacity and to focus on what is possible, in a phased and asymmetric manner. A peer-learning and mentorship approach can complement any approach in building capacity in subnational governments.

Information

Similar problems exist with information. In a developing country, even basic statistics may not be available. Population figures, even where they exist and are reliable, may not be available by region or locality. The challenge facing policy-makers in such a changing or dynamic environment is to construct policy (and formulae), and to improve information at the same time. As information improves, policies must be adjusted and fine-tuned. One cannot wait to improve information, and then set out to construct policy. The poorer an area, the more likely that information on such an area is inadequate. This makes it difficult to cost the needs of such communities.

Poor information is not only the product of poor capacity, but also the result of non-existent or poor management in the public sector. Reforms to introduce and improve management in government departments will go hand-in-hand with the process to improve public sector management and other information. By ensuring that managers use available information, the quality of information will come under closer scrutiny and would likely improve. An initial lesson in implementing financial management and reporting reforms indicates that monthly reporting is more effective than quarterly (or irregular) reporting, as monthly reporting is more likely to become a routine activity (together with the closing of monthly accounts) for managers.

The issue of poor information, and improving such information is particularly applicable to the budget process. The budget process has to proceed, irrespective of the quality of information. Budget and financial information may not be reliable for a number of reasons, especially where audits on financial statements are not available when required – this may be due to the fact that there is no auditing, poor audit capacity, poor quality of financial statements or long delays in the completion of financial statements. Where actual expenditure and revenue is not being monitored on a monthly basis, and such information is not available in time to inform the next budget, the quality of information will tend to be poor and unreliable, making budget decision-making even harder.

The issue of poor information must be factored in when analyzing fiscal decentralization in a developing country. It is all to easy to blame poor information for any weaknesses in fiscal decentralization. Instituting reforms to improve information must go hand-in-hand with other budget reforms.

Political factors

The type of political system, or the stage of its development, is a critical factor to consider when assessing why conventional economic theory may not be applicable to developing countries.

The South African system consists of elected national, provincial and local governments, an independent judiciary, and a critical and independent media. While the electoral process is sensitive to public opinion, the level of literacy may determine the speed of such political response. Left to themselves, subnational governments can bleed for a long time before the democratic or political process can respond to correct the problem. The response is slowest in the local sphere, as national departments are, almost always, much more in the public eye. Most media are national or regional, and are generally not particularly interested in local news. In a developing country, with a high degree of illiteracy, and with a high level of conflict or division, the political process may take even longer to respond to events at the local level. Transparency without effective accountability undermines fiscal decentralization, particularly where the political process is too slow to respond to negative actions.

The quality of audits by the office of the Auditor-General, and its ability to focus the legislature on material issues (rather than technical violations), is important for the accountability mechanisms to be effective. The capacity of the legislature to focus on such material issues, and to monitor the implementation of any corrective measures, and to apply sanctions over non-complying accounting officers, is a major challenge. Many of the parliamentary committees which oversee departmental activities tend to shy away from financial monitoring (leaving this to the public accounts committee).

The problem is even greater in provincial legislatures, where capacity is a bigger problem. The informed media adds to public confusion by ignoring the local governance arrangements, and expecting national intervention for every problem at the subnational level. Building the capacity of the various stakeholders in the political process is important for ensuring that the local political process functions effectively.

Conclusion and way forward

Fiscal decentralization does offer benefits to developing countries, because many functions like housing, municipal infrastructure, school education and primary health are better situated at the regional or local level. There are sufficient examples in South Africa to indicate why it is problematic for national departments, and more appropriate for provincial/regional or local government, to co-ordinate or organize these functions. However, determining which functions to decentralize may be less clear-cut. While obvious for some functions, it is more difficult with complex functions like highly specialized/academic hospitals, welfare grants and major roads.

The South African experience indicates that no system, whether centralized or decentralized, will work well if basic budget and financial reforms (together with good governance measures to promote transparency and accountability) are not in place. South Africa has benefited greatly from the implementation of a multi-year budget framework, where budgets are set at realistic levels and they are supported by effective monitoring and auditing systems, including in-year management. To be effective, the financial statements must be submitted on time, with audit opinion and financial statements submitted to the legislature within a specified period (say six months) after the end of the financial year.

A fiscally decentralized system is probably riskier than a centralized one if such budget and good governance mechanisms are not in place. The national government (or its treasury) must ensure that no subnational government ignores these basic budgeting and financial management principles.

Decentralization is far less likely to work if these basic elements are not in place or fail to be addressed as decentralization is implemented. In determining the extent of fiscal decentralization, and the sequencing of such fiscal powers, the South African experience indicates that it is important to ensure that basic expenditure controls are in place before devolving further functions. Furthermore, the revenue potential of existing revenue sources must be maximized, with additional taxation powers devolved only after significant progress has been made with regard to expenditure controls and the collection of revenue. South Africa shows that increasing revenue capacity (by shifting the fiscal powers from the central government) will not necessarily lead to more fiscal responsibility or a better outcome.

The process of aligning expenditure and revenue-raising powers at subnational levels (so-called "fiscal matching") must therefore be phased in, but imbalances may never be totally eliminated. While moral hazard is clearly a risk in the case of such a mismatch, this risk can be contained if government adopts a strict no-bail-out approach, backed by a policy of not guaranteeing any subnational loans or deficits. The fiscal system also requires a workable intervention mechanism in the event that subnational governments ignore good fiscal practices.

Institutionalizing a comprehensive budget process is important, not only to promote more transparency and accountability, but to facilitate more participation in the budget process. This is even more important in a fiscally decentralized environment, where the provincial and local spheres are dependent on grants from nationally raised revenue. It is critical that the process of dividing nationally raised revenue is effected through a transparent and participatory process. Having one comprehensive budget process is critical in this respect. A separate process to determine some grants (e.g. conditional grants) can fragment the budget process, undermine the underlying policy-prioritization process, introduce uncertainty and confuse lines of accountability.

Contrary to the approach frequently espoused, the South African experience indicates that it is more important to ensure that the process of dividing nationally raised revenue between the spheres is an objective one, rather than a formula-driven one. The three-year budgeting process in South Africa offers subnational governments a certain degree of certainty about their allocations, allowing for proper planning to take plan, and focuses the annual budget discussions on the *additional* resources to be allocated. This approach takes into account that budgets should be determined in terms of a policy-prioritization process. In contrast, the horizontal division of the provincial and local equitable share allocation can and should utilize a formula to ensure fairness in allocating funds between provinces and municipalities.

The budget process must integrate policy, planning and budgeting. In South Africa, the creation of joint forums between the treasury and line functions across the spheres has helped to reduce budget-games through sectoral collusion, without undermining subnational autonomy.

Some of these lessons seem to go against conventional wisdom. But from the perspective of a practitioner, the real lesson is that a country cannot enjoy the benefits of decentralization without simultaneously reforming its budget process. It has to address the problems of capacity, information and financial management simultaneously, and ensure that the political system is responsive at subnational levels. These elements cannot be viewed in isolation from the implementation of a decentralized system, and need to be seen as part of a dynamic process where they improve as implementation takes place. It is often not possible to carefully phase in fiscal decentralization after bringing capacity and information up to a minimum standard.

Indeed, the process of improving capacity and information is part of a broader developmental strategy, and must be addressed as part of a general process to modernize and improve the public sector. In determining when to decentralize, national government should consider an asymmetric approach, choosing those subnational governments that have demonstrated their capacity (or shown the potential) to perform. In South Africa, a peer learning or mentorship approach, together with benchmarking, has proved to be an effective and invaluable approach in improving the quality of budgeting and financial management in subnational governments. Improving budget formats, introducing the new GFS classifications, improving the accounting standards and reforming the chart of accounts are essential elements for reforming the financial management system, and improving information for the purpose of benchmarking.

Donor agencies can and should do much more to assist in the area of building capacity and developing budget and financial management systems. Such a program could include the development of training institutions for public officials, as well as a major program to deploy experienced budgeting staff from developed countries (on for e.g. two-year secondments). The South African experience demonstrates that, with a few exceptions, donor agencies have not made this type of assistance program a major priority. The benefits of any such a program, however, can and will significantly improve the service delivery capacity of governments in developing countries.

To conclude, when assessing the success of the South African government in fiscal decentralization, the provincial experience is particularly instructive. In implementing a decentralized system in the post-Apartheid era, the South African government has faced challenges that are typical of many developing countries. Although the specific solutions to problems may have been tailored to South Africa's unique situation, these techniques can easily be adapted to suit the circumstances in other developing countries. At the heart of the South African approach, however, has been a dedication to proper budgeting and financial management. These have proven to be essential ingredients in the promotion of an effective decentralized system.

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Appendix: type of reforms to be prioritized in developing countries

The following measures have been critical to lay the basis for success in the provincial sphere of government:

- a Ensuring provinces have credible budgets;
- b Introducing mechanisms to close the budget and policy gaps;
- c Deepening the budget preparation process, with the involvement of the elected political executive at key points in the process;
- d Ensuring provinces manage and stick to their budgets in-year;
- e Publishing "state of the budget" reports on a monthly or quarterly basis;
- f Introducing consistent and comparable budget formats, classifications and chart of accounts;
- g Benchmarking provincial budgets through the publication of the intergovernmental fiscal review.

General budget and financial management reforms

Whatever the political system (centralized or decentralized), some necessary reforms to modernize the public sector are necessary. These reforms should be implemented as the very first steps, and will be part of the process to improve capacity and the quality of information. Many of these measures may be obvious in a developed country, but should not be taken for granted in a developing country. Sticking to the deadlines, and the underlying processes, is a major challenge for any government, and requires building the capacity of the various players (e.g. financial accountants, treasury officials, auditors and legislators). A lax attitude by any of the players (e.g. legislators or auditors in accepting delays in the submission of financial statements) not only entrenches bad practices, but results in poor management and information systems, and undermines the accountability chain. New legislation in South Africa (the Public Finance Management Act) introduces harsh penalties and sanctions if these deadlines are not met. Much technical assistance will however be required to improve the current situation, but simple enforcement will result in significant improvements in the short-term.

The critical reforms can be broken down into three phases: budget preparation, implementation, post-implementation.

Budget preparation

- implementation of a three-year budgeting system;
- coordinating the budgeting, policy-making and planning processes;
- ensuring that the budgets are credible and realistic;
- deepening the budget process to include political executives to ensure that budgets reflect political priorities and have greater buy-in;
- simplifying the formats of budgets (away from line-item telephone directory type) budgets; and
- ensuring that the chart of accounts are adjusted to reflect management and other statutory information once the budget is implemented.

Budget implementation

- ensuring that once budgets are adopted by the legislature, all officials and the political executive enforce such budgets, and do not illegally stray from the budget;
- most importantly, ensuring a monthly reporting system, whereby heads of departments responsible for specific departments close their monthly accounts, and issue to the treasury a monthly report no later than twenty days after the end of the month;
- having a formal process to adjust budgets (only once) in-year should this be necessary (such a process must only focus on very limited cases, for unforeseen and unavoidable adjustments); and
- the treasury, to actively monitor monthly reports on actual revenue and expenditure, and to publish such information for public scrutiny.

Post-budget implementation (after financial year ends)

- ensure that financial statements are completed and submitted for audit no later than two months after the end of the financial year;

- ensure that the financial statements are audited no later than five months after the end of the financial year, and that an annual report containing the financial statements is tabled a month later;
- ensure that an independent audit office prepares high-quality audits, and focuses on material transgressions rather than small technical issues; and
- ensure that the legislature insists on receiving the annual report no later than six months after the financial year, and is empowered to deliberate on the report.

Notes

1 All the documents referred to in this paper are available on the treasury or other websites. Key documents referred to in this paper include the two *Intergovernmental Fiscal Reviews* (1999, 2000), *Budget Review* (2000, 2001), *The Constitution* (especially Chapter 13), Division of Revenue Acts (2000, 2001), *Public Finance Management Act* and various guidebooks to implement this Act. These are all available on the national treasury website *www.treasury.gov.za*.

2 J. May (ed.), 1998, Using a household income of R800 per month, Stats SA, 2000 estimates the percentage of the poor at 28.4 percent using imputed expenditure.

3 Local government has undergone a two-phase transformation. The initial transformation in 1995 created 843 *transitional* municipalities, combining adjoining white and black areas. The second phase in December 2000, significantly changed boundaries by incorporating urban and rural areas, and reduced this number to 284. The new system consists of six one-tiered urban metropolitan governments or metros (Johannesburg, Cape Town, Durban, Pretoria, East Rand and Port Elizabeth) and 232 two-tiered *primary* municipalities falling under forty six *district* municipalities.

4 South Africa is a multi-party democracy. While the biggest party, the African National Congress (ANC) controls the national government, seven of the nine provinces, and five of the metros, opposition parties control two provinces and one metro.

5 Schedules 4 and 5 of the Constitution divides functions on a concurrent and exclusive basis between the three spheres.

6 The Budget Council comprises the national and provincial Ministers of Finance, while the Budget Forum consists of the members of the Budget Council and the national and provincial chairpersons of local government associations in each province.

7 New public service policies will allow some differentiation in salaries.

8 Municipalities (and most public entities) tend to have higher levels of remuneration for staff.

9 Section 214 of the Constitution determines a revenue-sharing arrangement for South Africa. The provincial and local spheres of government are entitled to an unconditional equitable share to enable them to provide basic services and perform the functions assigned to them. Sections 228–230 of the Constitution also spell out the taxation and borrowing powers of the two spheres.

10 The Provincial Tax Regulation Bill is available on the treasury website.

11 The Municipal Finance Management Bill is available on the treasury website. In addition to financial management arrangements, the bill also deals with borrowing and judicial management issues.

12 The Intergovernmental Relations Act (no. 97 of 1997) gives effect to Chapter 13 of the Constitution which requires the national executive (Cabinet) to consult with the key role players (provinces) and organized local government (South African Local Government Association (SALGA)) when determining budget allocations between the spheres.

13 The FFC's Project 2001 proposals are available on its website *www.ffc.co.za*. The response of the national government is outlined in Annexure E of the *Budget Review 2001*, tabled on Budget Day, 21 February 2001. This document is also available on www.treasury.gov.za.

14 See for example the Division of Revenue Bill, 2001 available on *www.treasury.gov.za*.

15 Refer to Annexure E in the *Budget Review* 2000 (or 2001) or Annexure A in the Intergovernmental Review 2000.
16 Refer to National Treasury , 21 April 1998.
17 Minmecs, or meetings between the national Minister and the nine provincial ministers (MECs) for that function (education, health or welfare), was created to discuss policy and implementation. These are advisory institutions, making recommendations to the national executive (if it is to adopt national policy), or to provincial executives (if it is to implement national policy).
18 These forums, referred to as a "4 × 4" comprises officials from the national treasury and the national department, as well as officials from three provincial treasuries and three provincial departments.
19 Johannesburg's restructuring plan, called Igoli 2002 and now Igoli 2010, are available on its website *www.igoli.gov.za*. Their restructuring agreement with the national treasury is available on the treasury website.
20 Shocks to the system are an ever-present risk. This is particularly the case in the local sphere in South Africa, as the recent new demarcation of local government demonstrates. Some of these problems are restricted within the two tiers of local government, in terms of the division of functions between them. National restructuring of the electricity sector is another potential shock. A significant cost here to consider is foregone investment/expansion due the paralysis resulting from uncertainty.
21 Refer to the Section 100 interventions in two provinces in the *Budget Review* 1999 (p. 94), available on the treasury website.

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