Submission on National Intervention in Financially Distressed Provincial Governments

"For an Equitable Sharing of National Revenue."

10 July 2012

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1. Introduction and Purpose

The financial stability of South Africa's provinces has become a matter of public interest because of recent events. In December 2011, national government intervened in the financial and administrative affairs of several provincial departments: Health and Provincial Treasury (Gauteng); Police, Roads and Transport, and Provincial Treasury (Free State); Education, Health, Public Works, Transport and Provincial Treasury (Limpopo). These interventions were needed to stabilise provincial finances and avert the possible collapse of essential services (insolvency[1]). After a diagnostic assessment by the National Treasury to establish the degree of fiscal and financial severity, provinces were put under different types of intervention. These cases demonstrate that, regardless of size or past history, no province is immune to a financial emergency.

These interventions have also raised broader concerns about the financial health of provinces, and the resulting impacts on service delivery. Financial and service delivery breakdowns undermine not only the government's priority outcomes, but also the socio-economic rights of poor citizens who are disproportionately dependent on public services. Similarly, large accumulated, irregular expenditures and overspending may affect government's ability to meet its future obligations, particularly if the no-bailout principle is strictly adhered to.

In this submission, the Financial and Fiscal Commission (the Commission) seeks to (a) isolate specific factors that have played a decisive role in creating financial distress, (b) examine the current fiscal position of affected provinces to determine potential danger signals, and (c) outline the respective roles of government and oversight bodies in treating and preventing financial emergencies in provinces. In particular, the submission will highlight and discuss issues related to the special Section 100 interventions and weak application of enabling legislation – primarily the causes, consequences and dimensions of the failure of the Public Finance Management Act of 1999 (PFMA) to improve provincial financial management.

2. Nature of the Interventions

A cornerstone of South Africa's Constitution is the obligation to preserve economic unity, transparency, accountability and sound fiscal discipline over central and sub-national budgets and related processes. This is necessary to maintain political credibility and macroeconomic stability and, most importantly, to prevent insolvency of sub-national governments and the likely deterioration in service delivery. The Constitution and certain provisions of the PFMA and Municipal Finance Management Act of 2003 (MFMA) provide for a continuum of interventions into the affairs of sub-national government, including monitoring, support and supervision, directives and actual take-over of powers and functions. The national or

[1] Insolvency is used loosely to refer to inability to meet, either partly or fully, constitutional obligations to provide or sustain service delivery, or material breach of financial commitments.

provincial executive is empowered to intervene in the fiscal affairs of provinces and municipalities respectively. National government intervention into provincial affairs is guided by Section 100 of the Constitution and Section 6 of the PFMA, while intervention by provinces into municipalities is governed by Section 139 of the Constitution and Section 136 of the MFMA.

This process is not without international precedence. For instance, Section 365 of the Indian Constitution has similar federal provisions:

> Where any State has failed to comply with or to give effect to any directions given in the exercise of the executive power of the Union under any of the provisions of this Constitution, it shall be lawful for the President to hold that a situation has arisen in which the government of the State cannot be carried on in accordance with the provisions of this Constitution.

In India, the application of Section 365 has often been seen as controversial because of allegations of political motivations, which may or may not be applicable in South Africa.

Interventions currently underway in Gauteng, Free State and Limpopo are being carried out in terms of South Africa's national intervention framework. In Gauteng the intervention is undertaken according to Section 6 (2) (f) to (g) of the PFMA of 1999. At the start of the intervention in December 2011, a memorandum of understanding was signed between national government, represented by the Minister of Finance, the Minister of Health and the Premier of Gauteng. The Free State intervention is in accordance with Section 100(1) (a) of the Constitution and is a less intrusive intervention, requiring national government to issue directives on necessary corrective steps. Thus, a Section 100 directive was issued to the Premier of the Free State outlining changes that need to be effected with the assistance of National Treasury's technical support team. Initiated in terms of Section 100(1) (b), the Limpopo intervention entailed an effective takeover of the powers and functions of aspects of the provincial administration for a specified period. Various national departments appointed teams who were sent to administer their corresponding provincial departments for the 180-day period of intervention.

Broadly speaking, the framework for intervention at provincial level is less developed than that of local government. While Section 139(5) of the Constitution was amended to distinguish between financial crises and other failures by municipalities to fulfil executive obligations, a similar amendment relating to provinces was never made to Section 100. Further, if provinces are unwilling or unable to intervene in fiscally distressed municipalities, amendments to Section 139 allow national government to intercede in the place of provinces, when appropriate. Intervention in a financial crisis by other spheres is obligatory, not optional, as Section 139 states "must intervene". Yet the wording in Section 100 remains "may intervene", i.e. intervention is left to the discretion of national government in the event of both financial and non-financial (service delivery) crises. Notwithstanding, the PFMA stipulates that National Treasury must get involved by taking appropriate steps in terms of Section 100 of the Constitution, or by withholding funds in accordance with Section 216 (2) of the Constitution, "to address a serious or persistent material breach of this Act by a department, public entity or constitutional institution … or do anything further that is necessary to fulfil its responsibilities effectively”. However, neither the Constitution nor the PFMA prescribe criteria for determining a “serious or persistent material breach” or an inability to fulfil executive obligations.

In contrast, the local government intervention framework (outlined in the MFMA of 2003) is more detailed, explicit and objective. It clearly set out different types of interventions (financial recovery plans) and factors under which provinces may initiate voluntary or mandatory interventions. The MFMA also provides a system of checks, balances and protection, by calling for an obligatory consultation between the MEC and the Mayor before intervention and allowing municipalities to apply for stay of legal proceedings against creditors during the intervention. Unlike the PFMA, the MFMA also sets out criteria for determining the seriousness of financial problems, such as failure to make payments or approve budgets, adverse audit opinions etc.

The main points flowing from the discussion are twofold. The first challenge is the lack of enabling legislation and the misalignment between constitutional provisions that apply to municipalities and provinces. Second, the framework for intervention at provincial level is less developed and objective compared to that of local government. This is also the case for the constitutional framework and subordinate legislation (i.e. the PFMA and its regulations). The MFMA gives guidance on what should constitute triggers for intervention, whereas the decision to intervene (and mode of intervention) in provinces is completely at the discretion of national government. Therefore, the provincial intervention process is potentially more open to subjective decisions by national government. This could result in delaying appropriate interventions, allowing a further worsening of financial conditions, or inappropriately applying that intervention.

3 Causes of Fiscal Stress, Budget Analysis and Accountability

Fiscal stress – a gap between projected revenues and expenditures – can be short term, in the case of transitory economic shocks, or long term, in the case of structural budget imbalance. Such structural imbalance may arise from persistent economic shocks (such as a global financial crisis) or other factors (i.e. low regional tax base, low revenue raising and disproportionately high expenditure needs). When the design of the intergovernmental fiscal system is vertically imbalanced – i.e. revenue is highly centralised and spending is decentralised – sub-national government’s fiscal space to manoeuvre around fiscal shocks is invariably restricted. The result is moral hazard[2] risks associated with sub-national fiscal prudence, discipline and sustainability.

[2] A situation where provinces fails to internalise full costs, or take into account the welfare of national taxpayers when making spending decisions or use funds prudently motivated by the perception that national government will provide a bailout if they fall into financial problems.

Several factors explain this fiscal behaviour and often lead to policy tensions between the spheres, thereby creating fertile ground for 'budget gaming'[3]. Firstly, the traditional misalignment of national policy with sub-national budgeting (sub-national fiscal coordination) means that provincial governments and municipalities may prefer to fund their own priorities and objectives rather than national policies. Secondly, the roles and responsibilities are at times not clearly defined and overlap considerably between national and provincial government on concurrent functions.

To explore this argument further, it is important to look at fiscal balances and changes in the composition of expenditure over time for the nine provinces. As Table 1 shows, provinces spent on average 75% of their budget on personnel expenditure (compensation of employees and transfers and subsidies). In the short to medium term, provinces have little or no control over this item because of centralised wage bargaining and labour-law restrictions on reducing the number of state employees.

Table 1: Aggregate provincial expenditure composition 2011/12

	Compensation of employees	Goods and services	Transfers and subsidies	Payment of capital assets	Total
Eastern Cape	33,920,637	8,865,316	7,403,318	4,137,848	54,327,119
Free State	14,112,549	3,916,290	3,482,920	2,670,191	24,185,740
Gauteng	36,424,670	15,589,625	14,480,611	2,386,111	68,886,688
KwaZulu-Natal	44,715,945	16,091,888	9,774,851	7,761,854	78,387,035
Limpopo	28,879,352	7,091,616	5,194,729	3,151,744	44,320,526
Mpumalanga	17,182,620	6,147,984	3,766,440	2,870,158	29,967,202
Northern Cape	5,718,710	2,515,550	1,358,815	1,367,695	10,962,237
North West	14,316,262	4,692,729	4,059,358	1,967,348	25,036,317
Western Cape	20,105,038	7,613,328	6,170,084	3,156,153	37,050,880
Total	215,375,783	72,524,326	55,691,126	29,469,102	373,123,744

Source: National Treasury, 2011 – as per 3rd quarter Section 32 reports[4]

Three provincial functions – education, health and social development – account for over 75% of total spending. These functions are traditionally labour intensive and tend to be important drivers of budget pressures (especially with respect to the wage bill). As Table 2 shows, employee compensation accounts for 77% and 60% of total education and health spending respectively.

[3] This occurs when sub-national governments overestimate the effects of government policies on their budget or readjust their budgets rapidly to cover non-priority items at the expense of priority expenditure.
[4] This is a monthly financial report required by the PFMA.

Table 2: Disaggregated composition of provincial expenditure 2011/12

	Compensation of employees			Goods and services			Transfers and subsidies			Payment of capital assets		
Expenditure composition	Amount	% of all provinces	% of sector	Amount	% of all provinces	% of sector	Amount	% of all provinces	% of sector	Amount	% of all provinces	% of sector
Education	120,353,897	55.9%	76.8%	14,934,744	21%	10%	13,373,800	24.0%	8.5%	8,099,598	27.5%	5.2%
Health	66,569,150	30.9%	59.5%	31,439,928	43%	28%	3,924,129	7.0%	3.5%	9,935,963	33.7%	8.9%
Social Development	4,600,185	2.1%	39.0%	1,966,670	3%	17%	4,575,327	8.2%	38.8%	655,336	2.2%	5.6%
Office Of The Premier	1,345,117	0.6%	46.9%	1,260,756	2%	44%	188,489	0.3%	6.6%	74,739	0.3%	2.6%
Provincial Legislature	983,177	0.5%	43.7%	709,753	1%	32%	425,202	0.8%	18.9%	132,881	0.5%	5.9%
Safety, Transport, Roads And Public Works	8,971,569	4.2%	21.4%	13,052,707	18%	31%	10,890,348	19.6%	26.0%	8,996,698	30.5%	21.5%
Housing and Local Government	3,681,601	1.7%	16.9%	1,782,108	2%	8%	16,091,728	28.9%	73.9%	221,491	0.8%	1.0%
Agriculture	4,149,448	1.9%	44.4%	2,833,451	4%	30%	1,764,221	3.2%	18.9%	607,304	2.1%	6.5%
Provincial Treasuries	1,744,510	0.8%	47.3%	1,756,131	2%	48%	109,990	0.2%	3.0%	48,101	0.2%	1.3%
Sport, Recreation, Arts And Culture	1,408,349	0.7%	34.5%	1,473,264	2%	36%	615,891	1.1%	15.1%	581,394	2.0%	14.3%
Economic Development	1,369,253	0.6%	22.0%	1,232,588	2%	20%	3,524,876	6.3%	56.6%	100,434	0.3%	1.6%
Other Functions	199,527	0.1%	39.3%	82,226	0%	16%	207,125	0.4%	40.8%	15,163	0.1%	3.0%
Total	215,375,783			72,524,326			55,691,126			29,469,102		

Source: National Treasury, 2011 – as per 3rd quarter Section 32 reports

Table 3 shows that employee compensation is the main driver of provincial budget deficits. According to the most recent National Treasury Section 32 reports, provinces were expected to overshoot their personnel budgets by R4-billion. KwaZulu-Natal, Gauteng, Limpopo and Eastern Cape provinces have the highest personnel expenditure. The picture may look gloomy for KwaZulu-Natal, but the Free State appears to have real problems. At the time of publication of the Section 32 reports, the Free State was projected to have a net deficit of R2-billion, which is explained by high overspending on transfers and subsidies. Interestingly, with the exception of the Free State and Western Cape, all provinces are expected to under spend their capital budget.

Table 3: Provincial surplus/deficits per expenditure item 2011/12

	Compensation of employees	Goods and services	Transfers and subsidies	Payment of capital assets	Total Net Surplus/ deficit
Eastern Cape	-587,107	-657,552	138,904	659,415	-455,414
Free State	-35,172	-7,768	-1,744,574	-116,569	-1,914,880
Gauteng	-774,872	-102	-173,553	1,567	-952,635
KwaZulu-Natal	-1,783,072	245,899	343,003	479,324	-687,319
Limpopo	-660,999	43,434	-69,433	92,442	-594,558
Mpumalanga	-140,935	197,105	-3,071	46,681	99,600
Northern Cape	62,424	-173,928	-3,782	14,101	-101,914
North West	-45,453	-130,537	22,891	22,891	-153,892
Western Cape	9,517	36,004	-42,220	-42,220	-4,211
Total Net Surplus/ deficit	-3,955,669	-447,445	-1,531,835	1,172,041	-4,765,223

Source: National Treasury, 2011 – as per 3rd quarter Section 32 reports

From this analysis, an important deduction is that provinces undergo serious fiscal adjustment exercises to bring their operating budgets close to the legislatively required budget balance[5]. This process appears to be critical in addressing some of the perceived provincial budget pressures resulting from statutory obligations and uncosted national policies. Although deviations are normal practice in sub-national budgeting, if not properly monitored they can be used to mask financial problems within expenditure programmes or create the wrong impression about the state of financial health at the expense of service delivery. This may be especially true in a system that strictly monitors financial and budget outcomes as opposed to service delivery outcomes.

Table 4 demonstrates that provinces go through annual cycles of surplus and deficits but eventually attain budget balance. The data suggests that fiscal ill-discipline – defined as overspending – is not acute (although it is present) among provinces, which puts into perspective the interventions. Over the 12-year period, the average incidence and size of overspending, is less than two years and significantly small (well below the 8% limit). However, caution needs to be exercised, as National Treasury rigorously enforces the

[5] Note that the Constitution permits deficits on capital budgets.

principle of hard budget constraint, which limits the extent of overspending. Whether desirable budget balances are attained through hard fiscal constraints or at the expense of delivery remains an empirical question.

Table 4: Historical provincial budget balance 2002–2014

R' Million	EC	FS	GP	KZN	LP	MP	NC	NW	WC
2002/03	-275	2028	150	534	-555	2065	733	213	-80
2003/04	-2252	2950	-35	155	262	2914	901	167	476
2004/05	225	3824	1037	158	-69	3370	1428	1298	533
2005/06	1333	4022	-555	-84	-1036	-9561	1427	-683	-402
2006/07	1101	51	-636		110	-47	103	65	-604
2007/08	583	101	275		220	151	146	130	-318
2008/09	402	149	1276		330	536	167	195	-294
2009/10	-2198	410	-2228	-1126	273	196	237	245	-104
2010/11	-2428	-56	-1089	1423	-1885	-10	37	-280	208
2011/12	1041	26	380	884	-88		126		-77
2012/13	1678	19	864	948			124		256
2013/14	1503	22	1919	948			150		287
	713	13547	1358	3841	-2439	-386	5579	1351	-118

Source: National Treasury, 2011

Table 5 illustrates inconsistent programme allocations between financial years, demonstrating volatile expenditure across the nine provinces. The detrimental effect is common, as provinces balance their budgeted by adjusting upwards and downwards various components. However, expenditure volatilities, caused by reasons unrelated to economic conditions, may result in uncertainty about future fiscal policy or government's commitment to certain policy goals.

In principle, provinces have three fiscal adjustment tools at their disposal: revenue, borrowing and the current and capital expenditure budget. The institutional and political constraints that inhibit using taxes, debt and current expenditure as fiscal remedies mean that sub-national governments tend to use capital expenditure cuts to manage their finances. A study of Scandinavian municipalities by Rattso (1999) makes a similar finding and concludes that such adjustment tools are counterproductive. Whether the effect is the same for provinces in South Africa is difficult to determine, partly because capital expenditure is funded mainly through conditional grants. However, an emerging trend, albeit limited, is to use part of capital grants to supplement operational spending. What can be discerned is that National Treasury has been able to enforce hard budget constraints by ensuring that advances were paid back and thus do not constitute a true bailout. While to some extent mitigating the perverse incentive for rewarding provincial overspending, this could have been at the cost of current and future service delivery (e.g. through deferred maintenance and deferred training and other forms of capacity investment).

Table 5: Percentage expenditure growth rate per programme 2003/4–2013/14

Province	Expenditure composition	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Eastern Cape	Education	11	5	8	13	13	11	27	17	1	4	6
	Health	17	(1)	20	11	11	10	44	25	(6)	6	7
	Social development	27	(14)	28	42	25	29	17	5	13	5	6
	Other	25	(9)	5	9	16	11	39	3	7	3	6
	Compensation of Employees	9	8	7	7	6	6	54	15	2	5	6
	Infrastructure						36	8	(11)	17	5	6
Free State	Education	15	9	15	4	7	8	29	10	10	5	5
	Health	16	10	11	4	7	8	39	11	17	7	6
	Social development	37	3	46	(2)	6	6	42	7	13	5	4
	Other	8	8	11	9	26	15	30	28	(6)	6	7
	Compensation of Employees	10	9	11	7	6	6	32	15	11	6	7
	Infrastructure						29	1	26	3	10	5
Gauteng	Education	17	4	10	14	9	9	38	15	12	4	4
	Health	7	5	15	6	6	8	55	16	7	10	7
	Social development	12	18	9	14	16	22	35	12	15	5	5
	Other	12	4	13	72	(2)	2	74	(9)	(4)	5	6
	Compensation of Employees	11	6	11	10	7	6	51	16	11	6	5
	Infrastructure						16	8	(8)	6	7	(4)
KwaZulu Natal	Education	15	10	16	8	11	8	35	13	10	6	6
	Health	9	9	15	14	9	8	47	6	13	8	7
	Social development	19	6	48	12	5	6	36	23	17	5	5
	Other	17	12	41	8	22	25	24	10	4	7	7
	Compensation of Employees	8	11	10	12	8	8	40	14	8	6	6
	Infrastructure						53	9	5	7	7	6
Limpopo	Education	11	16	9	6	11	11	31	15	2	5	5
	Health	19	15	22	7	9	11	38	17	9	5	6
	Social development	(21)	147	17	7	8	49	11	52	(1)	4	3
	Other	12	3	26	2	15	9	5	25	5	6	5
	Compensation of Employees	10	8	10	5	10	6	39	16	6	5	6
	Infrastructure						39	(4)	30	12	5	7
Mpumalanga	Education	15	8	22	4	11	9	45	9	8	6	5
	Health	18	15	23	5	10	10	64	12	14	6	6
	Social development	(10)	32	13	71	9	29	24	14	12	6	5
	Other	12	11	14	5	13	4	63	19	8	4	7
	Compensation of Employees	11	8	15	10	7	7	61	13	9	7	5
	Infrastructure						52	42	10	23	1	9
Northern Cape	Education	10	8	12	5	10	9	63	10	16	6	6
	Health	37	0	28	20	8	(2)	61	26	6	8	6
	Social development	19	16	18	22	22	18	35	14	9	5	5
	Other	14	8	26	4	12	9	57	16	(0)	7	6
	Compensation of Employees	12	13	12	10	6	5	65	15	11	5	6
	Infrastructure						4	5	103	11	9	4
North West	Education	11	7	15	6	6	8	16	9	12	6	5
	Health	12	14	15	15	10	6	30	12	9	10	8
	Social development	27	(4)	36	20	39	16	(12)	23	18	6	6
	Other	11	8	39	1	17	16	6	11	3	7	8
	Compensation of Employees	10	6	10	7	8	6	16	9	14	5	5
	Infrastructure						16	19	13	(2)	9	6
Western Cape	Education	10	7	14	7	9	8	29	13	11	6	6
	Health	15	14	11	10	7	8	41	19	8	7	9
	Social development	11	16	15	5	19	19	13	6	8	5	6
	Other	5	14	29	9	8	10	51	9	1	3	5
	Compensation of Employees	7	9	11	13	8	7	32	16	10	7	7
	Infrastructure						49	16	7	5	2	5

Source: National Treasury, 2011.

Finally, in the interest of proper observance of rules and regulations, accountability requires that those administering the rules must be held responsible and accountable for their actions.

In South Africa, overlapping accountability in concurrent functions, coupled with little provincial accountability for raising revenue, creates perverse incentives. The perception of a vertical fiscal imbalance[6] creates incentives for provinces to behave strategically in order to extract additional assistance from national government. For example, provinces may overspend or simply not collect own revenue. This situation is exacerbated by the centralised collective bargaining regime, which leaves provinces with no control over remuneration levels and limited control over employment levels in the short term. In other words, when provinces spend funds they don't raise themselves ("other people's money"), they are more likely to spend inefficiently and to expect bailouts. Eventually this creates a common pool problem[7] and spending pressures on central funds.

The complex concurrent functions and lack of clearly defined norms and standards tend to blur the lines of accountability. This creates room (and a tendency) for provinces to 'pass the buck' to national government on the grounds that ultimate authority lies with the centre and revenue-raising powers are skewed. As a result, national government's ability to hold provinces accountable for delivery is limited, while provinces are not incentivised to use resources efficiently, knowing full well that they cannot be held directly responsible for non-delivery (Rodden *et al*., 2003). It reinforces the notion that sub-national government are superficial extensions of the centre rather than representative institutions accountable to local councils, provincial legislatures and most importantly the citizens (World Bank, 2011).

The intergovernmental relations framework does not fully recognise other institutions of accountability further down the value chain, in particular citizens who may be appropriate in addressing sector-specific interventions. For example, normal practice in provinces should be to publicise and explain in detail to citizens the objectives, benefits, work plan and estimated cost of projects. During implementation, periodic progress reports should be provided, and upon completion, a final report should highlight how the project's objectives were achieved and present audited accounts of the total contributions received and costs incurred. Under these circumstances, provincial authorities can be held accountable for their actions and, when something appears questionable, improper, or inaccurate, can be asked to explain the matter, take corrective action and to make amends. Thus, doubts are cleared, and remedial or disciplinary actions are taken to the satisfaction of all concerned. Accountability to citizens is not currently catered for in the interventions and needs to be addressed.

4. Socio-economic and Management Causes of Financial Distress

Policy lessons for South Africa can be found through exploring international perspectives of the socio-economic and managerial causes of financial distress (Chernick and Reschovsky 2001; Kloha *et al*,. 2005; Kihmi 2008).

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[6] Imbalance between expenditure responsibilities and revenue powers assigned to sub national governments

[7] A situation where sub-national government fail to internalise cost of excessive spending because part of its spending is shifted onto the national taxpayers.

4.1 Perspectives on Sub-national Government Fiscal Distress

Two diverging general approaches are used to investigate the causes of sub-national government financial distress; the socio-economic decline approach and the local-management approach. The first approach considers the causes of financial distress to be external to the provincial governments, lying beyond the control of officials, whereas in the second approach internal local management and political environment explain financial decline (Kihmi, 2008). In practice, financial failures could be a mixture of both. For instance, when revenues decline, politicians and bureaucrats avoid hard decisions about cutting staff establishments, etc., deferring training and maintenance until the damage cumulatively manifests. Bureaucrats may also buy time through strategies such as using existing surpluses, re-budgeting, selling goods, short-term borrowing and creative bookkeeping, in order to delay financial failures appearing. In addition to delaying tactics, sub-nationals may ask for intergovernmental aid through bilateral negotiation (at least in both the USA and the UK), or deal with fiscal pressures by increasing revenues and reducing expenditure, including cutting costs directly related to service provision and personnel (Wollmann, 1983).

External socio-economic causes of provincial governments' financial troubles can include national negative business cycles, urbanisation and migration, demographic changes, decline in local business activity, loss of jobs and tax-base erosion, and bureaucracy and national policies that assign public responsibilities without appropriate taxation tools or sufficient transferred funds to finance services (Chernick and Reschovsky, 2001; Kloha *et al.,* 2005; Kihmi, 2008). The real issue is whether the exogenous socio-economic factor is permanent or not. If it is permanent, the question is whether national government should always insure the sub-national government to avoid adjustment – i.e. rework the grant system or tax handles – or whether the grant system supports the provincial government to make the hard adjustment choices such as scaling down establishments. Related to this is whether the socio-economic decline is pervasive (i.e. nationwide) or localised. If it is nationwide, all spheres will have to adjust simultaneously, and the question is which sphere bears the cost of adjustment. If the decline is localised, there is room for insurance within and across spheres.

The financial distress of provincial governments may be the result of internal circumstances. These include: bad managerial practices (poor accounting methods, erroneous estimation procedures, incorrect budgeting practices, erroneous financial disclosure practices, accounting gimmicks and short-term thinking); local officials' ineptness, incompetence and eventually corruption related mainly to lack of adherence and compliance to procurement procedures and regulations (on which the Auditor General's reports on provinces dwell extensively); political size and procedural fragmentation (the number of social groups participating through their representatives and the level of decentralisation in the budgetary processes); and vulnerability to special interest groups (Kloha *et al.*, 2005; Kihmi, 2008).

The Commission's view is that a financial crisis does not evolve for a single reason, as diverse factors acting at the same time can affect provincial governments' financial vulnerability. Thus, the relative importance of both external and internal factors causing financial disequilibrium needs to be investigated (Wolmann, 1983). If the problems are systemic and exogenous, then managerial solutions (e.g. appointing an administrator) simply will not work. In the short term, the financial situation of a sub-national government can be made to look decent (e.g. through sale of assets) but will invariably deteriorate once the administrator withdraws. The lesson for public policy is to establish whether the causes are exogenous or not.

4.2 Evidence from South Africa

The circumstances that led to the intervention are immaterial, although the type of intervention is different for the three provinces. Intervention was mainly prompted by fiscal mismanagement, such as disregard for supply chain and asset management processes, late payment of suppliers, weak cash-flow management, human resources deficiencies and, most importantly, poor expenditure management and budget controls. Table 6 provides reasons for intervening in each of the three provinces – contract manipulation, overspending and unauthorised expenditure feature prominently in the list of fiscal transgressions. Both Gauteng and Limpopo have a significant number of fiscal misappropriations.

Table 6: Crosscutting, underlying causes of intervention per province

Reason	Gauteng	Free State	Limpopo
Supply chain problems			
Late payments/accruals	X		X
Illegal procurement and payments		X	X
Overpricing/contract manipulation/leakages	X	X	X
Transparency	X		
Cash management			
Poor cash position			X
Frequent payments without backing cash			X
Over-withdrawal of bank account			X
Human resources			
Excess staff			X
Vacant critical position	X	X	
Potential default in payment of salaries			X
Personnel cost not fully funded			X
Expenditure and budget control			
Budget shortfall			X
Accumulated unauthorised expenditure	X		X
Large bank overdraft			X
Illegal borrowing/disregard for procedures		X	
Accumulated outstanding debt	X		
Projected overspending	X	X	X
Asset management			
Unaccounted for assets	X		X
Count	8	5	14

Source: Adapted from National Treasury, 2011.

The fiscal mismanagement listed in Table 6 implies serious financial, economic, fiscal and service delivery risks, not only for the provinces concerned but also the country at large. The inability to pay suppliers on time may jeopardise critical supplies to hospitals and schools, as became evident in Limpopo.

The fiscal risk associated with ill-discipline in the three provinces amounted to over R20-billion at the time of intervention (Table 7). Interestingly, the fiscal exposure in Gauteng, which is attributed to only one department, is slightly higher than that of Limpopo, where more than five provincial departments are involved. Similarly the fiscal exposure in the Free State, which is also attributed to a single department, constitutes more than half of the total fiscal exposure in Limpopo.

Table 7: Fiscal position per provinces at the time of intervention[8]

R'millions	Gauteng	Free State	Limpopo	**Total**
Unauthorised expenditure	4,740		2,700	**7,440**
Accruals	2,100		500	**2,600**
Projected overspending	1,000	448	2,000	**3,448**
Budget shortfall			2,000	**2,000**
Overdraft			1,260	**1,260**
Outstanding debt	1,600			**1,600**
Exposure to the fiscus		4,200		**4,200**
Total	**9,440**	**4,648**	**8,460**	**22,548**
Less accruals	-2,100		-500	-2,600
Total fiscal exposure	**7,340**	**4,648**	**7,960**	**19,948**
Fiscal exposure as % of total budget	11%	19%	18%	

Source: Adapted from National Treasury, 2011.

Given the similar provincial fiscal positions, Tables 6 and 7 put into perspective questions about the criteria used to place provinces under different types of intervention. These questions are difficult to answer because the intervention process is fraught with several unknowns, at least to an outsider. To illustrate, the Auditor-General issued the 2010/11 Provincial Audit Report that contained widespread findings, some of which partly led to the intervention in the provinces concerned. A total of 42 provincial departments accounted for R16.3-billion of unauthorised expenditure, up to 45% of departments did not pay creditors within 30 days from receipt of invoice, and 24% (i.e. 25 departments) did not have competitive bidding processes. The Auditor-General's report found that fiscal ill-discipline is confined not only to a few provinces but is found across provinces, although the degree of materiality varies. However, the absence of objective intervention triggers in the intervention framework means that other provinces, which may be in a similar position to those that were put under administration, may very well have been left out of the process..

The absence of a clear enabling intervention framework is further exacerbated by the manner in which several factors other than fiscal ill-discipline are given as underlying causes of provincial fiscal problems. In Limpopo, one of these factors is the number of excess teachers. The Commission's own assessment based on schooling data, suggests that Limpopo is not the only province with excess teachers. Based on the assumption that each province adheres to

[8] Note that total figures are only indicative and do not necessarily represent the true fiscal position as there may be double counting.

the national norm of 30 learners per educator, four other provinces appear to have too many teachers. As Table 8 shows, the Free State has the highest number of excess teachers (1957) followed by Limpopo with 1241. A large part of the explanation for excess education staff in provinces is historical and may not necessarily be because of fiscal ill-discipline, as is often assumed. However, this should not detract from the fact that provinces need to cut expenditure according to their available budgetary resources, unless labour laws and unions and other rigidities prevent them from doing so or delay adjustment. The personnel cost clearly lies largely outside of provincial control. In principle provinces have the right to fire and hire staff but, in practice, implementation in the short term is difficult because of well-known constraints imposed by the collective bargaining system. The system of centralised determination of service conditions within the public sector, weak management and powerful union demands impose rigidities on provincial budgets, which later manifest as both fiscal and service delivery problems. The Eastern Cape department of education was recently held to ransom by unions and coerced into reinstating over 4 000 temporary teachers, although the budget for paying the teachers was clearly not available.

Table 8: Shortage and excess educators per province

Province	Number of leaners	Numbeer of educators	Learner/ educator ratio	Educators (normalised to national average)	Educator surplus/ shortage
Eastern Cape	2 003 129	66 626	30.1	66 041	-585
Free State	638 756	23 016	27.8	21 059	-1 957
Gauteng	1 777 794	57 463	30.9	58 612	1 149
KwaZulu-Natal	2 743 979	87 466	31.4	90 466	3 000
Limpopo	1 660 700	55 992	29.7	54 751	-1 241
Mpumalanga	1 013 760	33 245	30.5	33 422	177
Northern Cape	266 296	8 617	30.9	8 779	162
North West	746 096	25 074	29.8	24 598	-476
Western Cape	959 714	31 870	30.1	31 641	-229
South Africa	**11 810 224**	**389 369**	**30.3**		

Source: 2010 SNAP survey, department of basic education – own calculations

The data shows that both external and internal factors contribute to financial distress. External factors include changes to the national legislative framework related to taxation tools and expenses from non-recurrent events (such as collective bargaining). However, internal factors – contract manipulation, lack of leadership (defined by the Auditor-General as executive hiring of the right people for the tasks at hand), overspending and unauthorised expenditure – seem to be the result of poor financial practices and a lack of political and managerial will to make the requisite changes rather than intrinsic structural status. In fact, the national government seems to support this view, as only over certain thresholds (of overspending) do these factors become significant in identifying either structurally distressed or financially destabilised provincial governments.

5. Concluding Remarks and Recommendations

An array of financial difficulties confronts provincial governments in South Africa today. In previous studies, the Commission has called for the country's intergovernmental fiscal system to be strengthened by rearranging fiscal relations among the three spheres of government. Provinces have severe expenditure challenges that range from out-dated capital facilities, to demands for increased services for poor persons and worn-out equipment. Some problems are because the revenue resources cannot be stretched to meet the expenditures mandated by the Constitution and demanded by the people, while others are related to widespread inefficient use and inappropriate allocation of resources. This submission has highlighted the latter as an area, which any intervention process will have to address.

In this submission, the Commission highlights the challenge of maintaining financially functional provincial governments that are able to fulfil their constitutional role as effective institutions for social change. Financial distress in the national context is investigated using the data available on provincial government finances. Some provincial government departments appear to be involved in pervasive and bad managerial practices that are capable of leading to critical fiscal distress. The causes of and indicators for financial and fiscal distress are an area of current research work by the Commission, which will table recommendations on this to Parliament in the near future.

The interventions currently under way in Gauteng, Free State and Limpopo are the product of the evolving nature and design of South Africa's intergovernmental fiscal system and the apparent lack of accountability deriving from, inter alia, the unclear legislative framework, the lack of credible financial distress-management information, unclear roles and responsibilities within concurrent functions, and weak provincial legislature oversight. Administratively, the level of deterioration that triggers intervention in provincial fiscal affairs is not clear cut. The Constitution and the PFMA are not explicit in prescribing interventions necessary to maintain national and minimum service delivery standards, economic unity and national security, and to prevent provinces from prejudicing the interest of other provinces or the country at large. The large discretion left to national government to interpret these constitutional imperatives may be overtly subjective. For instance, in many provincial areas of responsibility, national or minimum standards in a number of areas of concurrency are neither clearly defined nor adequately costed. Even where standards are defined, they seldom include time limits or set levels beyond which deviation from national or minimum norms automatically prompt intervention.

Furthermore, there is a lag between the making and the manifesting of poor revenue and expenditure decisions. Poor monitoring and evaluation systems at sector level make it increasingly difficult to detect financial problems sooner and prevent sporadic total collapse in service delivery, as was the case in Limpopo. Financial problems are often pre-cursors to, or the consequences of, service delivery failures.

In conclusion, the Commission is of the view that the effectiveness (or otherwise) of provincial intervention faces regulatory, structural, incentive- and capacity-related challenges. In order to address these challenges the Commission makes the following recommendations:

(1) *Improving institutions and legal framework.* The Commission recommends refining the national intervention processes set out in Section 100 of the Constitution and Section 6 of the PFMA to bring them in line with the intervention framework governing local government. Specifically:

    a. Align Section 100 of the Constitution with Section 139, with a view to making intervention mandatory in the event of financial crises in provinces.
    b. Make Section 6 of the PFMA more explicit (and similar to Section 136 of the MFMA) by setting out criteria for determining serious financial problems, with clear measurable factors of what constitutes persistent material breach or the inability to fulfil executive financial obligations.
    c. Introduce an early warning system and promote transparency. Once these criteria are spelt out, National Treasury must disclose key fiscal data, exposure to hidden liabilities and action plans to address the Auditor-General's findings on a quarterly basis (Section 32 reports). The utility and credibility of these fiscal distress indicators will depend on the quality of financial management information systems at the level of individual departments as detailed further below.
    d. Share responsibility for intervention at provincial level between Provincial Treasuries and the Legislature. Provincial Treasuries must monitor and disclose key fiscal health indicators at provincial department level, where prolonged deviation (as defined by the amended PFMA) from expected or healthy fiscal trajectory triggers automatic intervention mandated and overseen by provincial legislature. This will enable the provincial executive to be held accountable and to take the necessary remedial action expeditiously.
    e. Develop clear and objective guidelines for when interventions should be triggered in accordance with the Constitution or subordinate financial legislation. This would dispel the perception that financial accountability takes precedence over service delivery accountability. For instance, constitutional interventions may be activated in the case of service delivery failures, whereas financial interventions may be instituted for fiscal problems. Each intervention should be accompanied by measurable objectives, so that its effectiveness, impact and sustainability can be evaluated retrospectively and independently.
    f. Set clear norms and standards for the performance of Provincial Treasuries in the PFMA. This will reinforce the Treasuries' authority to exercise their functions without undue interference from organs or persons when implementing provincial budgets and promoting sound financial management practices. Further, the National Treasury should periodically review the institutional capacity of Provincial Treasuries, assessing factors as diverse as filling of critical positions, cash and expenditure management, functionality of

budget office and political meddling in procurement affairs, in line with its Constitutional responsibility.

g. Review the PFMA and Public Service Act to clarify the political and administrative interface for procurement and human resource management, in line with the MFMA. The MFMA clearly distinguishes the political and administrative roles when tendering and deploying personnel (for instance, it specifically prohibits councillors from interfering in supply chain matters), whereas the PFMA is silent on these issues. The conflicts between the PFMA and the Public Service Act (PSA) must also be resolved (for instance the Public Service Act (PSA) allows ministers to intervene in employment decisions, which is contrary to the spirit of the PFMA).

(2) *Improving accountability*: The Commission recommends that the current accountability framework should be reviewed. At present, politicians and bureaucrats cannot be easily held responsible for their deeds, and lines of accountability are blurred between and across the three spheres of government. Some legislatures are unable to deal effectively with inept members of executive councils, apart from asking them to appear before the House. Equally, accountability in the system is displaced because of fragmentation. For example, premiers sign performance agreements with the President containing outputs, but legislatures are responsible for allocating resources, while accountability for outcomes lies with national ministers.

(3) *Improving oversight.* Oversight and accountability go hand in hand. Oversight institutions must be clear on what they want to oversee and have powers to seek or demand remedial actions where laws are violated or services are not delivered. The oversight function should ideally remain the preserve of political office bearers. However, in order to carry out these roles effectively, legislatures need to increase their capabilities with regard to policy analysis and review, budget analysis, information systems and consultation with constituency. Legislature should also make more effective use of reports from institutions supporting democracy (e.g. South African Human Rights Commission, Office of the Public Protector, Auditor-General, Financial and Fiscal Commission,) and civil society groups.

(4) *Improving financial management capacity.* National Treasury should set uniform quality standards for provincial treasury oversight, monitor provincial treasury performance against these standards and assist in building the necessary capacity to meet these standards. This would include creating statutory competence standards for CFOs and other senior financial management personnel in terms of the PFMA, similar to what is in the MFMA, and ensuring the recruitment of capable personnel, as covered in the Municipal System Act Amendment.

(5) Improving financial management information. Government must speed up the implementation of an integrated financial management information system or invest in interim business intelligence solutions. Thus, timely and accurate financial

information can be generated for statutory reporting requirements and for decision making in such critical areas as budget planning, cash-flow management, procurement and asset management. These systems must be supported by the legal framework, which recognises advances in budgeting and financial management practices.

(6) *Enforcement of rule of law.* The Commission reiterates the need to increase credibility and respect for the law by ensuring that action is taken against those who violate the law. Over the past ten years, since the enactment of the PFMA and the annual Division of Revenue Act, few people have been charged for financial misconduct. Serious or persistent infractions of the PFMA and the Division of Revenue Act must be dealt with promptly through criminal or disciplinary proceedings.

For and on behalf of the Financial and Fiscal Commission

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