CHAPTER 6

Improving the Fiscal Performance of Provinces In South Africa

Eddie Rakabe

6.1 Introduction and Background

The aftermath of global economic crises continues to affect the economies of South Africa and many other developing countries. Global economies are battling slow recovery and growth, and governments are confronted by policy dilemmas over whether to continue with stimulus interventions or budget consolidation. In the midst of this predicament, the demand for public services continues to rise because of high levels of poverty and unemployment. Government is under pressure to fulfil its developmental goals (to educate, provide health services, keep the public safe, and invest in the public infrastructure) using available fiscal levers to support a sustainable economic recovery and high quality of life.

The rising need for basic services and the lower growth (or stagnation) of government revenues to pay for those services contributes to high budget shortfalls (or fiscal stress), which in turn threatens the attainment of developmental goals. When expenditure increases are not matched by corresponding increases in revenue, governments are compelled to make hard choices between mobilising additional resources, pursuing budget consolidation or improving fiscal performance, all of which are associated with substantial economic and political costs. For example, the trade-off between losses to the national economy from expenditure cuts and political costs associated with "stop and go" implementation of policies. National government takes a keen interest in sub-national budgetary affairs, primarily because developmental goals could be adversely affected by actions taken to address ensuing fiscal stress, such as increasing taxes, laying off employees, reducing expenditure and postponing or eliminating infrastructure projects (Digler, 2011).

In the context of South Africa (and perhaps elsewhere around the globe), fiscal stress is a common feature of decentralised budgeting frameworks. Governments constantly experience revenue shortfalls relative to original budget estimates and planned outlays, leading to periodic deficits. For provinces in South Africa, the phenomenon and existence of fiscal stress is a subject of considerable controversy. National government retains much of the revenue-raising powers, while provinces are expected to run balanced budgets from their meagre resources, made up predominantly of transfers. The balanced budget rules and the system underlying provincial transfers are premised on the assumption that transfers insulate provinces against endogenous and exogenous budget pressures. For this reason, provincial spending overruns are strictly discouraged, and borrowing is restricted to capital finance and subject to national government approval.

Notwithstanding these fiscal arrangements, provinces in South Africa claim their budgets are under significant pressure. Evidence emanating from provincial submissions at various forums, especially the Medium Term Expenditure Committee (MTEC) hearings, and from the implementa-

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tion of various expenditure programmes (i.e. bus subsidies), increasingly suggests that provinces face some degree of fiscal stress. According the prevailing view, provincial fiscal stress is a fallacy and mainly attributable to poor fiscal performance i.e. fiscal mismanagement. However, anecdotal evidence points to a myriad of complex explanatory factors, including high levels of service needs versus funding adequacy, poor long-term planning, budget incrementalism, inefficiencies or "fat" in the budgets, quasi-fiscal activities, high statutory obligations, inadequately funded national policies (i.e. wages), unaffordable and unrealistic national expenditure norms and standards, devolution of functions. As well as misalignment in the growth of the economy and the budgets (budget moderation).

From time to time, provinces come under heavy criticism over their growing inability to allocate resources effectively, assign sufficient funds to nationally determined policies and meet service delivery targets. Similarly, provinces claim to be confronted with exogenous cost pressures (some of which are imposed by national government) and increasing demand for services, which are not always matched by adequate transfers. The result is budget shortfalls, which manifest as spontaneous spending overruns (unauthorised expenditure), the inability to meet set delivery norms and standards, under-servicing/backlogs, delays or deferment of expenditure commitments, and rationing of services (e.g. long queues at clinics or low quality of service).

This chapter seeks to assess the phenomenon of provincial fiscal stress, which is defined as the inability to meet current and future financial obligations, to provide minimum service levels and to reduce service backlogs (infrastructure in particular) with minimum efficient expenditure. It looks at whether and why provincial fiscal stress exists and how to address it, given the constitutional requirements for the progressive realisation of needs. A fiscal stress index is constructed by reviewing and then using theories of sub-national budget constraint, resource-use and allocation management, and fiscal adjustment. Fiscal stress is viewed as a structural, institutional, legislative, and expenditure and revenue problem. The chapter concludes that the fiscal performance of provinces must be improved by monitoring various elements of fiscal stress and putting in place necessary fiscal rules.

6.2 Problem Statement

South Africa is facing ongoing and unresolved debates around the existence or non-existence of provincial fiscal stress. The implicit and explicit intergovernmental fiscal arrangements between national government and provinces make it difficult to establish with certainty the degree to which provinces are affected by fiscal stress. In South Africa, transfers represent a bigger share of provincial revenue and are used to fulfil mainly delegated expenditure responsibilities – that is, nationally determined policies. A widening gulf between the available resources and expenditure needs often leads to concerns about whether the revenue is adequate for the provinces' responsibilities, and counter concerns (from national government) over the efficacy of expenditure management (Premchand, 1993).

National government often dismisses the fiscal stress argument, citing poor resource-allocation planning, as shown by growing incidents of poor fiscal performance, and that the annual equitable share adjustments insulate provinces from exogenous expenditure shocks. National government's stance on fiscal stress can be explained in part by the perceived adherence to core principles of resource-use management, including propriety, accountability and adequacy. Propriety refers to the ability to spend funds for the purpose approved by legislature (in 2010/11 alone provinces accumulated over R25 billion in unauthorised, irregular and wasteful expenditure). Accountability and adequacy relate to the ability to implement policies prudently and transparently and the capacity to produce outcomes commensurate with the respective outlays (Premchand, 1993). Yet an increasing number of expenditure reviews, especially in education and health, suggest that the outcomes are less than desirable, relative to allocated expenditure.

If not properly managed, run-away fiscal imbalances can cause irreversible damage to macroeconomic balances. Sub-national governments, which have the flexibility to run rolling fiscal deficits, can endanger overall fiscal sustainability and increase the risk of moral hazards associated with soft budget constraints.

While national government's arguments are not without merit, it fails to acknowledge the inherent problems of alignment between policies, budgets and implementation. National government often makes commitment budgets, promising in its plans and new policies unrealistically high levels of services, which provinces are then required to deliver, without costing or providing commensurate resources for these services. Furthermore, provinces have numerous exogenous input-cost pressures, such as employee compensation, which are growing at a faster rate than the allocated revenues. When the impact of these arrangements is recognised, and provinces are compelled to adhere to balanced budgets, payment controls are often adopted as key adjustment measures, thus leading to the build-up of arrears and service backlogs.

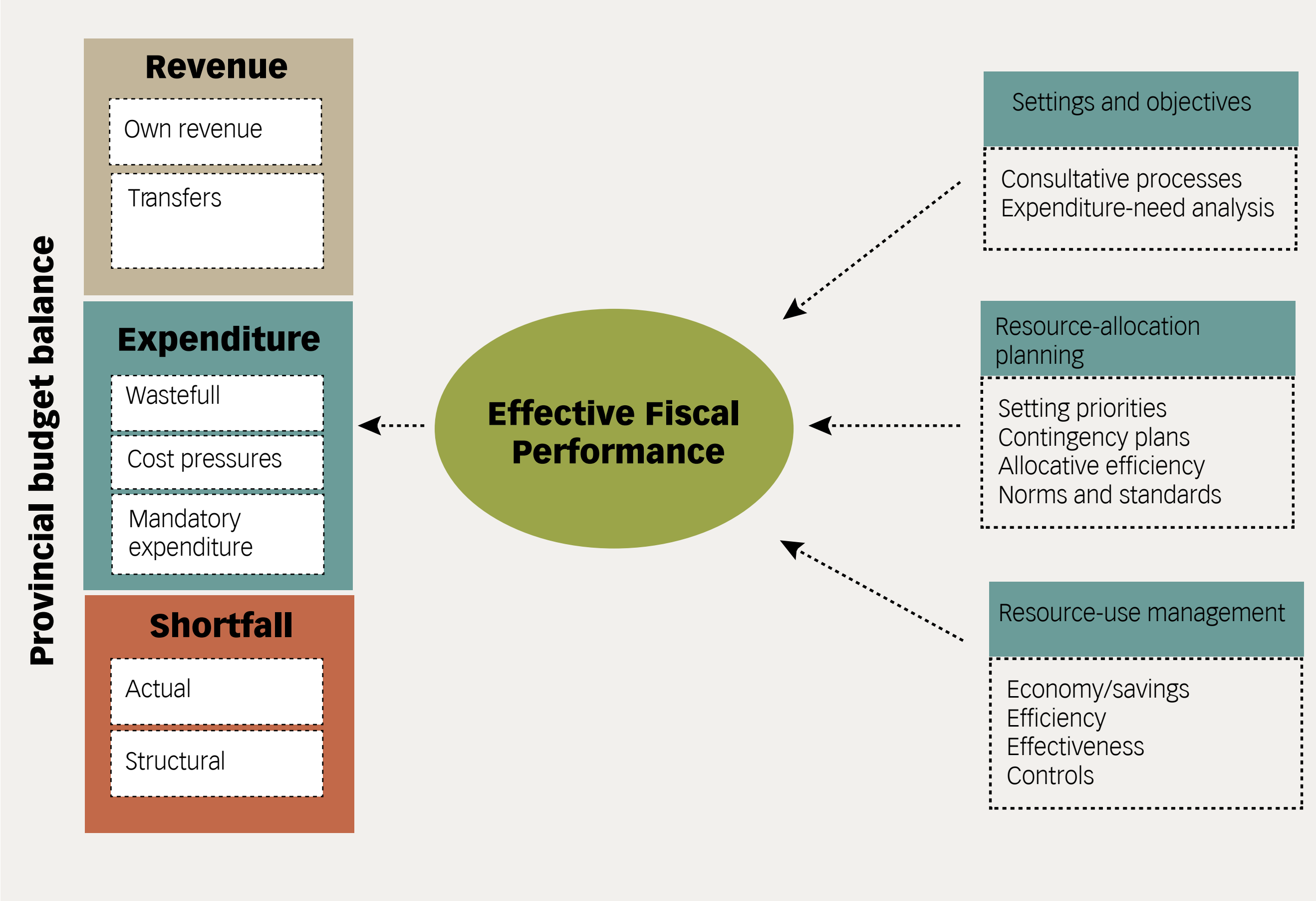
With so much complexity over what exactly constitutes or causes provincial fiscal stress, national government's ability to hold provinces accountable for delivery becomes limited, while provinces have limited incentives to use resources efficiently as they know that they cannot be held directly responsible for non-delivery (Rodden et al., 2003).

6.3 Aims and Objectives of the Study

The main aim of this study is to assess how the fiscal performance of provinces can be improved to support national developmental goals. Specific objectives of the study are:

- To determine whether fiscal stress, as perceived by provinces, is genuine, self-imposed, temporary or chronic/structural.
- To understand and evaluate the fiscal adjustment mechanism available to, and used by, provinces to ease their respective fiscal pressure.
- To strengthen intergovernmental relationships by understanding the peculiar provincial budget dynamics.
- To contribute to the Financial and Fiscal Commission's Annual Submission on the Division of Revenue.

Figure 10: Conceptual Framework



6.4 Conceptual Framework

Figure 10 depicts an analytical and conceptual framework for assessing fiscal stress. In this model, effective fiscal performance is regarded as a composite process that contributes to making timely and effective decisions on the use of public funds. The operational framework for expenditure management comprises a three-stage administrative process: determination of policies, objectives and resources required; allocation of resources required to meet policy objectives; and commitment to carrying out tasks and spending resources economically, efficiently and effectively.

6.5 Framework for Evaluating Fiscal Stress

6.5.1 Overview

Like many other developed and developing countries, South Africa has undertaken fiscal decentralisation reforms, assigning expenditure functions and revenue powers to lower levels of government. However, as with many intergovernmental fiscal systems around the world, South Africa is facing ongoing and unresolved debates around whether adequate devolution of revenue sources accompanies the devolution of spending responsibilities. Sub-national governments, particularly provinces, rely on national transfers (and to a lesser extent on borrowing) to finance their expenditure commitments. These arrangements raise concerns and/or perceptions of budget imbalances in the lower spheres (Eyraud and Lusinyan, 2011).

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Disagreement around imbalances is a feature of any decentralised system of government due to the common economic problem of scarcity. Some level of discrepancy between sub-national own revenues and spending is inevitable, and may even be desirable for the purpose of retaining national control over provinces. However, large and persistent budget shortfalls, (perceived or otherwise) can have detrimental effects, including the partial collapse of public service, under-delivery, missed delivery targets and prolonged service backlogs (Besfamille and Lockwood, 2004).

6.5.2 Conceptual Definitions of Fiscal Stress

Fiscal stress is a term that is interchangeable with concepts such as fiscal distress, fiscal strain, fiscal crises, fiscal squeeze, poor fiscal health, poor financial condition or budget pressures. The term is used to describe the predicament of government dealing with social, financial and economic difficulties (Arnett, 2012). This conceptual medley means that there is no single, universally accepted definition of fiscal stress. According to Rubin (1982), there are as many definitions as there are scholars interested in studying fiscal stress, and the situation is yet to change. The lack of a clear definition creates confusion about the meaning of fiscal stress.

The term is used to refer to the financial conditions of different spheres or organs of government, as well as to two different types of analysis. In addition to the proper meaning of financial strain, fiscal stress is used to describe fiscal disadvantage relative to other spheres, absolute or relative fiscal decline over time, and fiscal emergencies or crises that involve defaults and failure to meet obligation (Shelley, 1982).

Fiscal stress is difficult to define because it is a dynamic, transient condition with multiple facets and interpretations. As Arnett (2012) observes, some definitions include reactions to and symptoms of fiscal stress, rather to the condition itself. To get around these problems, scholars tend to adopt different definitions to accommodate their respective research objectives, mainly restricting themselves to financial conditions rather than the causes and consequences. This makes for ease of comparison across government and time.

Notwithstanding, the above definition problems, a compelling body of literature suggests that fiscal stress is a condition of imbalance (Gold, 1992; Premchand 1993; Müller and Rohr-Zänker, 1998; Skidmore and Scorsone, 2009; Congressional Budget Office, 2010). Intuitively, the balance is between what the public would like and what government can provide, given available resources. Balance can also be viewed in the context of overall budget balance (a general accounting balance, taking into account the difference between expenditure and revenue) and generational balance (inter-temporal generational equity issues).

Operational definitions of fiscal stress are common. For example Müller and Rohr-Zänker (1998) describe fiscal stress as a condition where government is unable to meet the demands of growth and change and to maintain the existing levels of service, as a result of expenditure demands growing faster than the available resources. For Premchand (1993) fiscal stress is defined as a growing imbalance between revenue and expenditure over a period, usually confined to a fiscal year and reflecting a deviation from original budget estimates. Hendrick (1989) Jiménez (2009) and Wang et al. (2007) view fiscal stress more broadly, as government's inability to meet its short- to

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long-term financial and services obligations, as and when they arise, accompanied by the inability to raise adequate revenue. Accordingly, fiscal stress entails elements of government in trouble, liquidity, insolvency, tax base and debt problems. However, Gold (1992) is quick to point out that fiscal stress is not to be confused with self-inflicted poor budgeting practices. Good budgeting requires holding funds in reserve, as a buffer against unexpected contingencies; only when those reserves are below the desired level can agencies be said to suffer from stress. Furthermore, spending that exceeds revenue because of capital investments may not necessarily be a sign of stress.

In terms of these definitions, fiscal stress can be major or minor in size and impact. It can also be a short-run phenomenon – a one-time event that puts the budget off balance – or long term in nature, whereby government is under continuous financial strain and so is unable to provide minimum levels of service (Gold, 1992). The latter entails severe forms of fiscal stress and may be attributable to a number of factors, including indebtedness and structural and demographic issues (section 6.5.4 provides full discussion). Furthermore, fiscal stress can emerge from either sudden or recent events, or slowly develop.

6.5.3 Theoretical Foundations

The study of fiscal stress dates back to the middle of the 19th century, when industrialised countries began using budgets as an integral part of broader macroeconomic management, rather than as mere vehicles for government expenditure and accountability. Until the early periods of industrialisation, government revenue kept pace with public spending, reflecting aspirations to establish welfare states across Europe. In the aftermath of the Great Depression, public spending began to outstrip revenue, contributing to high levels of public debt. The growth in deficits led to an increased awareness of the budget linkages to the macro-economy and, more importantly, of the long-term budget pressures on government when public spending is diverted into debt servicing (Premchand, 1993).

In response to financial problems in urban areas such as New York and Cleveland, more attention began to be focused at the local government level (Savage and Schwartz, 1999). The main purpose was to identify which cities were the mostly fiscally strained, so that the size and destination of federal and state aid could be redirected, and to distinguish between fiscally reliable and non-reliable investments (Arnett, 2012). The theoretical approaches used to explain fiscal strain vary, but two cross-cutting themes always emerge: internal and external factors.

One approach stresses that government policies are the main causes of their financial situation, while the other argues that structural and environmental factors are key determinants of fiscal condition (i.e. causes of fiscal stress can be found in expenditure management weakness or, according to public choice theory, are the result of distorted market mechanisms). The neo-Marxist (or economic structuralist) approach is more comprehensive, taking into account both economic and social conditions. Fiscal policies, particularly composition of expenditure, are seen as a major cause of fiscal strain, but also a necessary result of the state's function in a capitalist society (Müller and Rohr-Zänker, 1998).

For advocates of the structuralist approach, fiscal stress is not exclusively attributable to poor expenditure management, but also a reflection of the underlying structural contradictions and constraints imposed by the economic system. Fiscal stress is viewed as an intrinsic feature of late capitalism, resulting from government's attempt to reconcile two contradictory functions. Government is seekings to ensure capital is accumulated by securing the profitability of priority sectors of the economy, while at the same time maintaining the legitimacy of social and public order (i.e. mediating the class interests of workers and capital owners). In an attempt to respond to various claims and to avoid an economic and social crisis, the government is caught up in a structural gap – between satisfying demand for public services and the capacity to pay for them. This gap manifests through the budget allocated for social capital – expenditure to sustain capital profitability – and social expense – expenditure to secure social and political patronage (Müller and Rohr-Zänker, 1998).

Fiscal stress is also central to theories explaining rapid public expenditure growth. In both developed and developing countries, bloated governments tend to create many economic ills, including slow economic growth, large government deficits and internal and external imbalances. Alm and Embaye (2010) classify theories explaining growth in government spending into "institutional" and "a-institutional" approaches. Institutional theories focus on political/public choice considerations (e.g. the roles of government bureaucrats, voter-taxpayers and special interests, as they engage in rent-seekings practices) and rely on structural changes (e.g. voter suffrage) and major shocks to the political system (e.g. war, economic crises). A-institutional theories emphasise the impacts of changing market conditions (e.g. income and price effects) on the demand for government services

6.5.4 Causes of Fiscal Stress

While the definition of fiscal stress is fraught with challenges and confusions, the literature reveals considerable consistency and consensus about what factors lead to, influence or cause fiscal problems, i.e. cyclical downturns. For Premchand (1993) these factors are many; some may be long standing, while others may be relatively recent. As noted earlier, institutional, behavioural, structural and policy factors, as well as budget practices contribute to fiscal stress.

From an institutional angle, the following factors are perceived to contribute to fiscal stress, although the magnitude of their contribution is difficult to measure (Premchand, 1993). When major financial decisions are made outside the budget process, fiscal stress problems inevitably arise. Driven by expediency and rent-seekings motivations, politicians make high-priority commitment budgets or promises that violate self-imposed parameters of formal fiscal plans (budgeting by volume). As a result, spending overruns accumulate, representing successive waves of historically compressed spending and commitments, which are far in excess of available resources (fiscal illusion [58]).

Other political economy explanations of fiscal stress are rooted in models of polarisation or bargaining between rival political interest groups. The models suggest that multi-party, budget

[58] A situation where citizens ask for and politicians promise more than government can deliver.

decision-making systems are likely to run bigger deficits because individual political parties make unilateral decisions and do not internalise the full cost of funding group-specific needs. Similarly, in a two-party state, an incumbent ruling party is likely to shift the financing of current spending into the future, if the prospects for being replaced by a rival group are high (Khemani and Wayne, 2008).

Furthermore, unintended fiscal disorders often result from the lack of explicit procedures for coordinating revenue and expenditure, as well as the linkage between the budget process and macroeconomic framework. Powerful, rigid and long-term macroeconomic policy and political habits tend to overwhelm the budget pressure in a mechanical sense (Schick, 1988). Budget reserves are put under enormous pressure to meet the budget claimants' insatiable demand for additional funds, since the political machinery does not permit resource constraint to be internalised through various phases of the budget. As a result, budget outcomes (deficit/surplus) become a mere case of impromptu, rather than deliberate, policy decisions and, more importantly, the financial implications of decisions or budget outcomes are not fully recognised.

The two factors mentioned above tend to reinforce the notion that sub-national governments face soft budget constraints, i.e. have incentives not to pay attention to the quality and consequences of their expenditure decisions (Besfamille and Lockwood, 2004). Thus recognising or acknowledging any level of (perceived or actual) fiscal stress will be tantamount to further softening of the budget constraint. In other words, the expectations of additional resources may lead sub-nationals to behave opportunistically, which precipitates a self-imposed financial crisis and a request for more resources or bailouts from national government.

Another important institutional factor dominating the discourse on fiscal stress relates to vertical fiscal imbalance and assignment of expenditure responsibilities (Sutherland et al., 2005; Jiménez, 2009). When the balance is disproportionate between the revenue assigned and expenditure responsibilities, sub-national government may find it difficult to meet minimum services requirements or expenditure commitments imposed on them by the national government or statutes. National government controls tax and debt limits, determines public wages, sets delivery norms and standards, and introduces various legislations with permanent mandatory costs. National government can mandate provinces to provide certain services, which provinces have to figure out how to finance (Shelley, 1982). These arrangements sometimes create conditions or incentives for provinces to behave strategically in order to extract additional funds from national government. A common view articulated in Eyraud and Lusinyan (2011) is that the vertical structure of the public sector may "soften" the budget constraint of sub-national governments, causing them to overspend, and lower their tax effort – mainly because they do not fully internalise the cost of spending and/or anticipate that additional transfers will cover their financing gap.

From a policy and budgeting standpoint, rapid growth in expenditure, which leads to fiscal stress, can result from the pursuit of populist policies, formulation of indefinite expenditure programmes, lack of (or poor) costing of policies, high delivery norms and standards, incremental budget decisions and uncontrolled borrowing to finance new programmes (Premchand, 1993; Shelley, 1982). Incremental budget decision making is a direct product of the budget process, which lacks technical rationality – i.e. is not a comprehensive review of all expenditure components and existing alternatives (Arnett, 2012). This raises concerns over the fair share of revenue allocation, since expenditure adjustments are largely communal, and the share of budget among various spheres and organs remains relatively the same.

The lack of, or weak, budget expenditure and financial controls by budget claimants (spending agencies) and budget conservers (finance ministries) can also lead to excessive fiscal stress. Actual spending levels are most likely to exceed the original budget estimates when the budgetary institutions are incapable of: monitoring spending by line ministries, adjusting outlays downward after budget approval, and sanctioning profligate budgetary practices and fiscal choices, such as over-spending. The lack of control exacerbates the common pool problem, as spending agencies have an incentive to overspend and derive total benefit, but only suffer a fraction of the costs (Schick, 1988; Stasavage and Moyo, 1999). Furthermore, when budgets are not transparent and information is incomplete, national government may underestimate the effects of national policies on sub-national budgets, or the revenue effects of small changes in grant allocation. Similarly, sub-national governments may overstate the effects of national policies on their budgets to create a fictional budget shortfall.

Other causes of fiscal stress are listed in Table 45. These factors are not mutually exclusive but can generally be grouped in three categories: socioeconomic decline, internal political dynamics and bureaucratic expansion.

Table 45: Miscellaneous Causes of Fiscal Stress

Demographic changes (e.g. high school enrolment or failure rate); disease burden (i.e. high infection rate)	General cost increases/inflation. National government often makes aggregated inflationary adjustment to transfers, without taking into account the rate of cost increase in various expenditure categories, whose rate of growth far surpasses that of the Consumer Price Index e.g. health-care cost (Gold,1992)
Court decisions (Gold, 1992)	High personnel (including ghost employees) and capital outlay costs
Weak economic base	Economic swings
Rapid expenditure growth rate and/or high entitlement expenditure	Wasteful expenditure or tax competition, service benefit spill-over
Redistributive policies	Debt obligations
Expenditure inflexibility. Factors contributing to inflexibility include obligatory programmes that are structured by law, as well as programmes based on political agreements	Fraud and corruption
Revenue collection inefficiency	Unfunded mandates (Jiménez, 2009)

Source: Compilation from various sources.

6.5.5 Measuring Fiscal Stress

Finding an acceptable measure is one of the biggest hurdles when empirically determining the extent to which fiscal stress affects government structures. Like the definition itself, the concept of fiscal stress has no generally accepted measure or indicator, making the task or process of declaring fiscal stress cumbersome, political and fraught with many disputes (Gold, 1992). The debate over appropriate measures of fiscal stress focuses on the breadth of the measure: whether it should reflect once-off events, long-term financial decline or deviation from/inability to adapt to socioeconomic changes. As the concept is inherently dynamic and circumstances vary across agencies, there are unresolved debates over the appropriateness of a single measure or a composite indicator to denote fiscal stress (Arnett, 2012). For Jiménez (2009), an all-encompassing single indicator is difficult to construct because of the different dimensions of fiscal stress and the non-contingent relationship among different causes.

Several applied and theoretical frameworks have been developed and used to measure fiscal stress. Many applications draw on the work of Groves et al. (1981), which breaks down fiscal stress into three types of insolvencies. This includes (a) cash solvency, which is concerned with government's liquidity and ability to pay its bills; (b) budgetary and long-run solvency, which is related mainly to fiscal sustainability; and (c) service level solvency, which measures the ability of government to meet the needs of the community by providing the required minimum service levels. The key indicators to consider in measuring the underlying dimensions of solvency are:

- Fund balances
- Equity or net assets
- Surpluses and deficits
- Revenue performance
- Spending pressures and expenditure needs
- Outstanding debt, debt service, post-employment benefits
- Liquidity
- Financial ratios.

Table 46 demonstrates the applicability and accuracy of selected indicators of fiscal stress in measuring the different dimensions of solvency.

Table 46: Comparison and Effectiveness of Fiscal Stress Measures

Measure	Sphere-to-sphere comparison	Year-to-year comparison	Budget solvency	Cash solvency	Long-run solvency	Service level solvency
Budget deficit	weak	moderate	✓			
Year-end budget balance	weak	moderate	✓	✓		
Revenue perfor-mance	weak	weak				✓
Tax increase relative to expenditure trends	weak	Weak				✓
Financial ratios	moderate	moderate	✓	✓	✓	✓

Source: Arnett, 2012.

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6.5.6 Taxonomy Response to Fiscal Stress - Closing the Gap

Responses to fiscal stress are generally limited and depend on the underlying causes, severity of the situation and flexibility of fiscal rules. The most generic and common responses found in the literature are expenditure cuts, revenue enhancement and borrowing where it is permitted (Porteba, 1996; Kalambokidis and Reschovsky, 2005; Jiménez, 2009; Arnett, 2012). The budget can also be balanced through budget gimmicks (deferring expenditure such as maintenance), expenditure reviews, drawing from reserves or "rainy day funds" and much tougher fiscal stances, such as absorbing part of the fiscal pressure within existing budgets and the current fiscal year. The limited number of responses mentioned conceals the wide variety of other specific approaches available within each broader category. Table 47 outlines some of these approaches classified by problem area or cause of fiscal stress.

Table 47: Approaches to Fiscal Stress

Problem area	Approaches
When ministry of finance lacks power to adjust outlays after budget approval	Provision of emergency powers to finance ministry through legislation
Low revenue efforts, extensive regulations, indefinite spending programmes.	Revenue generation through user fees, reduction in regulations, introduction of sunset legislation, reallocation of task and responsibilities, postponement of policy initiatives and programmes
Uncontrolled deficits, policy implications and costing analysis,	Introduction of global targets, forward expenditure planning; institutionalisation of functional costing.
Lack of programme or project review	Expenditure review, programme reconsideration, performance based budgeting, incentives.
Personnel growth and expenditure rigidities	Hiring freezes and restrictions, salary reductions, staff ceilings, retrenchment, reduction in capital outlay, across the board cuts, reprioritisation of spending into core and non-core. .
Difficulty in implementing approved budget	Cash management, cash limits, centralisation of payments
Decision taken outside the process and no explicit efforts to coordinate revenue and expenditure.	Expanded budget process, envelope or portfolio budgeting

Source: Adapted from Premchand (1993).

Premchand (1993) suggests that, before considering any of the above approaches, an elaborate process should be undertaken to identify the nature and duration of the problem, formulate the corporate strategy and build consensus to gain support for implementation. Each of the choices explicitly reflect the opportunity costs of alternative policies, especially because all the approaches have the effect of reducing the rate of development, foregoing social welfare and adding to the future costs of maintaining or refurbishing assets.

Making choices about which remedy to administer requires practical considerations of the sequencing of approaches, ease of implementation and effectiveness, for example trade-offs between whether to introduce across-the-board cuts or sector-specific cuts. The political process is biased against limiting item-by-item spending, and there may be arguments about which items to cut (and by how much), even where cutback decisions have been made (Wildavsky, 2003). Across-the-board cuts represent an easy way out and a lack of prioritisation and method in the handling of stress (Premchand, 1993). Where the magnitude of the problem is severe, universal cuts may not be adequate and will have to be supplemented by specific reductions, preferably within unprotected or non-core expenditure categories. Another tactic for avoiding deeper cutbacks is to schedule a series of down payments over a period of years for closing the gap (Schick, 1988).

However, cutbacks within core spending areas are not without precedent. Schick (1988) found that most developed countries made marginal cutbacks in entitlements and transfer payments, making patients pay a higher share of the cost of medical care by tightening eligibility standards for social grants and by relying more heavily on non-governmental revenues to finance these programmes. Kalambokidis and Reschovsky (2005) observed a similar trend in the United States, where budget shortfalls between 2001 and 2004 led various states to cut spending in protected areas, such as K-12 education, and contain costs in Medicaid.

Similarly, the efficacy of curbing personnel expenditure depends on a number of factors. The widely held perception that the public sector is overstaffed led many countries to introduce measures such as staff reduction targets and ceilings, freezes in recruitment and wages, and retrenchments through incentives for early retirement. However, in many instances these efforts were a smokescreen to the real problem. Increased personnel expenditure is often the result of growth in programmes that tend to be labour intensive. In other words, staff increases reflect a structural problem that requires an exhaustive response. Thus, unless a comprehensive programme review is carried out, measures such as freezing and ceilings may only have a short-term effect on fiscal stress (Premchand, 1993).

Premchand (1994) proposes that fiscal stress responses be centred around the four pillars of expenditure management: stabilisation, economy, efficiency and effectiveness.

- Stabilisation is primarily concerned with determining and sustaining the aggregate level of expenditure, and observing the limit.
- Economy entails using fewer resources than planned (i.e. economies of scale and savings).
- Efficiency involves the ability to produce more with the allocated resources.
- Effectiveness is concerned with the extent to which the programme objectives have been fulfilled.

Thus, if the issue is one of excessive use of resources in relation to the needs, the policy response may have to emphasise economy. Alternatively, if the problem emanates from leakages and inefficient operations, policy options focus on restoring efficiency. However, in practice, Schick (1988) found that governments tend to look for the easiest places to reduce spending, rather than resort to reviewing the efficiency or effectiveness of programmes.

To deal with sub-national fiscal stress, Shah (2006) notes that it is important to deal with sources through a combination of policies, such as the reassignment of responsibilities, tax decentralisation or tax abatement by the centre, and tax-base sharing (by allowing sub-national governments to levy supplementary rates on a national tax base). Only as a last resort should revenue sharing or unconditional formula-based transfers be considered to deal with the gap, as they weaken accountability to local taxpayers. According to the OECD (2009), the most critical intervention for bridging fiscal stress and overcoming associated obstacles is the promotion of coordination and capacity-building at national and sub-national levels. However, Wildavsky (2003) argues that improving efficiency (reducing overlap or duplication and perfecting procedures) ordinarily does not involve substantial sums that quickly cumulate into large savings.

6.6 Fiscal Stress in the Context of Provinces in South Africa

Constructing acceptable measures of fiscal stress is empirically difficult, and provinces agree that declaring themselves fiscally stressed (or not) is difficult without carrying out a comprehensive costing of delivery norms commensurate with all their functions. Notwithstanding the importance of costing as a critical factor, provinces do encounter numerous budgetary problems, which are consistent with the literature on causes of fiscal stress. Most notably, the issue of misaligned expenditure responsibilities (or unfunded mandates) tops the agenda of problems that affect the budget significantly. Misalignment cuts across different provincial departments and is often linked to political decisions on policy, which are made without being accompanied by funding for implementation. The most compelling finding from the interaction with provinces is that their positive budget balance is in effect masking a number of "budget gimmicks", which may not necessarily show up in official budget and audit reports. For example, spending agencies tend to understate their performance targets to cater for national mandates, unforeseen expenses and profligacy. Table 48 provides a list of practical factors, which the provinces consider create or contribute to budget pressures and service level fiscal stress. Factors are classified as either exogenous or endogenous. *(Please see Table 48 on page 154).*

In addition, the South African legislative framework describes and specifies factors that may constitute fiscal stress, and how such conditions should be addressed. First, the legislation stipulates that national government may intervene in provincial and municipal affairs if they fail to fulfil their obligations, or experience material and persistent financial problems (sections 100 and 139 of the Constitution and sections 6 and 136 of the Public Finance Management Act (PFMA) and Municipal Finance Management Act (MFMA) respectively).

The PFMA does not explicitly list criteria for determining the seriousness of financial problems. However, section 138 of the MFMA, which applies to municipalities, provides a list of factors that constitute financial problems and by implication fiscal stress. These factors are generic and are equally applicable to provinces. They include:

- Failure to make payments as and when due.
- Default on financial obligations for financial reasons.
- Actual current expenditure exceeding the sum of actual current revenue plus available surpluses for at least two consecutive financial years.
- Operating deficit in excess of five per cent of revenue in the most recent financial year for which financial information is available.
- Submitting annual financial statements to the Auditor-General more than 60 days late.

- The Auditor-General withholding an opinion or issuing a disclaimer due to inadequacies in the financial statements or records.

Both the Constitution and public finance management legislations discussed above suggest that fiscal stress is much broader than financial problems.

Table 48: Causes of Service Level Fiscal Stress in Provinces

Exogenous	Endogenous
Policy contradicts compliance with the Financial Management Capability Maturity Model, where the Auditor-General raises an opinion about adequate staffing of financial units, but at the same time National Treasury requires provinces to contain personnel expenditure. Statutory obligations (competency levels).	MEC adverts.
Setting up of district offices for the Department of Cooperative Governance and Traditional Leaders.	Administrative cost of oversight for Members of Parliament (MPs). MPs must have both a secretary and researcher for every committee on which they sit.
Strengthening of oversight in the premiers' offices.	Operational costs of royal trusts in KwaZulu-Natal and the Eastern Cape.
Health staffing norms (1 nurse per 1 000 people) Minimum delivery norms are expensive to meet National Health Insurance norms on training	Operational costs. Catering for meetings.
Implementation of the Administrative Adjudication of Road Traffic Offences (AARTO).	Executive imbizo – visits.
Declaration of no-fee schools and occupational specific dispensation (OSD). Inadequate funding of no fee schools. Change in early child development norms and standards. 10 new schools per annum (Gauteng).	Expenditure on Industrial Development Zones and Special Economic Zones.
Inadequate personnel costs adjustments.	Ghost staff.
Court decisions to reinstate staff.	Over-pricing.
Costing of social services is not properly aligned with norms set by national government.	
Emergency services (no control over).	

Source: Author's compilation.

6.6.1 Operationalising and Measuring Fiscal Stress – Fiscal Stress Index

The literature does not contain a clear, optimal operational definition and measure of fiscal stress. The concept is highly dynamic and encapsulates numerous political, institutional, managerial, structural and cyclical elements. Existing definitions of fiscal stress are mostly country specific (and narrowly tied to the research objective under review) and focus mainly on financial conditions. The financial bias gives the impression that fiscal stress is strictly a budgetary problem and hence the overemphasis on budget-related variables as measures or indicators. For the purpose of

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this study, fiscal stress is viewed more broadly, as the manifestation of service delivery problems transmitted through the budget from political, institutional, structural, legislative, financial and economic factors. These factors constitute most of the variables that indicate the degree to which government is fiscally stressed (i.e. unable to meet current and future financial obligations, to provide minimum service levels, and to reduce service backlogs, in particular infrastructure, with minimum efficient expenditure).

Variables or indicators are drawn from literature and selected on the basis of their relevance to the South African environment and ease of measurement. Table 49 provides a list and description of 10 indicators, which capture the underlying drivers of fiscal stress, used to compute a composite fiscal stress index. Indicators are classified as either exogenous or endogenous.

Table 49: Selected South African Indicators of Fiscal Stress

No	Indicators	Description	Source
1	Provincial annual budget balance	Credit rating agencies and lenders view two operating deficits within a five-year period as a financial risk. For provinces in South Africa, the minimum allowed threshold for over and under-spending is eight per cent.	Endogenous
2	Cash balances	A cash balance of five per cent or less is generally regarded as a low cash balance, which results in delays in paying suppliers.	Endogenous
3	Expenditure buoyancy	Expenditure elasticity measures whether growth in expenditure is keeping pace with the rate of growth in national income.	Exogenous
4	Expenditure rigidity and earmarking	This measures the extent to which the composition of provincial expenditure fluctuates in response to changing economic conditions and spending priorities.	Endogenous
5	Unfunded mandates / Misalignment of expenditure responsibilities	delivery responsibilities undertaken by provinces for which funding from national government is non-existent or incomplete.	Exogenous
6	Wastage and profligacy	This measures the extent of inappropriate use of resources by provinces.	Endogenous
7	Budget and expenditure control	This measures the ability of provinces to maintain fiscal discipline, allocate resources in accordance with national priorities and produce maximum output with minimum costs. The inability to control budgets is one of the biggest triggers of fiscal stress.	Endogenous
8	Maladministration/managerial capacity	This measures the extent to which the province is able to comply with regulatory requirements pertaining to reporting, performance oversight and internal audit controls.	Endogenous
9	Minimum efficient expenditure	This measures the minimum expenditure associated with the inputs required to deliver national minimum service standards that are within provincial mandates, given that certain prices are set by national government (e.g. wages).	Exogenous
10	Service needs/burden	This measures the extent of service needs and burden in relation to other provinces, as well as budget allocation in response to such needs. .	Endogenous

Source: Author's compilation.

6.6.2 Evaluation of Provincial Fiscal Performance

Before calculating a composite fiscal stress measure, each indicator is evaluated separately to establish historical provincial fiscal performance. Table 50 shows provincial fiscal balances over a nine-year period ending in 2011. Provinces do not show a clear, consistent pattern of surpluses or deficits in the nine-year period, which suggests possible fiscal stress. However, there are isolated incidents of surplus and deficit, which are beyond the threshold of eight per cent to total budget strictly enforced by the National Treasury. Most notably, in 2005 the Free State and Mpumalanga provinces recorded a surplus of R4 billion and a deficit of R9 billion respectively. Cases of deficit or surpluses are immediately corrected within a single financial year, as indicated by a significant drop in Mpumalanga's fiscal balance between 2005/06 and 2006/07. Over the long term, all provinces seem to gravitate to near a zero budget balance, as shown by the average budget balance in Table 50. However, zero budget balance is not sufficient as a measure of fiscal stress, as surpluses may not be indicative of 100 per cent service delivery, while deficits may not be symptomatic of genuine tight fiscal space.

Table 50: Provincial Annual Budget Balance

R' Million	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	Average
Eastern Cape	-275	-2252	225	1333	1101	583	402	-2198	-2428	-390
Free State	2028	2950	3824	4022	51	101	149	410	-56	1498
Gauteng	150	-35	1037	-555	-636	275	1276	-2228	-1089	-201
KwaZulu-Natal	534	155	158	-247	598	-380	-2308	-1126	1423	-133
Limpopo	-555	262	-69	-1036	110	220	330	273	-1885	-261
Mpumalanga	2065	2914	3370	-9561	-47	151	536	196	-10	-43
Northern Cape	733	901	1428	1427	103	146	167	237	37	575
North West	213	167	1298	-683	65	130	195	245	-280	150
Western Cape	-80	476	533	-402	-604	-318	-294	-104	208	-65

Source: National Treasury budget database and author's calculations.

The ability to raise revenue plays an integral part in determining whether a province has fiscal stress. In any given year, prevailing economic conditions and structural factors affect the amount of revenue likely to be raised. The design of South Africa's intergovernmental system means that provinces rely almost entirely on transfers from national government for revenue. This makes the task of assessing fiscal stress from the perspective of revenue generation rather debatable. On aggregate, provinces account for nearly 45 per cent of nationally raised revenue. Figure 11 shows the share of revenue between national and provincial governments and a gradual decline in the provinces' share of revenue.

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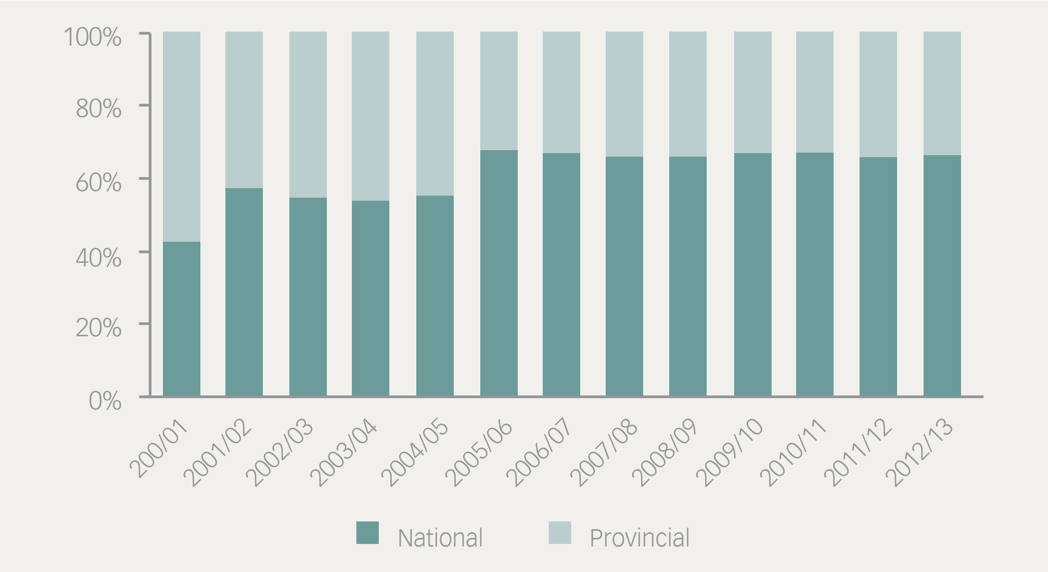
Figure 11: Share of Provincial and National Revenue.



Source: National Treasury budget database.

The issue of whether revenue and expenditure responsibilities between provinces and national government are misaligned or not – and more specifically whether provinces are adequately financed or not (unfunded mandates) – is contentious. While settling this debate is beyond the scope of this chapter, acquiring a definitive answer is critical to determining whether misalignment contributes to stress or not. Getting closer to the answer requires detailed information about minimum levels of service and associated costs. In South Africa, provinces are compelled to provide minimum levels of service, but national government always sets the norms and standards for delivery in various areas of functional assignment.

Table 51: Fiscal Stress Induced by Vertical Fiscal Imbalance

Province	Per capita spending	Per capita spending variance (mean)	Per capita spending variance (top 3 average)	Fiscal stress (scenario 1)	Fiscal stress (scenario 2)
Eastern Cape	8 152	-613	589	-4 023 472 756	3 867 597 356
Free State	8 663	-1 124	78	-3 087 017 073	214 639 160
Gauteng	5 519	2 020	3 222	24 788 926 101	39 546 698 976
KwaZulu-Natal	7 664	-126	1 077	-1 290 008 334	11 056 735 004
Limpopo	8 018	-479	724	-2 587 938 138	3 911 581 500
Mpumalanga	7 272	266	1 469	1 075 603 470	5 933 754 097
Northen Cape	9 409	-1 870	-668	-2 142 868 895	-764 935 878
North West	6 822	717	1 919	2 515 228 473	6 736 054 671
Western Cape	6 329	1 209	2 412	7 041 399 586	14 043 415 912

Source: Author's calculations

To make up for this deficiency, a modified Factor Assessment Method (FAM) is used to measure the fiscal stress effect of provincial revenue adequacy. FAM measures expenditure need as the per capita expenditure that a region needs to provide a standard level of services (measured as

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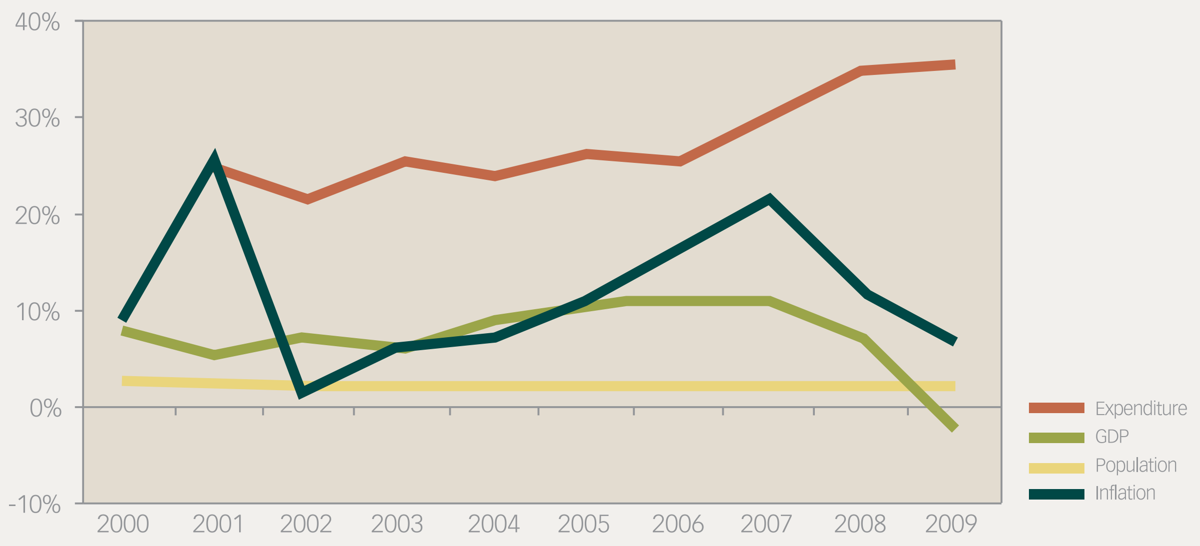
mean per capita expenditure of top three provinces) and the per capita difference in the region's demand for services and the unit cost of providing services. Table 51 shows the application of the FAM for provinces in South Africa. The table uses mean per capita spending and the average of the three highest per capita spending as the hypothetical cost of providing standard level services. The two scenarios shows the difference between actual and mean per capita spending extent to which budget needs to be adjusted upwards or downwards if actual per capita spending is normalised across all provinces to a mean average. In scenario 1 where actual per capita expenditure is compared to mean per capita spending, the extent of fiscal stress is only concentrated in 4 provinces because of lower actual per capita spending. Scenario 2, where actual per capita expenditure is compared to an average of the three highest per capita spending, implies a significant element of stress.

Figure 12 assesses fiscal stress from the perspective of the rate of expenditure growth in relation to the economy's capacity to sustain such a growth, as well as the alignment of the rate of increase with the general price level and population growth as proxy for expenditure needs. In general, total provincial expenditure growth appears to consistently outpace growth in real GDP and inflation. For Mitchell (2010), the expenditure growth path depicted in Figure 12 is unsustainable because it outpaces the wealth-creating sectors of the economy and therefore indicates possible fiscal stress.

Figure 12: Provincial Expenditure Growth Moderation



Source: National Treasury budget database, StatsSA, 2012, and Reserve Bank, 2012.

While rapid expenditure growth in itself does not indicate fiscal stress, a growth pattern that is inconsistent with inflation and the population growth rate can induce fiscal stress, which may have been avoidable if an inflation-linked spending path had been adhered to. Many of the factors explaining high expenditure growth rate (i.e. incremental budget decisions) play out within South Africa's intergovernmental system. These factors are typically not amenable, clear-cut measurements. Every year the government introduces spending priorities, which require significant budget commitments and add to the rate of spending increase. In the 2011/12 financial year alone, more than 34 spending priorities were identified and funded.

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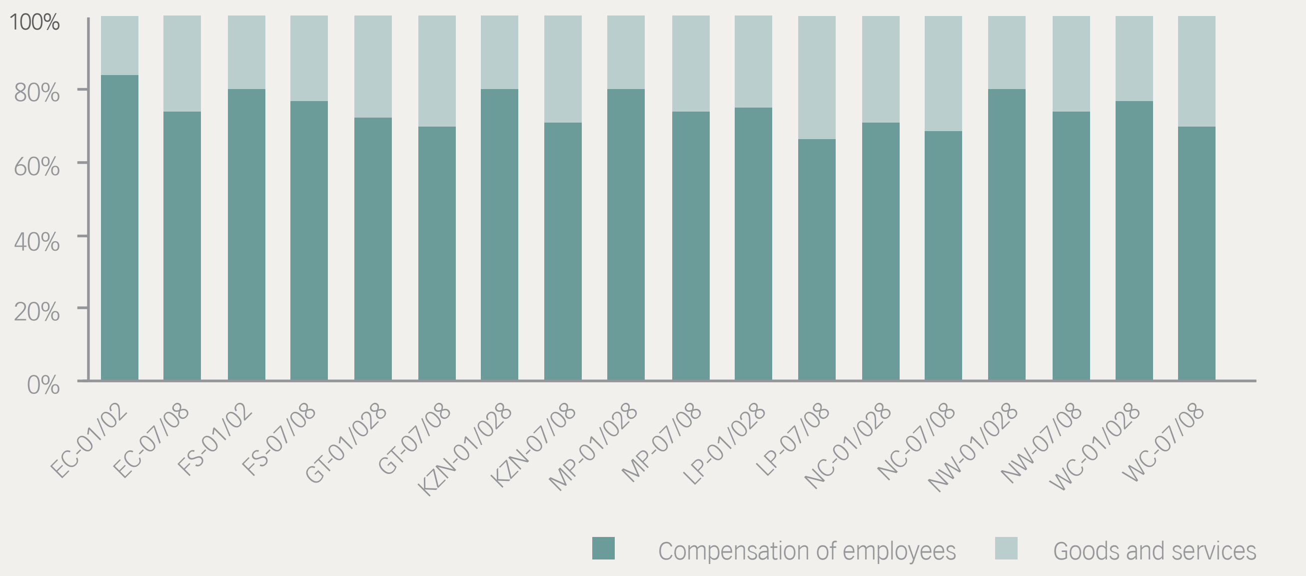
Rigidities in expenditure line items can cause irreversible fiscal damage. Generally, personnel costs are considered to be most invasive and damaging because they are a first charge against expenditure and tend to encroach on other important expenditure line items. Figure 13 compares expenditure composition across time within and among provinces. A discernible trend of rigidity or drag is apparent, given the insignificant change in the proportion of funds allocated to goods and services.

Figure 13: Expenditure Rigidities/Flexibility



Source: National Treasury budget database.

The last, important component of fiscal stress assessed is the ability of government to deliver services. Fiscal stress invariably arises when a province has a disproportionately high level of expenditure needs or responsibilities relative to the available revenue. In Table 52, selected service responsibilities are used to demonstrate service access levels, while expenditure needs indicators serve to gauge the provinces' ability to provide the level and quality of services required for the general health and welfare of the residents. Provinces with the highest level of expenditure needs will likely experience pressure on their respective budgets, especially where delivery norms and standard are adhered to. For example, KwaZulu-Natal (KZN) has the highest level of primary healthcare visits and hospital workload. However, this information alone is not sufficient to determine whether KZN is fiscally stressed, but needs to be validated against costs or applicable norms and standards. In education and health, provinces must adhere to set staffing norms at considerable costs. Provinces whose staff/learner or staff/patient ratio falls below the set norm fit the fiscal stress definition of being unable to provide minimum levels of service.

Table 52: Service Level Fiscal Stress

Primary health-care visits / 1000	Hospital workload	No of children below six years	No of people above 60 years	Fiscal stress (scenario 1)
Eastern Cape	17 556	4 525	1 082 368	638 223
Free State	6 598	1 617	408 514	228 787
Gauteng	20 216	5 968	1 586 554	842 283
KwaZulu-Natal	26 151	7 982	1 649 310	779 375
Limpopo	13 972	2 681	936 332	467 364
Mpumalanga	8 029	1 724	634 681	284 155
Northen Cape	3 472	507	169 407	98 388
North West	8 025	1 550	547 887	292 390
Western Cape	15 643	3 941	762 412	520 784

Source: National Treasury 2011, Statistics South Africa, 2011.

Audit opinions are important in determining whether provinces are well managed and governed to prevent financial or governance fiscal stress. A negative audit opinion (disclaimer, adverse or qualified) suggests that a province is performing poorly on various aspects that contribute to clean governance, including procurement contracts, human resources and expenditure management, and compliance with preventative measures such as setting up of audit committees. In 2009/2010 a total of 53 out 251 audited provincial departments and entities received negative audit opinions (see Table 53). Similarly, negative audit opinions are not entirely a reflection of fiscal stress, unless they show a consistent pattern over a given period. As Table 53 illustrates, incidents of negative audit opinion are too few to discern a consistent pattern.

Table 53: Provincial Audit Outcomes 2008/09–2009/10

Province	Disclaimer		Adverse		Qualified		Financially unqualified with findings*		Financially unqualified with no findings*	
	2009/2010	2008/2009	2009/2010	2008/2009	2009/2010	2008/2009	2009/2010	2008/2009	2009/2010	2008/2009
Eastern Cape	2	1	0	2	5	5	16	18	3	0
Free State	2	0	0	1	5	7	12	14	8	7
Gauteng	4	4	0	0	3	11	23	20	11	4
KwaZulu-Natal	0	1	0	1	9	13	19	21	6	5
Limpopo	1	1	0	0	3	6	12	10	1	1
Mpumalanga	0	0	0	0	2	3	14	17	3	1
Northen Cape	2	3	1	0	4	6	10	10	0	0
North West	4	5	0	0	6	7	15	12	0	5
Western Cape	0	1	0	0	0	3	13	23	12	0
Total audits	15	16	1	4	37	61	134	145	44	23

Source: Auditor-General, 2010.

Service level fiscal stress is also a function of successive incidents of fiscal profligacy. Provinces that continuously receive unacceptable audit opinions and are found to squander millions in fruitless and irregular expenditure are most likely to experience fiscal stress. Table 54 shows the amount of funds spent on fruitless and wasteful expenditure; Gauteng province has the highest amount of fruitless, irregular and unauthorised expenditure.

Table 54: Provincial Fiscal Profligacy 2010/11

Province R'000	Fruitless expenditure	Irregular expenditure	Unauthorised expenditure
Eastern Cape	116 886	4 553 334	139 372
Free State	57 784	1 159 685	81 386
Gauteng	400 455	4 813 889	1 436 527
KwaZulu-Natal	12 363	1 402 851	265 037
Limpopo	252 446	1 135 804	773 771
Mpumalanga	10 149	535 589	84 730
Northern Cape	9 784	1 323 561	101 755
North West	9 003	1 682 604	66 023
Western Cape	7 702	182 880	-

Source: Auditor-General, 2010.

6.6.3 Provincial Fiscal Stress Index

When assessed individually, the above provincial fiscal performance variables do not give a clear picture of whether provinces are especially fiscally stressed. Table 55 shows a composite fiscal stress index, or a combination of indicators that provide a better picture of the overall provincial fiscal situation. Each indicator is scored from 1 to 5 (where 1 is good and 5 is bad) to measure the severity and weight of its relative contribution to total stress. Scores are assigned to each quintile on the basis of variation from a set norm or national average over a given period.

The results suggest that fiscal stress within South Africa's provinces may not be as severe as reported. The Eastern Cape has the highest weighted fiscal stress score at 3.25, followed by Gauteng at 3 and the Free State at 2.8. The Western Cape and Mpumalanga have the lowest fiscal stress score of 1.3 and 1.4 respectively. Surprisingly, Limpopo, which is always compared to Eastern Cape in terms of poor socioeconomic attributes and fiscal performance, has a middle fiscal stress score of 2.5. Yet in 2012/13, national government took over the provincial administration in Limpopo because of poor financial and expenditure management. The result of this index seems to suggest that Limpopo province is performing better, despite having been a candidate for national intervention.

This difference can be explained by the triggers that inform national government intervention and the indicators used to compute the index. Interventions are mainly driven by internal expenditure and financial control weaknesses, whereas the fiscal stress index comprises indicators or variables beyond mere expenditure and financial control. Under the broader definition of fiscal stress, expenditure and financial mismanagement alone do not constitute fiscal stress. As seen

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from Table 55 most provinces score 5 on wastage and irregular expenditure, budget and expenditure control and maladministration, indicating that such problems are not limited to Limpopo when assessed over a long period.

Table 55: Composite Provincial Fiscal Stress Index

	Weight[59]	Eastern Cape	Free State	Gauteng	KwaZulu-Natal	Limpopo	Mpumalanga	Northern Cape	North West	Western Cape
Budget balance	5	1	1	1	1	1	1	1	1	1
Cash balance[60]	10	0	0	0	0	0	0	0	0	0
Expenditure bouyancy/ growth	5	5	4	2	1	3	1	1	5	2
Expenditure regidity	5	4	4	1	4	5	4	2	2	2
Unfunded mandates[61]	10	0	0	0	0	0	0	0	0	0
Wastage and irregular expenditure	15	4	3	5	3	3	2	2	2	1
Budget and expenditure control	15	5	5	5	4	4	2	4	3	1
Maladministration/ management capacity	15	5	5	2	2	3	1	4	3	1
Minimum efficient expenditure	10	3	1	5	5	3	1	2	1	3
Service needs/ burden	10	3	3	5	4	3	2	2	1	3
Overall Fiscal stress score (Weighted)	100	3.2	2.8	3	2.55	2.55	1.35	2.1	1.8	1.3
Overall Fiscal stress score (unweighted)		3	2.6	2.6	2.4	2.5	1.4	1.8	1.8	1.4

[59] It should be noted that weights are based on author's judgement
[60] Information outstanding
[61] No adequate indicator

6.6.4 Case Studies of Limpopo and KZN

Limpopo

Description of the fiscal situation

Towards the end of 2011, National Treasury declared Limpopo technically bankrupt. At the time the province was experiencing serious financial problems, which later manifested in some hospitals running out of medical supplies and food, and schools not fully funded and/or receiving textbooks. The province ran an overdraft facility of just over R1.2 billion, had a large accumulated unauthorised expenditure of R2.6 billion and accruals of R1.2 billion, and did not have sufficient cash to finance its budget or pay teachers and doctors etc.

Causes of the situation

The causes of fiscal stress in Limpopo appear to have been mostly self-induced and consistent with the factors that constitute financial problems, as listed in the MFMA. These include poor cash-management system, ineffective expenditure management, non-compliance with supply chain regulations and a weak provincial treasury. National Treasury's diagnostic found that cash-flow management was weak; payments were made too frequently, without being backed by documentation and cash; suppliers were either paid late or not paid at all; and the provincial treasury did not have enough skilled staff. Other underlying causes listed were weak HR management controls, excess staff and vacant critical positions.

Response mechanism

The severity of the situation in Limpopo led to the national government responding swiftly by invoking section 100 of the Constitution, which provides for the takeover of a provincial administration. The intervention resulted in the development of recovery plans for five provincial departments. The recovery plans focused mainly on cash management, cost containment, reduction of personnel costs, organisational realignment, financial accountability, restoration of legal procurement practices and service delivery monitoring. In each remedial area, specific activities were undertaken and reported over the period of intervention. Some of the activities included cleaning up the personnel payment system, undertaking personnel head counts, issuing a schedule of payments, and instigating disciplinary processes and criminal charges against fraud and corruption. Within the twelve-month period under administration, the province's cash and liquidity position improved from negative to positive, the cash management system was fully restored, accruals declined from R1.2 billion to just under R250 million and a budget surplus was expected.

KwaZulu-Natal

Description of the fiscal situation

In 2009/10 KwaZulu-Natal was expected to overshoot its budget by over R5.6 billion. In the same year the total revenue for the province totalled just over R62 billion. In spite of the projected overspending, the province was still expected to meet the majority of its financial and service delivery obligations. Unlike Limpopo, there were no concerns of liquidity, cash position or growing accruals.

Causes of the situation

The reasons given for overspending were: extra medication needed to treat Aids-opportunistic infections and extreme drug-resistant tuberculosis, the OSD, skills retention incentives and nursing that resulted in many patients (especially in Durban) being "farmed out" to the private sector, costing the fiscus several additional millions. However, this does not rule out the possibility of fiscal ill-discipline, as reports indicate a dramatic rise in non-core staff in the province and isolated incidents of supply chain deficiencies.

Response mechanism

National government drove the interventions in Limpopo, whereas in KZN the provincial treasury (supported by the provincial legislature) instituted an internally driven fiscal restraint. The provincial executive committee approved a number of cost-cutting measures, which were strictly enforced and monitored by the premier and MEC of Finance. Key among such measures were:

- The freezing of all posts
- The freezing of capital projects for which tenders had not been issued
- A moratorium on the purchase of furniture and equipment
- Travel and accommodation controls (pool travelling, no overnight accommodation for distance below 500 kilometres)
- No payment of performance bonuses or leave-day conversions.

6.7 Conclusion

This chapter sought to answer one of the long-standing questions in South Africa's gradually evolving intergovernmental system: the fiscal condition of provinces in relation to the capacity to deliver their constitutionally mandated services in a sustainable manner. Those who sympathise with provinces decry the narrow fiscal space within which provinces operate, while detractors stress the need for improved fiscal performance. The balance between these opposing views is resolved through empirically testing whether provinces are fiscally stressed or not.

The answer is not straightforward because the concept of fiscal stress is value laden and because national and provincial governments have irreconcilable fiscal performance perceptions about each other. National government perceives provinces as perennial budget claimants, while provinces perceive national government as having an insatiable need to maintain its stronghold on available resources. Thus any answer to the question of fiscal stress is likely to be challenged according to whether it supports the particular perception or not.

In an attempt to mediate the two opposing views, this chapter has applied an objective method to measure fiscal stress. The method combined existing legislative prescripts and practical experiences borrowed from the literature in assessing various elements that are considered unfavourable to service delivery. These elements vary widely in nature, from political to institutional, structural, legislative, financial and economic, but broadly manifest as service delivery problems transmitted through the budget. A fiscal stress index was then compiled, containing 10 indicators to capture the underlying drivers of fiscal stress.

The index reveals that (based on the broad definition) fiscal stress is not rampant in provinces. The Eastern Cape has the highest weighted fiscal stress score (3.25/5), followed by Gauteng at 3 and the Free State at 2.8. The Western Cape and Mpumalanga have the lowest fiscal stress scores of 1.3 and 1.4 respectively. The stress appears to be mostly attributable to endogenous factors, such as expenditure management, maladministration and wasteful expenditure. These findings are consistent with national government's perceptions of the efficiency and effectiveness of provincial budgets.

6.8 Recommendations

With respect to **improving provincial fiscal performance,** the Commission recommends that:

- National and provincial treasuries put in place an agreed-upon measurement and assessment framework for fiscal performance against which provinces are evaluated. The assessment framework must:
  - Take into account various factors that capture fiscal performance holistically, including services burden, expenditure efficiency, and funding and delivery norms;
  - Incorporate information from internal audit reports and serve as an early warning system to complement section 32 reports and National Treasury benchmarking exercises;
  - Provide for monitoring and disclosure of key fiscal performance indicators of provincial departments, particularly when deviation (as defined by the PFMA) from a healthy fiscal trajectory is prolonged;
  - Provide for monitoring of expenditure benchmarks against which key provincial expenditure items are regularly evaluated and reported by provincial Accounting Officers.

Rationale

The current legislative and accountability framework for detecting and responding to financial and delivery problems at provincial level is weak. This recommendation seeks to ensure that the legislative and accountability framework is strengthened through constant monitoring and public disclosure of key fiscal performance indicators. Poor fiscal performance does not evolve for a single reason, but results from diverse factors acting at the same time. Thus, a framework is needed that covers both external and internal factors that cause disequilibrium in the national context.

- Government considers reducing or replacing the maximum allowed threshold for over- and underexpenditure with relative inflation-adjusted figures, to avoid "budget creeping" – a situation where the budget's annual rate of growth makes large amounts of over- and under-expenditure acceptable because they are below threshold.

Rationale

A stagnant threshold for over- and under-spending, which is not constantly adjusted for buoyant expenditure growth, invariably increases the likelihood of highly volatile provincial budget balances. A lower threshold will stabilise provincial budget balances and, more importantly, foster effective expenditure planning. As explained earlier, stabilisation is primarily concerned with determining, sustaining and observing the limit of the aggregate level of expenditure.

- National and provincial Accounting Officers rigorously enforce section 86 of the PFMA, which provides for the initiation of criminal and disciplinary proceedings for persistent contravention, especially for wasteful and unauthorised expenditure. Where individuals are found guilty, consistent sanctions should be applied, commensurate with the seriousness of the offence.

Rationale

The Public Service Commission found that less than five per cent of people who violated the PFMA were charged with financial misconduct. Rigorous enforcement of the rule of law will not only increase its credibility, but will deter further fiscal irresponsibility.

- Provincial treasuries must carry out mandatory expenditure reviews (overseen by National Treasury and the Department of Performance Monitoring and Evaluation in the Presidency) after every Medium Term Expenditure Framework (MTEF) cycle, specifically focusing on composition, efficiency, economy and effectiveness of expenditure, as well as on access to services and realignment of spending with programme objectives and delivery targets.

Rationale

Expenditure reviews will assist provinces in determining whether they are on a sustainable fiscal path, the degree to which they have fulfilled programme objectives and introduce self-imposed fiscal restraints where necessary.

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