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South Africa: Transition to Democracy Offers Opportunity for Whole System Reform

by
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This case study considers the substantial reforms to the South African public expenditure management system undertaken since the mid-1990s. The key aspects of the reform process have been: establishing the institutional framework for budget reforms through the "new" Constitution and further national legislation and practice; adopting a multi-year budget framework and top-down budget process; developing a framework for public financial management and reporting; improving the classification system of public finances; and creating a performance-oriented public service. South Africa has successfully implemented a number of these reforms and has radically altered the way in which it budgets for public services and how it accounts for public expenditure and commitments. The case study concludes by drawing on the lessons learned through this process.

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1. Introduction

The 1994 transition to a democratic state brought many challenges for managing the public finances in South Africa. Not only did the new constitutional dispensation lay down a changed structure and distribution of power in the state, with implications for the way in which public funds were allocated and used, but the new government had a critical political commitment to improve the coverage and quality of public service delivery to the majority of the population, in order to redress the racially based distortions of the past.[1]

The new government did not start with a clean fiscal slate. In the 1992/93 fiscal year, the main budget net borrowing requirement had reached 8.7% of GDP, and in the 1994/95 fiscal year, public debt rose to almost 47% of GDP (from a level of approximately 30%, ten years earlier), leaving very little fiscal room for the state to improve the equity of public services. The annual budgeting system the new government inherited provided inadequate tools with which to stabilise fiscal balances and manage the required policy shifts. It was highly fragmented, not only in terms of a de-linking of policy, budgeting and implementation, but also institutionally, increasing budgeting uncertainty, lack of clarity and the scope for budget games. It planned and controlled for inputs and cash, with limited opportunity for systematic assessment of the effectiveness and efficiency of spending, or for relating allocations directly to policy. It was not transparent, with poor underlying information systems, hidden spending and inadequate mechanisms to extract good information for use in the budget process and for accountability purposes. The budget process itself was largely incremental, offering insufficient opportunity for the new government to identify ongoing non-priority activities and create fiscal room for higher priorities. Accountability was procedural, and the system was plagued by deeply entrenched inefficiencies.

In short, what was required was an overhaul of the system of budget management, not only to fulfil the demands of the new constitutional framework, but also as a tool to bring about the improved substantial outcomes sought in terms of fiscal sustainability, improved alignment of spending with the new national priorities and the maximisation of existing resources towards these priorities.

The South African public expenditure management system has undergone substantial reform since the mid-1990s. While the early reforms shaped macroeconomic stability and strengthened public spending, the more recent emphasis of the reform programme has been on efficient resource allocation and effective service delivery. The highlights of the reform programme have been: the roll-out of a new intergovernmental system that requires all three levels of government to formulate and approve their own budgets; the introduction of three-year rolling spending plans for all national and provincial departments under the Medium-term Expenditure Framework (MTEF); new formats for budget documentation that include a strong focus on service delivery information; and the enactment of new financial legislation. In addition, changes to the budget process have allowed role players to deliberate on key policy choices and on the matching of available resources to plans, rather than item-by-item cost estimates.

Underlying the reforms were the following principles:

- **Comprehensiveness and integration.** The main national budget framework co-ordinates, integrates and disciplines policy and budget processes for the country at national, provincial and, increasingly, at local level.
- **Political oversight and a focus on policy priorities.** Choices between priorities are political in the final instance. The South African system recognises this and structures the integration of political and administrative practices to ensure that funding choices align with the priorities of government, and that political oversight is reinforced.
- **Using information strategically.** The reform process systematically sets out to improve the timeliness, quality and usefulness of information on the allocation and use of funds, both internally and externally, to improve public policy and funding choices and to enable accountability.
- **Changing behaviour by changing incentives.** Responsibility was devolved to spending departments for spending choices and use of funds within approved ceilings and against policy commitments.
- **Ensuring budget stability and predictability while facilitating change at the margin.** The budget process includes various mechanisms to manage uncertainty and maximise funding and policy predictability over the medium term, while promoting alignment with policies at the margin, through the use of rolling baselines, a contingency reserve and a disciplined budget process, amongst other measures.

These principles, applied throughout the institutional arrangements of the budget process from preparation to audit, put in place a changed set of incentives for budgetary actors, reducing the potential for budgeting games and improving planning practices to align policy with budgets and actual spending. A key aspect of these arrangements is the recognition that, while the quality of budgetary estimates is important for the eventual policy outcomes, the process by which they are derived should carry equal weight in reform design. Similarly, while the technical information systems are important to support financial management practices, good budget implementation is about getting the institutions right. In fact, it can be argued that the South African reforms placed emphasis in the early years on getting a functional budgetary process in place (involving all relevant, and not just financial, decision makers, and changing incentives to change behaviour) rather than on attempting to formulate budget estimates that were technically the best expression of policies and/or expenditure realities.

The budget reform process is still underway. In some ways it will never be complete, since the budgeting system would always need to be responsive to changing circumstances and demands. However, there are remaining budget reform challenges that have not been addressed adequately yet, and also some persistent weaknesses in the system, which the current institutional arrangements have not overcome. Despite these issues, the system in place today is significantly different from that of ten years ago, and the changes introduced have succeeded (or have yielded substantial budget outcome benefits) in several critical respects.

First, the reforms facilitated the disciplined implementation of fiscal policy aimed at setting the economy on a renewed growth path. The first few years after transition were still marked by relatively high deficits and a steady increase in public debt (to almost 50% of GDP in 1996/97). The period 1997-2000 saw fiscal consolidation (in tandem with other macroeconomic reforms), stabilising the level of debt and reducing the budget deficit to contribute to lower interest rates, improving fiscal sustainability and freeing up resources for social, developmental and infrastructure expenditure. Simultaneously, the overall burden of tax was reduced, so as to lower the costs of investment and job creation while releasing household spending power. Since 2001 a more expansionary fiscal stance has been adopted, reaping the benefits of the consolidation period. These gains would not have been possible without the establishment of a functional intergovernmental system, the introduction of medium-term expenditure planning and improvements in public financial management.

Second, not only did government succeed in maintaining a sound fiscal policy stance while simultaneously reducing the tax burden for the consolidation period, it also shifted the distribution of expenditure in a number of important dimensions. It shifted the functional distribution of expenditure, with social and developmental expenditure increasing at the cost of defence and business subsidies. In the latter years, it has also shifted the economic distribution of expenditure, turning around negative real growth in gross fixed capital formation of general government. Also, it has shifted the distribution of expenditure between households, spending relatively more on poorer and marginalised communities than in the past. Government has made significant inroads into meeting the basic needs of the poor, including building approximately 1.6 million houses, improving access to schooling for the poor, constructing and upgrading primary health clinics, extending and improving potable water supplies to about 9 million people, putting in place a sanitation roll-out programme, providing nutritional daily meals to over 4 million children and fiscal transfers to over 7 million poor South Africans (up from just under 3 million in 1997).

Third, overall budget credibility improved markedly after the implementation of a medium-term budget framework and improvements in public financial management. In both 1995/96 and 1996/97, fiscal out-turns for consolidated national and provincial spending showed marked under-expenditure. In 1997/98, the first year of a block unconditional transfer to provinces, this swung to marked over-expenditure. However, this shift was reversed and stabilised at less than 2% over-expenditure in 1998/99, the first year of the MTEF.

This article discusses the budget reform process in South Africa. It reviews the different aspects of the reforms, showing how the principles were consistently applied to integrate what could have been merely a series of technical reforms addressing specific shortfalls in budget management into an overall system of democratic budget governance. It does so, first, by discussing the different aspects of the main budget and financial management reforms in the national and provincial executives; then by taking stock of where the country is now, identifying remaining (and new) challenges and the likely future path of reforms; and, finally, by considering the reform process itself.

2. Aspects of budget reform

The Constitution provides the institutional framework for budget reforms in South Africa. In addition to detailing the structure of the state, expenditure and revenue assignment and setting out key institutions, roles and responsibilities, it also includes a Bill of Rights – with implications for the allocation of available resources between the spheres and functions of government – and establishes the principle of co-operative governance, which set the tone for a consensus-seeking budget process. However, the Constitution leaves it largely up to further national legislation and practice to sort out how these principles are given effect. The evolution of budgetary practice in South Africa since 1996 (the year in which the new Constitution was enacted) has been a key component in realising its democratic and developmental ideals.

2.1. Stabilising the intergovernmental system

South Africa is a unitary state with three interdependent but distinctive spheres of government: national, provincial (nine provinces, created in 1994 out of four provinces and ten so-called homelands and three ethnic administrations) and local (284 municipalities, demarcated in 2000).

The Constitution assigns to each of the three spheres of government certain functions, which may be concurrent (shared responsibility between spheres) or exclusive (sole responsibility of the unit of government). The national government's main role is policy making, regulation and oversight. It also administers exclusive functions (*e.g.* justice, defence and foreign affairs). Provinces are mainly responsible for social delivery, either concurrently with national government (*e.g.* primary and secondary education, health, social services and housing) or exclusively (*e.g.* provincial culture matters, provincial sport, recreation and amenities), while municipalities have localised functions (*e.g.* stormwater management and fire-fighting) and deliver basic services (*e.g.* water, sanitation, electricity and refuse removal).

The expenditure mandates of provinces and municipalities are not matched by their assigned revenue-raising abilities, although this is less so for local government, which has access to property taxes and user charges for basic services. The lion's share of revenue is collected nationally. Provinces (and to a lesser extent municipalities) therefore depend on transfers from national government to fulfil their expenditure responsibilities. The Constitution states that provinces and municipalities are entitled to an equitable share of nationally collected revenue, and that they may borrow under certain conditions. A key additional intergovernmental relations feature of the constitutional framework is co-operative governance.[2]

These provisions of the Constitution regarding intergovernmental relations and the intergovernmental fiscal system are supported by various pieces of legislation enacted in the first years after transition, providing the legal framework for ongoing intergovernmental relations supported by the evolution of practice.[3] This section briefly sketches the main institutions of the intergovernmental system.

2.1.1. Legislated frameworks, not specifics

Unlike in other federal and/or decentralised countries, neither the Constitution nor supporting legislation spells out quantitative parameters for revenue sharing, nor do they explore the minutiae of co-operative governance. The Constitution sets out the principles and requires subsequent acts of Parliament to determine how these principles are to be applied and their requirements met. In keeping with this spirit, the supportive legislation enacted in the first years after the 1994 transition also does not primarily legislate specifics, but puts in place sets of institutional arrangements to facilitate the best possible substantive outcome to be found in any given year or circumstance.

2.1.2. Integrating the intergovernmental system and annual budget process

The annual budget process provides the vehicle for the practical fulfilment of the constitutional and legislative requirements. The share of available revenue for provinces and municipalities is determined finally by Cabinet, but only after a process of intergovernmental consultation. In addition to their equitable share, which is a block grant, provinces and municipalities also receive specific-purpose grants and other transfers that are intended to fulfil national policy imperatives in sub-national spheres.

2.1.3. A predictable and transparent allocative process

The allocation of the equitable shares is determined in the same sequence annually. The first call on available revenue in the main budget framework is a provision for debt service cost, and the contingency reserve, on the logic that both support the financing of government functions in all three spheres. The remaining available revenue is then first divided between the three spheres of government before being divided between the provinces and municipalities by a transparent formula in the division of revenue process (and between national government departments in the national budget process).

The division of revenue process lasts from early May, when national Cabinet and provincial executive councils consider policy priorities, through to October, when government signals the likely division of revenue in the pre-budget policy statement known as the Medium-term Budget Policy Statement (MTBPS). The division of revenue process should not be seen as a separate process from the national and provincial processes; instead, it is an integrated process both informed by and providing the respective expenditure envelopes to these processes.

The division of revenue between spheres of government (vertical division) follows the principle that funds should follow function, and is informed by the responsibilities of each sphere and its capacity to generate revenue to meet its obligations, amongst other considerations.[4] It is managed primarily as a political decision, however, as it derives from the relative priority given to different functions of government and how these functions are shared between the spheres of government. As such, it is discussed in the administrative and political spheres through the work of intergovernmental forums, and is underpinned by technical work undertaken jointly by national and provincial Treasury task teams. However, it is finally determined by a meeting of the extended national Cabinet (the national Cabinet plus the premiers of the nine provinces).

2.1.4. Intergovernmental forums to improve allocations

Prime amongst the intergovernmental forums are the Budget Council and the Budget Forum, both of which are constituted in terms of the Intergovernmental Fiscal Relations Act of 1997. The Budget Council is a consultative body, comprising the Minister of Finance and the nine provincial Members of the Executive Council (MECs) for Finance, assisted by the Heads of Treasury and Treasury advisors. In the Council, consensus amongst "Team Finance" is reached on fiscal and financial matters affecting provincial government, and recommendations are made to Cabinet. The Budget Forum comprises the Budget Council plus local government representatives and discusses local government matters.

It is primarily through these forums that discussions take place (from June to September each year) between the three spheres of government on the overall budget framework and the division of revenue between the spheres of government. These political/technical forums are supported by committees of officials preparing and discussing technical background work for use in the budget process. They include national and provincial Treasury and national and provincial sector department officials.

2.1.5. Use of formulae to maximise transparency and predictability

Only after the share of each sphere has been determined is the horizontal division of revenue between the provinces determined by transparent formulae that take into account national priorities, relative demand for services between provinces and particular provincial circumstances. The practice is to phase in any drastic shifts in allocations on account of changes in formula structure or key determinant data so as not to upset the stability of provincial budgets. Similarly, the redistribution of resources from previously advantaged to disadvantaged provinces, which resulted from the formula structure and weighting, were phased in over the first few years of the formula. The formula is currently under review, partly to take account of changes in the financing of social security grants.

In South Africa, therefore, the sequencing of annual decision making on the allocation of available revenue to competing policies is inextricably bound up with the intergovernmental system. The institutions created within the system are key structures in the annual budget process. Aligning the intergovernmental and budgeting system through the budget process strikes a fine and responsive balance between the need to reduce the fiscal risk associated with decentralised systems and to co-ordinate national policy objectives, on the one hand, and the constitutional requirements of provincial autonomy, on the other.

2.2. Adopting a multi-year budget framework and a top-down budget process

The MTEF operates at the centre of the South African budget reforms and frames, in the final instance, all policy discussions in the country. In the case of South Africa, the benefits of the MTEF have been realised, in part, through the application of clear objectives. The first of these objectives has been to ensure affordable programme budgets through the preparation of spending plans within the context of existing macroeconomic and fiscal policies. The annual revision of these policies determines the extent of additional money that gets allocated for new priorities. The second objective of the MTEF is to strengthen the link between policy priorities and public expenditure, by ensuring early policy prioritisation, rigorous evaluation of competing policies and programmes, and the matching of current and medium-term plans with available resources. Through this process, and over time, a higher proportion of public funds is spent on core programmes that have the highest returns in terms of poverty alleviation, job creation or whatever the government has put at the top of its agenda. In this way, the focus of public expenditure can gradually shift with the changing needs of government and its main stakeholders. In recent years, for example, having a medium-term planning and budgeting perspective has assisted in facilitating a balance between spending on poverty alleviation and spending on economic services programmes.

Understanding how the MTEF operates to realise these objectives has two important dimensions. The first is that the MTEF system revolves around integrated sets of rolling national and provincial three-year forecasts, targets and plans – from macroeconomic forecasts and fiscal targets, through revenue forecasts, to the forward projection of what public goods and services will be delivered by spending departments at what cost. These plans are the end product of the annual process by which the expenditure needs are matched to the available resources. The second dimension is that the MTEF system is as much about the structures, institutions and rules of the budget process as it is about the sets of three-year plans that result.

The discussion of the MTEF below identifies the key institutions (or budgeting norms) that make it functional (not in order of importance) and considers the MTEF process and role players.

2.2.1. Fiscal policy drives expenditure envelopes

As is common practice in most MTEFs, the top-down process starts with updating the forecasts for key macroeconomic variables over the medium term, including GDP and inflation. Fiscal policy targets are subsequently revised. Since the inception of the MTEF, these targets have included reducing the tax burden, reducing general government dissaving (use of domestic savings to fund recurrent rather than capital spending), reducing public debt as a percentage of GDP and increasing public fixed investment spending. The important point for budgeting systems is that fiscal policy targets are generally determined in the absence of any detailed expenditure bids. The overall available expenditure in the main budget framework is a function of what is fiscally affordable, which constrains and disciplines the subsequent spending choices. What is fiscally affordable is driven first by the targeted ratio of tax to GDP, and then by what level of borrowing is affordable.

2.2.2. Central role of the budget framework

The fiscal policy objectives translate into the budget framework, which in its various forms (depending on which component parts are included or excluded) presents a comprehensive and transparent aggregate picture of all revenue and all expenditure in general government at national and provincial level. All allocations at national level are made from the available expenditure envelope in the budget framework, including funding the national departments and the unconditional and conditional grants to the provincial and local spheres of government. The nine provincial budget frameworks, therefore, reflect the national framework, with any differences being a function of provincial own revenue.

2.2.3. Preparing credible macro assumptions and revenue targets

In South Africa, the implementation of the MTEF has not been hindered by overestimation of revenue, as is often the case. Three factors contribute to this: the credibility of the macroeconomic assumptions, which are published in the pre-budget statement and debated in public forums; the tax administration reforms, which buoyed revenue collection in the first few years, enabling the fiscal authorities to provide predictability of funding to spending departments; and the use of the contingency reserve to absorb macroeconomic uncertainty.

2.2.4. The MTEF process is the annual budget process

Different from many other countries that have introduced multi-year budget frameworks, the South African system makes no differentiation between an MTEF and the annual budget process. This means that the budget proposals that are voted by Parliament are prepared and considered in the MTEF process, coherently with the forward estimates, and are not revised separately from the forward estimates in a subsequent process. All budget estimates, down to sub-programme level, are compiled for the full three-year period. This strengthens the link between policy and planning. Instead of having two separated phases impacting on budget allocations (with the first being of a more strategic/policy nature and the second dealing with annual budgeting), the process in South Africa facilitates strategic policy decisions being taken in the context of budgeting decisions and *vice versa*. The sequencing, instead, is from larger aggregations of funding (and policy) to vote, programme and sub-programme level, but keeping a medium-term perspective throughout.

2.2.5. A disciplined top-down process

All bids competing for the same envelope of available funds are considered together within an overall hard budget constraint, forcing hard choices. This may result in certain programmes receiving additional funding, while others will be required to accelerate delivery within baseline budgets. In certain cases, the budget allocation process may result in programmes having to release funding that can be used for new priorities. This holds in theory from the vertical division of revenue, where the hard budget constraint is available revenue and the competing claims on it from the different spheres are considered systematically in the process of division of revenue to be allocations within a vote or programme. There is evidence, though, that this system grows less robust lower down the allocation chain. However, in principle, unless it is unforeseen and unavoidable or emergency spending (in which case it is covered by a separate vote or the adjustment estimates), all spending is decided within the formal budget process and voted by Parliament (or the provincial legislatures) in one parliamentary budget process. Strict virement rules apply in-year (see Section 2.3.6). In addition, the budget process runs to a firm timetable, with transparent rules and allocation norms. All of these factors contribute to making the MTEF process the "only game in town".

A similarly disciplined process is followed for the adjustment estimates, which can be tabled legally at any time during the year. In practice, however, all claims on the additional available resources (from the draw down of the contingency reserve, additional borrowing or additional revenue collected) are brought together in one process, thereby improving contestability of policy.

2.2.6. Forward projections count

At the same time as the top-down processes are completed to determine the available expenditure envelope, individual spending departments revise their forward plans, based on their baseline funding envelopes of the previous year, and prepare spending bids motivating for additional funding. No adjustments are made to departmental ceilings at the beginning of the process. This means that departments can only fund new policies if they are able to convince Cabinet (or the provincial executive councils, in the case of provinces) to allocate a share of nationally (or provincially) available additional funds resulting from adjustments to the macroeconomic forecasts and fiscal targets, or if they can find savings within their existing spending baselines. This practice of spending departments starting their budget preparation from their existing funding baseline has the merits of imposing planning discipline and providing a stable medium-term funding and policy horizon. While zero-based budgeting may be the ideal scenario to align budgets with policy priorities, in practice it is not feasible on an annual basis, if at all. Forcing spending departments to live within their baselines, while holding them accountable for delivering on policy priorities, creates incentives to improve the quality of the forward projections.

2.2.7. Use of the contingency reserve

The contingency reserve is top-sliced before available revenue is divided between and within the spheres of government. It is not a separate bank account accumulating funds over years, but a budgeting device that entails reserving a percentage of the available funds in the budget as a cover against uncertainty and a pool from which to allocate funding to new spending priorities. This percentage is small for the budget year (the first year of the three-year medium-term period), but increases in the outer years where policy and macroeconomic uncertainty are larger. In the budget year, the contingency reserve is allocated in the adjustment budget, tabled six months after the start of the fiscal year, and used to cover the balance of revenue shortfalls or expenditure overruns on the fiscal framework. During budget planning, the contingency reserve plays a key role in making available additional resources for new expenditure, which come from the draw down of the contingency reserve and changes to the macroeconomic forecast. Thus, the contingency reserve plays an important function in providing flexibility and protecting stability in the MTEF (and thereby its credibility) against uncertainty.

2.2.8. Focus on the margin and on the outer years

In the system, flexibility around available additional funds and policy changes is least in the budget year, given existing policy and spending commitments, but increases towards the outer years, because of a larger contingency reserve that can be allocated and because spending that is non-discretionary in the short term, such as personnel costs, can be shifted over the medium term, for example through programme restructuring or phasing in new priorities. In this way, South Africa has been able to reduce personnel spending as a percentage of revenue, since the introduction of the MTEF, creating critical fiscal space for complementary inputs and investment spending.

For each budget round, baseline funding decisions have already been discussed for the bulk of spending in the first two years of any medium-term framework (those having rolled over from the previous year) and, particularly for the first year, the rule is to allow only minor changes. These factors shift the focus of discussions in the budget process to the use of funds in the outer year. Parliament is also increasingly centring its discussions on the outer years, where it can influence funding decisions more than in the year on which it is actually voting.

The budget submission format encourages departments to focus on maximising the alignment of policy and budgets over time by making changes at the margin. Reprioritisation is pushed as an important budgeting principle that identifies savings that can be reallocated to priority programmes. Departments are requested to provide information on their baseline spending (previous allocations rolled over for the first two years, and the new outer year being equal to year-two plus inflation) as well as changes to the baseline. Changes to the baseline need to be justified as either “structural changes” or “policy options”. Structural changes to the baseline are typically moderate adjustments for service delivery trends (such as higher than expected increases in demand for a service), higher salary increases or the acquisition of specific scarce skills. These are considered by the Medium-term Expenditure Committees (MTECs). Policy options involve much bigger amounts and/or new services/activities that require careful examination to determine long-term affordability and alignment with government’s priorities. These are deliberated and decided finally by Cabinet.

When evaluating policy options in order to advise Cabinet, the Treasury-led MTECs assess whether there is a clear link between the department’s budget proposals and government’s broad policy priorities and key sector challenges; whether new funding is required and whether the proposal can be accommodated in the baseline through reprioritisation; whether the department is able to implement the plan over the MTEF period; and whether the expected outputs are clearly defined.

Departments are also required to illustrate how they will generate savings within their baseline to fund new policy options. In the latest budget year, this requirement has been formalised, requiring departments to make a 2% saving on their administrative costs, and to illustrate how this saving will be generated.

2.2.9. Political oversight of the budget process

Deciding and agreeing on the best allocation of scarce resources to fund government's many social, economic and political goals is the main purpose of the budget process. The setting of these goals is clearly a political matter. However, trade-offs between these goals within the resource ceiling are equally political, although technical work can identify policy options and make clear what the consequences of trade-offs are likely to be. The South African budget process applies this principle through several mechanisms ensuring appropriate political oversight of the budget process, and ensuring that policies are made within the context of budget constraints.

The budget policy process begins with the identification of national policy priorities by the national Cabinet. These priorities are expressed in a spending priorities memorandum, which provides a basis for departmental planning and budgeting. Ministerial letters are also exchanged between the Minister of Finance and spending ministers on major policy thrusts, signalling the direction of sectoral policy early in the budget process (spending departments are required to get information to their ministers in time for this letter). This creates the opportunity for the Treasury to engage in bilateral discussions with departments at an early stage, where critical spending pressures and major policy considerations exist, in order to undertake a more rigorous examination of the economic and fiscal implications over the medium to long-term period.

The Ministers' Committee on the Budget is another critical vehicle through which overall political oversight of the MTEF process is realised. It is a formal sub-committee of Cabinet that considers policy changes with budgetary implications, and all main budgetary decisions, before making recommendations to Cabinet. After Cabinet has approved the new MTEF allocations, allocation letters are sent to all departments, informing them of their ceilings and triggering the final part of the budget process, where departments prepare their budget documentation for submission to Treasury, and Treasury prepares the Budget Review, the Estimates of National Expenditure and other components for tabling on budget day.

Other structures through which political involvement in the budget process is secured are the Budget Council, the Budget Forum and the Cabinet cluster system. Where it is known that the programme will impact on provincial and/or local expenditure (or that expenditure pressures arise at these levels), the fiscal implications will also be discussed in the Budget Council and the Budget Forum, and consensus on key trade-offs sought. At a sectoral level, committees of national sector ministers and their provincial counterparts discuss sector achievements, policy priorities and funding decisions that have provincial implications. At the national level, broad sector policies and budgets are integrated through the Cabinet cluster system, which mirrors the main functional spending categories in the budget.

The national Cabinet makes all the final decisions on medium-term policy priorities and spending; these include the macro and fiscal framework, the division of revenue, approving the Medium-term Budget Policy Statements (MTBPS) and changes to the medium-term allocations to national votes and provincial governments. An important event in supporting this decision-making process is Cabinet's periodic strategic planning ("lekgotla") at which budget policy and planning uses are discussed. At the provincial level, discussion on provincial policy priorities and the finalisation of allocations to provincial departments takes place in the Provincial Executive Councils.

An important principle in structuring political oversight of the budget process in South Africa is the use of inter- and intra-governmental political/technical forums where competing interests are represented on an equal footing, thereby maximising the possibility of political peer pressure, discipline and sanction if the commitments made are not kept. Together with appropriately timed public statements to signal closed-off budget decisions, a transparent budget process, the system of hard budget constraints and the provision of good technical support to these forums on the financial implications of policies, this reduces the potential of accessing funding "through the political back door" or through in-year budgeting games.

2.2.10. Aligning strategic policy development and budgeting at sector level

A closer alignment of policy priorities and spending allocations is facilitated by a number of mechanisms already discussed, for example the use of forward estimates as planning baselines in the new cycle and the use of hard top-down budget constraints. However, it is through the creation of a strategic policy planning process and making its outputs count in the budgeting cycle that this alignment is given substance.

Spending departments conduct an annual rolling strategic planning process in tandem with preparing medium-term budgets. A recent innovation is to provide longer planning horizons for capital spending plans. The strategic planning cycle is concluded with an annual report. In preparing annual reports, departments need to review the performance or service delivery results of the previous period, undertake an assessment of service delivery or performance targets and re-examine departmental strategic objectives against broader government priorities.

2.2.11. Using budget documentation strategically

The MTEF system in South Africa utilises key sets of budget documentation to extract strategic information for decision making, to ensure commitment to decisions taken and to enable accountability. Changing the format of budget documentation to achieve these objectives has been an important aspect of the budget reform process.

The first public document in the budget process is the Medium-term Budget Policy Statement, which is tabled in Parliament at the end of October, approximately four months before budget day. The MTBPS was also the first "new" document to emerge (in 1997) from the budget reform process. This public document serves to conclude the broad prioritisation phase of the budget process and consolidate the main budgeting ceilings. Thus, it signals government's fiscal and budget policy intentions, providing information on the macroeconomic assumptions and policy priorities driving the budget, the fiscal policy framework, the vertical and horizontal division of revenue and the expected functional and economic spending allocations.

The main budget documentation includes the Budget Review, the Estimates of National Expenditure, the Estimates of Revenue and the Division of Revenue Bill, and imparts a comprehensive and transparent review of government's current and planned future fiscal and budget directions, and the consequences of past decisions.

The Budget Review provides information on national policy priorities and how they are to be realised through the budget. The budget framework, in its various forms, represents a comprehensive picture of all revenue, including off-budget revenue, and expenditure of general government and the main fiscal balances, framed within information on the macroeconomic outlook and the key macroeconomic assumptions. Information on the broader public finances (including, for example, the borrowing requirement and investment performance of state-owned enterprises) is provided with a discussion on its implications for fiscal policy. The Budget Review also discusses revenue issues in detail and the management of public assets and liabilities, including an assessment of contingent liabilities.

In the South African budget structure, expenditure information is first broken down by government unit (national or provincial), then by vote (usually coinciding with a main spending department at national and provincial level) and then by programmes and sub-programmes within a vote. The programmes relate to the objectives of spending departments. A view of the economic distribution of expenditure is also provided at each level. Updated financial information is provided for the current fiscal year (*i.e.* the year in which the budget preparation is taking place), backed by actual spending information on the three previous years and with forward estimates for the budget year and two outer years. Most recently, the forward estimates for expected one-off, large expenditure outlays for a further two years have been added, extending the forward horizon to a five-year period.

On the expenditure side, the Budget Review provides aggregate information on the distribution of expenditure in the MTEF framework, between spheres and functions of government and between the economic purposes of expenditure. It does so, however, in the context of a discussion on past policy and expenditure performance, current national expenditure policy priorities, and future policy and service delivery objectives.

Detailed financial and non-financial revenue and expenditure information is provided by vote in the "Estimates of National Expenditure", which was developed and added to the stable of budget documents in 2001. The Estimates provide seven years of financial and performance information together, by national vote, and are aimed at providing parliamentary committees and other stakeholders with comprehensive information on departmental performance and plans. An important reform in 2002 was the introduction of measurable objectives for each programme, published in the Estimates document. Therefore, it effectively serves as a co-ordinating document for coherent planning (and information) from departments, since they are called to account in Parliament for their chapters. Departments are required to set out their main objectives and the strategies they will be deploying to achieve them, and how they intend to finance these strategies within their budget allocations. They also review their past performance, both financially and in terms of achieving objectives.

The Division of Revenue Bill details the respective shares of the three spheres of government in nationally raised revenue and, together with the Intergovernmental Fiscal Review, is the key public document in the intergovernmental system. It sets out how the provincial and municipal shares are to be divided horizontally, details conditional grants to the two sub-national spheres, and provides for various procedural matters regarding the management of intergovernmental finances and the responsibilities of Treasuries, accounting officers (individuals responsible for financial management in government departments and public entities) and the Auditor General. It also legislates a number of rules of co-operative governance, including what must happen if actual revenue falls short of anticipated revenue, under which circumstances allocations to sub-national governments may be withheld or delayed or a payment schedule changed, and under which circumstances, and how, funds may be reallocated from one horizontal unit of government to another. Finally, it determines sanctions and consequences for individuals if the provisions of the bill are not met. The annexes to the bill include a framework analysis of each conditional grant, detailing its conditions, rationale, criteria for allocation, monitoring mechanisms, past performance, allocations, projected life and payment schedule. This framework is published to provide clarity and certainty on the complex system of conditional grants to stakeholders, and for budget implementation and monitoring purposes.

Departments are expected to report against the Division of Revenue Bill and its schedules, covering both financial and non-financial performance. The Auditor General audits compliance with the bill, in both the transferring national departments and the receiving provincial departments and municipalities.

In the intergovernmental system, the Division of Revenue Bill is supported by the annual Intergovernmental Fiscal Review, first published in 1999, which is a compilation of expenditure and service delivery trends and financial issues in the nine provincial governments and local government. The Review provides invaluable holistic information on provincial service delivery achievements and obstacles. Similar to other public documents in the budget cycle, the Review has become an annual feature in the cycle, thereby contributing to a high and continuing level of transparency in a very complex system.

Finally, in addition to spending information in the documents detailed above, actual spending information is published in-year on a monthly basis for all national departments by the National Treasury, and on a quarterly basis across national and provincial government, providing vital information to Parliament and other stakeholders to monitor budget implementation. The information is submitted to the Treasury under the statutory reporting requirements of spending departments, and forms part of the "early warning system" whereby deviation from spending plans can be detected early and addressed by the Treasuries. Currently, the National Treasury is in the process of reviewing the in-year reporting system, both for national departments and provincial governments, in order to make it more effective.

2.2.12. A considered budget process

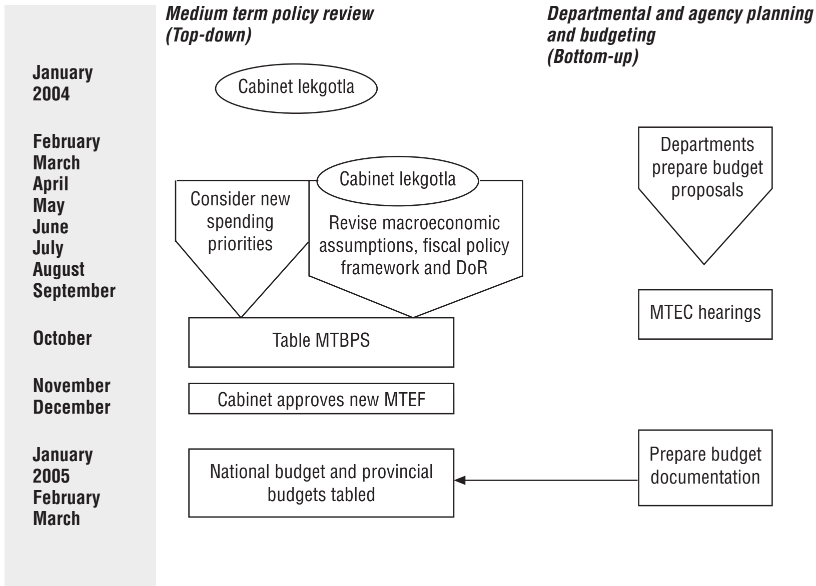
One view of the MTEF is that it is the end result of explicit and implicit policy decisions and policy trade-offs made by bureaucrats following the broad policy commitment of the executive, and finally decided on by the political principals. So, while the MTEF is usually presented as a broad conceptual framework with certain desirable features, it is important to recognise that it is effectively the outcome of many layers of micro decisions taken by programme and project managers in different spheres and at different levels of government. A signal achievement of the MTEF process in South Africa is the degree to which it has attained co-ordination of these decisions towards policy priorities. The key to that lies in the institutions discussed above and how they are sequenced in the budget process. This section provides a brief overview of this sequencing.

The budget process allows government to involve various role players that provide political and technical advice when faced with trade-offs between competing spending priorities. It starts with the national Cabinet determining the policy priorities, and high-level consultation between the Minister of Finance and other members of Cabinet, including provincial finance ministers. In the months that follow, from April to September, the two parallel dimensions of budget preparation take place: the determination of available resources and the preparation of good information on the competing claims on those resources.

The consultation process includes spending departments at national and provincial level preparing their budget proposals, national and provincial Treasuries engaging some departments in discussions on pertinent policy issues, and joint research teams working on specific expenditure issues. In addition to determining national spending priorities, the macroeconomic forecasts and fiscal policy targets are updated to prepare the national budget framework, followed by the vertical and horizontal divisions of revenue. The division of revenue process interacts with both these dimensions, culminating in the MTBPS, tabled in Parliament in late October. National departments and provincial governments are subsequently informed of their allocations. At the national level, spending departments then prepare their budget documentation. At provincial level, clarity on final allocations allows the provincial budget process to enter its final rounds. The national and provincial budgets are tabled in February and March, respectively, for the year beginning 1 April.

The multi-year, decentralised budgeting system in the context of co-operative relations between the spheres of government is a critical foundation of government's approach to public sector management. Its emphasis on getting managers at appropriate levels (*i.e.* those with the best information on which to base decisions) to plan and budget aligns budgeting with other evolving practices, such as human resources management. The provision of a multi-year funding horizon, coupled with incentives to make use of it, facilitates policy makers and managers making key policy decisions in light of their long-term cost and benefit estimates. The availability of much-improved information on the financial consequences of policies over a longer horizon enables public debate, which in turn supports improved policy making. A key success factor in the development and implementation of the MTEF was not to see it in isolation or as a technical response to a short-term need, but rather to develop it as a component of the overall vision of public finance management, together with other aspects.

Figure 1. **The budget process**



Notes: Lekgotla is Cabinet's periodic strategic planning (see Section 2.2.9). DOR: division of revenue. MTBPS: Medium-term Budget Policy Statement. MTEC: Medium-term Expenditure Committees. MTEF: Medium-term Expenditure Framework.

2.3. A new framework for public financial management and reporting

The introduction of an MTEF for the 1998/99 fiscal year was followed by a programme of financial management improvement. A cornerstone of this programme is the Public Financial Management Act (PFMA), which came into effect in April 2000. The PFMA repealed the ten exchequer acts that previously governed public financial management. It was developed to transform an environment where financial administration was rule-bound and management exclusively input-focused, where policy and financial responsibilities in departments were separated, where capital resources and liabilities were not properly managed, and where there was a great lack of reliable and timely information. Treasuries' resources were devoted excessively to exercising micro control, with even mundane matters referred to them for approval, and too little in the strategic management of public finances in line with policy and efficiency objectives. In short, there was insufficient practice of functional financial management of public resources in government as a whole.

The PFMA put in place a legal framework for modern public financial management, shifting the onus of managing the use of resources from central control to the managers of spending departments and agencies. This mirrors the shift in budget preparation practices from central decision making to discretion resting with spending departments for programme choices within spending ceilings.

In order to engineer this shift, the PFMA does not prescribe specifics, for example what payment approval procedures should be. Instead, the Act specifies who is responsible for putting in place such procedures, what the procedures should achieve, what the information and reporting requirements are, and how these are to be overseen and monitored and compliance assured. This section discusses the main public finance management institutions established under the PFMA.

2.3.1. Responsibility of individuals and ensuring checks and balances

Throughout the Act and the accompanying Treasury Regulations (as gazetted in terms of the Act), individuals are made responsible for flow of funds and/or establishing systems. In tandem, checks and balances have been instituted to ensure that individuals undertake their responsibilities. For example, the payroll is divided into pay points, where the legitimacy of payments needs to be certified monthly by an individual who is not the same person making the payments.

The Act designates heads of departments and constitutional institutions and boards of public entities as accounting officers or accounting authorities and gives them responsibility for the effective, efficient, economical and transparent use of resources in accordance with the Appropriation Act. In doing so, the PFMA requires them to produce monthly and annual financial reports and ensure effective, efficient and transparent systems of financial and risk management, internal control and procurement. If accounting officers do not comply with these requirements, they are guilty of financial misconduct and can have disciplinary or criminal proceedings instituted against them, depending on the nature of the offence. The Act, therefore, provides the legal framework for devolving responsibility for the use of public funds to spending departments, and for ensuring transparency and accountability.

2.3.2. Financial responsibility of the executive authority

The PFMA compels ministers to fulfil their statutory responsibilities within the limits of their vote amount in the Appropriation Act, and requires them to consider the monthly reports submitted to them by their accounting officers. It also sets out a framework to clarify accountability when a political directive could result in unauthorised expenditure.

2.3.3. Legal underpinning for the role of Treasuries in the budget process

In addition to regulating accounting officers and executive authorities, the PFMA provides a legal framework for the role of the national and provincial Treasuries in the budget process, including co-ordinating the national and provincial budget processes, managing budget implementation, and enforcing revenue, asset and liability management. In addition, it provides the legal framework for the National Treasury to develop the macroeconomic and fiscal framework, co-ordinate intergovernmental relations, and determine the banking and cash management framework. It also puts the Treasuries in charge of the revenue funds.

The PFMA makes its implementation the responsibility of the National Treasury. To this end, the National Treasury is required to gazette Treasury Regulations, giving practical effect to the framework provisions of the Act.

2.3.4. Systematic in-year monitoring, management and reporting

Giving managers financial management discretion must be commensurate with holding them accountable for resources used, which in turn requires that good information on budget implementation be available. The aim of the reporting system is to enable appropriate oversight throughout the system as an incentive on performance, and to locate the accountability at the correct level. This means that the reporting framework needs to strike the right balance between continuously filtering sufficient information upwards (without overloading the capacity of either those who compile reports or those who are supposed to use the information) and, at the same time, providing managers with good information at the level of implementation. The provisions for in-year monitoring, reporting and management of the PFMA, the Division of Revenue Act (DORA) and the Treasury Regulations, and other best practice frameworks prepared by the National Treasury, are aimed at achieving this balance and answering three questions for each level of budget implementation: What has happened so far? What do we think will happen to our plan for the rest of the year? What (if any) action do we need to take to achieve our agreed plan?

The PFMA specifies a variety of financial budget progress reports (monthly, quarterly and at year-end) with different responsibilities for executive authorities and accounting officers. These are supplemented in the intergovernmental system by the reporting requirements of the DORA. The National Treasury is currently developing a unitary, streamlined reporting system to meet the information needs of managers, provide an early warning system on budget implementation for Treasuries and satisfy the reporting requirements of the PFMA and the DORA.

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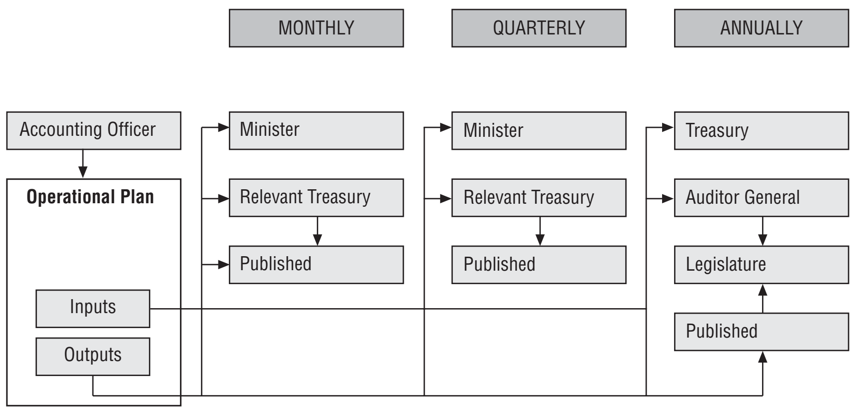
The current in-year and *ex post* reporting requirements are summarised in Figure 2. Accounting officers are required to compile monthly financial reports (including information on conditional grants) for their executive officers and relevant Treasuries, which publish monthly reports on the status of national budget implementation, in accordance with the PFMA. Accounting officers are also required to prepare quarterly financial reports. These are consolidated for national and provincial government by the National Treasury and are published.

Figure 2. **Reporting requirements of the Public Financial Management Act (PFMA)**



2.3.5. *Shortening the budget cycle*

The PFMA shortens the budget cycle to bring audited actual spending information to Parliament seven months after the end of the financial year. This means that public accounts committees deal with much more recent matters, enabling improved oversight and allowing audited information to be used more effectively in the assessment of departmental spending plans.[5]

The shortening of in-year time horizons for capturing transactions also reflects the principle of introducing early, accurate financial information as a management tool, and serves well to illustrate how adjustments to the financial management framework are aimed at improving the incentives in the system. Whereas previous regulations and accounting systems used to allow transactions to be written to a specific financial month up to three months after month-end, this period has been shortened to ten days. Given that departments are required to provide cash flow projections, that their cash use is made transparent through the monthly reporting system and that the limits on virement and rollovers (see below) are by and large enforced, this has considerably sharpened the incentives for effective and efficient accounting practices.

2.3.6. Providing for, but limiting, in-year flexibility

Budgeting can never predict the use of resources down to the last detail; projects may be delayed or events in the outside world may necessitate new expenditure. The PFMA allows for flexibility, within a framework, to make adjustments. The Act, supported by the Treasury Regulations, provides several rules to manage this flexibility, so as to support incentives on sound planning and to control for behaviour that, in aggregate, could compromise fiscal policy.

Managers are allowed to vire (shift) funds between subdivisions of a vote (up to 8% of any subdivision total). However, further limits hold; for example, funds may not be vired from capital to recurrent spending and, under current Treasury Regulations, personnel compensation may not be increased without prior Treasury approval. Accounting officers are required to report to Treasury and their minister within a week on any virement within the 8% limit.

Certain funds may be rolled over from one year to the next. Unspent funds on payments for capital assets may be rolled over only to finalise projects still in progress. Savings on transfers may not be rolled over for purposes other than those originally voted for, and savings on employee compensation may not be rolled over. While there is no restriction on what types of other recurrent expenditure may be rolled over, there is a limit of 5% of a department's non-personnel recurrent expenditure.

Emergency expenditure must be authorised by the Minister of Finance, but may not exceed 2% of the total national budget, must be reported to Parliament and the Auditor General within 14 days, must be made public and must be attributed to a vote.

The PFMA allows for a Treasury committee to approve additional expenditure and deviations from expenditure, but only if the expenditure is recommended as "unforeseeable and unavoidable" by Cabinet. The Treasury Regulations further define "unforeseeable and unavoidable" as excluding expenditures that were submitted and not approved in the budget preparation process, increases in tariffs and prices, and the extension of existing services or initiation of new services. The Adjustment Estimates approve roll-overs, virements and allocations for unforeseeable and unavoidable expenditures and savings.

2.3.7. Setting clear sanctions

Accounting officers can be subjected to disciplinary proceedings if they permit unauthorised, irregular, fruitless or wasteful expenditure, or fail to comply with any of the requirements regarding budget implementation, setting up of financial management systems and reporting. If they are found to be grossly negligent, criminal proceedings can be instituted. In addition, any loss accruing to the state on account of negligent or wilful action by an official must be recouped from the individual.

2.3.8. Internal control framework and regulating support for accounting officers

The Treasury Regulations require all departments to appoint chief financial officers, to whom the accounting officer can delegate some of his/her functions under the Act. As part of risk management, all departments must also set up internal audit committees and formulate three-year rolling internal audit plans that assess and address key areas of risk, as well as fraud prevention plans.

2.3.9. Providing for effective cash management

The South African budget is implemented in an environment of relative revenue certainty. This means that in practice departments can expect to receive their full budget allocation in a fiscal year. Any shortfalls in revenue are absorbed at Treasury level. One of the key challenges in the system is to extract relatively accurate predictions of cash flow requirements from spending departments, in order to match these with expected fluctuations in revenue collection and to avoid borrowing unnecessarily or locking cash in departmental accounts unnecessarily and inefficiently. The regulations require departments and provincial Treasuries to submit predictions of monthly cash flow requirements at the start of the financial year. These are updated monthly, throughout the year, but any changes to the approved cash flow need to be motivated to the National Treasury.

2.3.10. Mindful implementation

The paragraphs above set out, in principle, the framework for financial management in South Africa. While theoretically it is a comprehensive and coherent system, any system is only as good as its implementation. It can be argued that in the environment of its design, the PFMA represented a highly idealistic vision of a modern public finance management system for South Africa. However, six years later the basics of this system have been realised and the benefits in terms of accountability and improved budget implementation are evident. While the final section of this article pays attention to what made the reform process successful, it is useful to consider the implementation path of the PFMA here, in the context of its driving principles.

The PFMA made provision for its phased implementation over five years. Similar to the development of the MTEF, the approach was to put in place the scaffolding of a holistic system and then allow quality improvements to develop over time, driven by the changed incentives in the system itself. Thus, the PFMA was made immediately applicable to all government departments and entities and constitutional institutions. Specific areas of the Act were delayed, however, particularly if the necessary systems were not yet in place to enforce or support it. For example, the legal requirement of measurable objectives for all programmes was delayed, as were some of the provisions relating to financial statements and public entities.

In keeping with the spirit of the PFMA and its changed role, the National Treasury required all departments to submit implementation plans within six months after the Act came into effect, and provided best practice guides, training and capacity development support. The plans were structured to assess the financial management and accounting capacity in departments, the financial skills of line managers and the quality of internal control systems. They were required to propose an implementation plan for each department, particularly the strategy for risk and performance management. In the first year of PFMA implementation, the appointment of chief financial officers was prioritised, as were the establishment of internal audit committees and the implementation of monthly reporting requirements.

Today, in a context where public service delivery is managed in terms of the PFMA, programme managers are faced with only a limited set of choices when monthly reports point towards a year-end deviation between the budget and actual expenditure in a programme, and the cause is substantial (rather than accounting errors or delays in capturing information). In the case of over-expenditure, funds can be vired within the vote, the department can apply to the Treasury for additional funding, or spending for the remainder of the year in the vote can be curbed. In the case of under-expenditure, spending can be accelerated or funds can be rolled over. Given the threat of sanction, and the certainty of "exposure", increasingly the most unattractive choice these days is the one that would have been the default position six years ago: continuing with business as usual.

2.4. Improving the classification system

Before recent reforms, the South African budget was classified on functional, economic, line-item, administrative and programmatic lines. However, the quality of information was dubious, with many inconsistencies in the application of the standards. The line-item classification was also archaic and a hangover from an earlier incremental, input-based budgeting system. The relations between budgeting, accounting for funds spent, and reporting by the Auditor General and in the national statistics were not clean-cut, disabling the link between policy and actual spending, and ultimately affecting the quality of oversight and undermining accountability. Since 1997 the underlying classification structure has been modernised and the chart of accounts reviewed. This section briefly reviews the main features of the reforms.

2.4.1. The new economic reporting format

The old economic and line-item classification of inputs has been replaced by the new economic reporting format, which is aimed at providing better quality information to legislatures on the economic nature of financial outlays towards policy objectives. The new format is in line with the 2001 Government Finance Statistics standard, also enabling improved international reporting. However, in order to take into account the specific nature of the South African environment, certain modifications to the structure of the account and the labelling of receipt and payment items have been made. Most significantly, the South African system still operates a cash-based accounting system, although it is a modified cash base with entries for national budget data made in the time period in which transactions are captured on the financial systems, rather than when the actual cash flow occurs. The intention is to eventually move towards accrual-based accounting.

The new format, which is used consistently for the budget estimates and for recording and classifying the economic nature of transactions in the revised chart of accounts, organises the multitude of government transactions into three broad categories: receipts, payments and financing. The budget deficit or surplus is calculated as receipts less payments; by definition, it is equal to net financing, but with the opposite sign. Payments are also divided into three broad categories: current payments (*e.g.* employee compensation, goods and services, interest and rent), transfers and subsidies (funds that are transferred to other institutions, businesses and individuals and are not final expenditure by the spending unit), and payments for capital assets (buildings and fixed structures, machinery, cultivated assets, intangible assets and land and sub-soil assets).

2.4.2. Improved quality of functional classification

The functional classification is complementary to the economic classification. It serves to distinguish transactions by policy purpose, or expense by output. Its main purpose is to clarify how spending by government contributes to social, economic and other objectives. In the budget structure, four broad categories of functional classification are used: general government services, protection services, social services and economic services.

2.4.3. Improved programmatic classification

In co-operation with spending departments, the Treasury has been systematically improving the programmatic classification of the budget, in order to strengthen the link between policy objectives and financial information. One intervention has been to standardise vote structures across provinces, in order to enable co-ordination of policy implementation and monitoring.

2.4.4. Mindful implementation

While the careful redesign of the budget structure and chart of accounts framework is a necessary input into improving the quality of budget and financial information, it does not guarantee that spending departments, which are responsible for recording transactions in the South African system, will apply the frameworks well. A key feature of the South African reforms has been implementation support for spending departments, including working with departments to re-code their transaction base correctly, and providing training programmes for financial management personnel.

The new South African classification system is aimed at improving financial information for budget management and accountability purposes. The structure and presentation is fully compatible with, and can be converted easily to, the Government Finance Statistics format (since the same classification base is used at a high level of detail). However, the South African system avoids the use of unclear terms such as "other" and "miscellaneous", includes more detail on various transfer categories, and labels items more clearly.

2.5. Improving budget management for service delivery

The earlier phases of the South African reforms placed emphasis on planning better for the financing of new policies and priorities and, ultimately, improved service delivery. However, the reform vision recognised from the start that planning and budgeting need to be integrated with monitoring service delivery performance to strengthen the link between the services that departments provide and the benefits and costs of these services. Performance measures were to give effect to the emphasis on improved transparency and accountability for the management and use of public resources. As in many other countries, the development of effective and appropriate performance measures has been a difficult process, and is still ongoing as lessons are learnt and capacities built. This section reviews developments and discusses the main characteristics of the current system.

The meagre information on departmental policy and budget performance in 1997 has been systematically improved since then, slowly moving South Africa from an input-focused system towards a system of managing for performance. The National Expenditure Survey (NES) took the brief discussion of sector policies out of the Budget Review and expanded it at vote level in 1999. The PFMA requires "measurable objectives" to be formulated for each main division (*i.e.* programme) within a vote. In 2001 the Estimates of National Expenditure replaced the NES, bringing financial and narrative performance information together and making a first effort at formulating measurable objectives and indicators. The Intergovernmental Fiscal Review also provides more information on the context of budget implementation.

However, the introduction of service delivery and performance information into the budget documentation has meant that public service managers have had to grapple with new concepts and tools for monitoring and measuring performance. Experiences since 2001 have highlighted difficulties in developing appropriate output performance measures and service delivery indicators. Many of the "indicators" specified were not related to clearly measurable objectives of programmes and did not actually relate to the outputs. They have failed to show whether services contribute towards meeting government's outcomes. These indicators are, therefore, of little value to the public, Parliament, the executive and even the department itself. Today, attention is focused on improving the quality of the measurable objectives and the indicators. This section discusses the framework that is provided to departments to develop these measures.

2.5.1. Measurable objectives and output performance measures

The Treasury guidelines define "measurable objectives" as clear statements of the specific outcomes or results that can be achieved over the medium term in a given programme. They should provide a clear link between the programme's outputs and the department's goals, and define the actual impact on the public rather than focusing on the level of effort that is expended. Measurable objectives are tools to assess the effectiveness of an agency's performance and the consequent public benefit that is derived.

In the current performance management framework, departments are required to make a distinction between outcomes and outputs, with the former referring to the end social and economic results of public policies or programmes. Outcomes refer to, for example, changes in the general state of well-being in the community, examples of which include a safe and secure environment, healthy citizens, reduction in the number of repeat offenders, reduced poverty levels, and stable and self-sufficient families. Outcomes should clearly relate to the government's strategic priorities. At the same time, departments need to ensure that their measurable objectives link to the outcomes to which their programmes contribute. Outcomes are usually not within the control of a single department, or of government as a whole.

Outputs are the goods and services produced or delivered by departments to customers or clients who are external to the department. The framework defines outputs as the "what" that departments deliver or provide, contributing towards meeting the outcomes that government wants to achieve. Outputs are usually measurable, and include services such as issuing passports, providing policy advice, assessing applications for benefits and policing the streets, and must be within the control of the department.

Departments are required to develop output performance measures and service delivery indicators that measure how well an expenditure programme is delivering its output and contributing towards meeting the desired outcomes. Output measures represent the level of service provided, and may measure the quantity, quality and/or timeliness of services.

The Treasury guidelines advise departments to undertake an internal process to develop their performance indicators, including steps to agree on the results intended, to specify the outputs that are to be measured, to select the most relevant measures and indicators, and to set realistic targets. The framework emphasises the need for departments to be explicit about performance-reporting institutional arrangements, including a process and formats, and to establish mechanisms that will facilitate corrective action when required.

However, the South African experience shows that better financial management and improved service delivery do not occur simply through the passing of legislation and regulations and the provision of guidelines. Implementation of performance-oriented reforms requires appropriate training of managers and recruitment of additional management skills into the public service. It can require an overhaul of information systems and information processing. It necessitates the building of capacities and an understanding of new concepts and systems, and it calls for a different style of management across the public service. Successful implementation will take time, effort and a change of mindset within the public service.

3. The way forward

The reforms set out above have brought huge benefits. The introductory section of this article set out some of the policy outcome gains that have resulted. These came on the back of an improved environment for budget planning and financial management, in several respects, particularly the following:

- **More stable public finance environment.** The reforms have contributed to providing a stable environment for public policy delivery. They have enhanced macroeconomic stability, which has supported predictability of funding for policy priorities. They have improved policy predictability, requiring all policies to be developed within the medium-term framework, which in turn has supported the predictability of expenditures, stable public finances and macroeconomic stability.

- **Improved political involvement and oversight.** The budget process reforms have enabled greater political involvement in the budget process, turning it into the most important policy process. This facilitates the effectiveness of the medium-term budget framework as a mechanism to link policy making and budgeting.
- **Improved policy environment and improved performance.** While there is still much room for improvement, few would deny that policy contestability has improved (leading to pressure to formulate better policies), that there is better linking of policy, spending and delivery, and that policy co-ordination between the three spheres of government, while still imperfect, could have been in much worse shape without the reforms.
- **Greater transparency.** Parliament and other non-executive stakeholders in the budget have access to much better information than before 1997. The available information covers more of government and the public sector, it is more timely, its accuracy is improving and, to a large degree, its provision has been imbedded either in legal requirements or in well-established practices.

3.1. Remaining challenges

The reform process is far from complete. Some areas that were targeted for reform in the initial vision of a results-oriented, accountable budgeting environment have not yet been reached, such as a fully-fledged accrual accounting system. Other issues, such as performance management and the planning, budgeting and reporting links, have been tackled, but progress has been slow.

All in all, the South African system has reformed fast, up to a point, but has been struggling to deepen the reforms in order to further enhance service delivery. It can be argued that whereas fiscal discipline has been achieved, by and large, and the allocation of scarce resources to spending priorities improved, addressing efficiency issues is the greatest challenge remaining. Perhaps in these areas it is not only the public financial management systems that are at fault, but further reforms need to be co-ordinated with improvements in parallel systems, such as human resources management. Also, the improvements in the quality of information that were envisaged have taken time to materialise, because they are a function of capacity developments, particularly in management. The remaining challenges are outlined below.

- **Strengthening the planning, budgeting and reporting links.** While the improvement in information availability is one of the achievements of the budget reform process, the information that is provided is not always used sufficiently. There is still a lot of work to be done on developing and providing appropriate performance information in effective formats. Information sharing could improve; many departments are still not able to provide adequate information on their policy priorities and budget allocations and the links between them. Moving further towards an output orientation and improving the outputs of the reporting system are current reform focuses. However, these need to be supported by a reassessment of how well the information is being used. This holds not only for programme managers and their seniors, but also for ministers and for Parliament. Within the current framework, there is considerably more leeway for action in cases of poor performance than is being used. It can be argued that the way in which practice is evolving is diluting the original conception of the system as set out in the PFMA. Some of this is perhaps inevitable. Nevertheless, long-term expected non-enforcement may have the consequence of limiting the usefulness of the MTEF in forging a policy-budgeting link and could allow wastage of scarce resources through inefficiency and corruption.

- **Improving capacity throughout the system.** Effective medium-term planning at the departmental level cannot be taken for granted. A lot of work needs to be done to realise the benefits of a medium-term planning horizon. For example, while possible in principle, providing medium-term budgets for learner support materials to schools is not a standard feature of education management. The medium-term allocations stop at programme level, with financial planning lower down still being done largely on an annual basis. Deepening the reforms in this way would require working with individual departments at national and provincial level to develop managerial capacities.
- **Improving parallel systems.** Supply chain management and human resources (performance management) frameworks are two areas that need further development to realise improved service delivery.
- **Reforming the financing of specific services.** With improved basic budget and financial management, a better base is in place from which to investigate improved ways of financing certain public services, such as social security payments. Frameworks for public-private partnerships for the financing of large infrastructure projects have already been developed and are being implemented.
- **Increasing the planning and budgeting horizon.** It is becoming increasingly clear that a three-year planning horizon is inadequate for budgeting in some areas, such as the promotion of a sustainable social security system and for large, one-off expenditure outlays. Budgeting for social grants needs

to arise from a 10-20 year projection of demographic changes and other social dynamics such as the evolution of the population's health status. Investment projects often span more than three years. Extending the budgeting horizon is an area that is being investigated.

- **Integrating donor financing into the budget.** Donor financing is approximately 2% of the budget. However, in many cases it provides important marginal flexibility to implement policies. Ensuring that these resources are used well towards policy priorities and are reflected accurately in budget documentation remains a challenge.
- **Improving intergovernmental co-ordination further.** While the intergovernmental fiscal relations system is stable and supports affordable and effective spending, there is still room for improving co-ordination of spending towards policy priorities and for improving the functioning of the intergovernmental forums and other co-ordination structures.
- **Improving municipal financing and budgeting.** A key focus of current reforms is local government. Municipal financial management legislation was enacted recently, setting improved frameworks for budgeting and financial management practices at this level.

By and large, the reforms that occurred between 1997 and 2004 have put in place the foundations for modern public finance management in South Africa. Major system changes were undertaken and implemented with relative success. With the exception of one or two major structural reforms that still need to be undertaken, what remains is the patience and hard work needed to make the changes fully effective.

4. Conclusion

South Africa has succeeded in radically altering the way in which it budgets for public services and how it accounts for public expenditure and commitments. It did so in a relatively short time and has already started reaping the benefits, with more realistic policy debates and increased funds available for much-needed investment and poverty-alleviating expenditure. Many other countries that have embarked on similar processes struggle to anchor changes and make them count. South Africa has several advantages over other African countries: it has a modern economy that generates predictable resources for public spending, it has a functioning tax administration, donor financing is a minor proportion of its budget, and it started off from a base where cash was relatively well accounted for and with comparatively good capacity in the public sector. Several lessons can be taken from its reform experience, discussed below.

- **Political commitment to budgeting and financial management reforms.** The starting point for the reforms was not to put in place a sophisticated

MTEF system. The reforms were driven by a political commitment to realistic macroeconomic projections, sensible budgeting norms, good accounting practices and regular reporting through transparent budget documents, objectives for which medium-term budgeting and the public financial management reforms were tools.

- **A simple framework and transparent norms.** It is important that all actors in the budget process grasp the framework approach behind the reforms. This is the only way in which they will be able to fulfil their adjusted responsibilities in such a manner that the reforms achieve their objectives. In the case of South Africa, reforms centred on putting in place credible three-year plans, focusing in the budget process on changes to baselines and devolving accountability to spending departments. This was done through simple frameworks that were easy to communicate and easier to implement than systems with high levels of complexity. However, the complexity of the system has been growing as capacity and understanding develop, both in the centre and in service departments. At the same time, the budget process was changed from being a "black box" to one with a high level of transparency, where the criteria for decisions are communicated early and policy objectives publicly articulated. The rules that governed this process were made explicit and enforced.
- **Comprehensive implementation.** Major reforms in South Africa, such as the MTEF and the PFMA, were implemented throughout government, and replaced the existing frameworks. This made sense. Because the MTEF is a framework approach and because ceilings are determined in a top-down manner within the framework, it would have been very difficult to establish credible forward funding projections at any level if they were not connected to the fiscal framework and other projections. Similarly, because it is about competing priorities at any level, having only a few priorities competing within the MTEF, while others are still outside, would have undermined the principle of working within a framework.
- **Make sure it matters.** Because both the MTEF and the PFMA were implemented across government, they became the frameworks driving any policy and budgeting decisions and financial management. Departments did not have recourse to any other way of getting activities funded. Anchoring reforms by linking them with other processes has also contributed to their implementation, and was necessary for their effectiveness. For example, linking the MTEF to financial management through the PFMA (which makes it a legal requirement) and other reforms, such as those at the Office of the Auditor General, helped to consolidate the MTEF as the only system for budget planning. It can be argued that if the MTEF had been implemented in isolation, without linkages to improved fiscal and financial management, it would have been far less successful.

- **Convince stakeholders that you are serious.** Another aspect of making sure that it matters is disciplined and mindful implementation in the first year. It often takes only one instance of a rule being enforced for budgetary actors to change their behaviour. For example, in the first year of the intergovernmental fiscal system, there was pressure on the National Treasury to bail out some provinces that were unable to redeem overdrafts at commercial banks. The national government refused, enforcing the constitutional requirement that provincial governments are accountable for their finances, and signalling clearly that it was no longer business as usual. Similarly, spending agencies have had to absorb the unauthorised expenditure of one fiscal year within their budgets of the next year. The successful implementation of the budget reforms has been facilitated by the Treasury making the rules explicit and enforcing them. Enforcing hard budget ceilings, during planning and preparation, from the first year of the MTEF has been a key determinant of success.
- **Strong central agency responsible for reforms.** The implementation of the MTEF and the PFMA was strengthened greatly by the amalgamation of the former Department of Finance (responsible for macroeconomic, fiscal and budget policy planning) and the Department of State Expenditure (responsible for departmental budgeting and implementation) into the National Treasury. Institutionally, this has brought expenditure planning and monitoring together, and has located the full budget process, from macroeconomic forecasting and fiscal planning through to managing expenditure in-year and compiling reports on the state of the budget, under one executive authority and one accounting officer. Better integration in the budget process between budgeting and implementation has resulted. For example, one desk is now responsible for monitoring a spending department/sector, assessing budget plans and monitoring in-year performance. The unit responsible for determining budget planning modalities takes responsibility for managing the whole process, including reporting modalities. All in all, mainstreaming the reforms from the start, through making it the only process and system through which funds are allocated and used, and having the central agency responsible for budget management and implementation responsible for the main reforms, has ensured that they have taken root.
- **Build capacity by demanding it, and support its development.** Reforms were implemented in a comprehensive and disciplined manner, changing the incentives for budget actors, and they were supported through linkages with public service management frameworks, for example the Public Service Regulations. This immediately placed increased demands on spending departments, which often did not have the capacity to comply in any meaningful way and were forced to develop it fast. The Treasury,

however, developed specific strategies (for example, in the implementation of the PFMA) to support the development of the capacity in line agencies.

- **Demonstrate wins early.** Any reform process is likely to meet with resistance from vested interests, and to experience setbacks. Therefore, it is important to build support for the reform process at all levels of government. In the case of South Africa, the benefit of working within a multi-year budgeting framework was demonstrated early, when the fiscal framework for the 1999 budget had to contend with fewer resources than expected. Instead of having to institute budget cuts, as would have been required under a one-year framework in order to meet deficit targets, the government used the medium-term framework to keep spending stable in the short term, absorbing the shortfall by drawing down the contingency reserve and shifting the impact to the outer years. So, whereas an annual budget cycle would have forced immediate expenditure disruption (and could have reinforced the negative economic environment), the medium-term framework allowed the shock to public finances to be smoothed over the economic cycle. This demonstrated the usefulness of medium-term planning, helped to overcome resistance at political and institutional level, and contributed to making the MTEF a functional strategic budgeting tool.

The South African case illustrates the importance of being clear about objectives, getting the principles right when designing reforms to fulfil those objectives, and letting realism guide the reform process and the speed with which it is implemented. The South African experience also shows that, while it makes sense to approach budget reforms in terms of frameworks, it requires time for the reforms to take effect. Quality improvements in terms of expenditure estimates, actual spending information, performance information and service delivery materialise slowly. Reforming the budgeting system is never the full answer to economic governance challenges; however, when backed by robust political support and decision systems and sound human resources management, it plays a significant part in improving public sector management.

Notes

1. This article borrows from T. Chaponda, N. Cole and M. Schoch (2004), "Budget Reform as a Means to Strengthen the Link between Micro and Macro Policies", unpublished draft paper.
2. This requires that the spheres of government co-ordinate their actions and legislation, and exercise their powers in a manner that does not encroach on the geographic, functional or institutional integrity of government in another sphere.
3. This legislation includes the Intergovernmental Fiscal Relations Act, the Financial and Fiscal Commission Act, the Public Financial Management Act, the Provincial

Borrowing Powers and Tax Regulation Process Act, and legislation pertaining to the municipal level of government, such as the Municipal Finance Management Act.

4. The Constitution lists ten factors that need to be taken into account in the division of revenue. Other factors include the national interest and debt, addressing economic disparities, the interest of national government and provincial and local spending obligations in terms of national legislation. How these factors play out in any given year is made public in Annexure E of the Budget Review, as required by legislation.

5. Accounting officers are required to submit financial statements to the Auditor General and their relevant Treasuries within two months after year-end. The Treasuries, in turn, are required to submit consolidated financial statements to the AG within three months after year-end. The AG's audit must be completed within three months, and the audited financial statements returned to the minister to submit to Parliament within seven months after year-end.