Chapter 27
Public Finance

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213. National Revenue Fund

(1) There is a National Revenue Fund into which all money received by the national government must be paid, except money reasonably excluded by an Act of Parliament.

(2) Money may be withdrawn from the National Revenue Fund only—

(a) in terms of an appropriation by an Act of Parliament; or

(b) as a direct charge against the National Revenue Fund, when it is provided for in the Constitution or an Act of Parliament.

(3) A province's equitable share of revenue raised nationally is a direct charge against the National Revenue Fund.

214. Equitable shares and allocations of revenue

(1) An Act of Parliament must provide for—

(a) the equitable division of revenue raised nationally among the national, provincial and local spheres of government;

(b) the determination of each province's equitable share of the provincial share of that revenue; and

(c) any other allocations to provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations may be made.

(2) The Act referred to in subsection (1) may be enacted only after the provincial governments, organised local government and the Financial and Fiscal Commission have been consulted, and any recommendations of the Commission have been considered, and must take into account—

(a) the national interest;

(b) any provision that must be made in respect of the national debt and other national obligations;

(c) the needs and interests of the national government, determined by objective criteria;

(d) the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them;

(e) the fiscal capacity and efficiency of the provinces and municipalities;

(f) developmental and other needs of provinces, local government and municipalities;

(g) economic disparities within and among the provinces;

(h) obligations of the provinces and municipalities in terms of national legislation;

(i) the desirability of stable and predictable allocations of revenue shares; and

(j) the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria.

215. National, provincial and municipal budgets

(1) National, provincial and municipal budgets and budgetary processes must promote transparency, accountability and the effective financial management of the economy, debt and the public sector.

(2) National legislation must prescribe—

(a) the form of national, provincial and municipal budgets;

(b) when national and provincial budgets must be tabled; and

(c) that budgets in each sphere of government must show the sources of revenue and the way in which proposed expenditure will comply with national legislation.

(3) Budgets in each sphere of government must contain—

(a) estimates of revenue and expenditure, differentiating between capital and current expenditure;

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(b) proposals for financing any anticipated deficit for the period to which they apply; and

(c) an indication of intentions regarding borrowing and other forms of public liability that will increase public debt during the ensuing year.

216. Treasury control

(1) National legislation must establish a national treasury and prescribe measures to ensure both transparency and expenditure control in each sphere of government, by introducing —

(a) generally recognised accounting practice;

(b) uniform expenditure classifications; and

(c) uniform treasury norms and standards.

(2) The national treasury must enforce compliance with the measures established in terms of subsection (1), and may stop the transfer of funds to an organ of state if that organ of state commits a serious or persistent material breach of those measures.

(3) A decision to stop the transfer of funds due to a province in terms of section 214 (1) *(b)* may be taken only in the circumstances mentioned in subsection (2), and —

(a) may not stop the transfer of funds for more than 120 days; and

(b) may be enforced immediately, but will lapse retrospectively unless Parliament approves it following a process substantially the same as that established in terms of section 76(1) and prescribed by the joint rules and orders of Parliament. This process must be completed within 30 days of the decision by the national treasury.

(4) Parliament may renew a decision to stop the transfer of funds for no more than 120 days at a time, following the process established in terms of subsection (3).

(5) Before Parliament may approve or renew a decision to stop the transfer of funds to a province —

(a) the Auditor-General must report to Parliament; and

(b) the province must be given an opportunity to answer the allegations against it, and to state its case, before a committee.

217. Procurement

(1) When an organ of state in the national, provincial or local sphere of government, or any other institution identified in national legislation, contracts for goods or services, it must do so in accordance with a system which is fair, equitable, transparent, competitive and cost-effective.

(2) Subsection (1) does not prevent the organs of state or institutions referred to in that subsection from implementing a procurement policy providing for

(a) categories of preference in the allocation of contracts; and

(b) the protection or advancement of persons, or categories of persons, disadvantaged by unfair discrimination.

(3) National legislation must prescribe a framework within which the policy referred to in (subsection (2) must be implemented.

218. Government guarantees

(1) The national government, a provincial government or a municipality may guarantee a loan only if the guarantee complies with any conditions set out in national legislation.

(2) National legislation referred to in subsection (1) may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.

(3) Each year, every government must publish a report on the guarantees it has granted.

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219. Remuneration of persons holding public office

(1) An Act of Parliament must establish a framework for determining—

(a) the salaries, allowances and benefits of members of the National Assembly, permanent delegates to the National Council of Provinces, members of the Cabinet, Deputy Ministers, traditional leaders and members of any councils of traditional leaders; and

(b) the upper limit of salaries, allowances or benefits of members of provincial legislatures, members of Executive Councils and members of Municipal Councils of the different categories.

(2) National legislation must establish an independent commission to make recommendations concerning the salaries, allowances and benefits referred to in subsection (1).

(3) Parliament may pass the legislation referred to in subsection (1) only after considering any recommendations of the commission established in terms of subsection (2).

(4) The national executive, a provincial executive, a municipality or any other relevant authority may implement the national legislation referred to in subsection (1) only after considering any recommendations of the commission established in terms of subsection (2).

(5) National legislation must establish frameworks for determining the salaries, allowances and benefits of judges, the Public Protector, the Auditor-General, and members of any commission provided for in the Constitution, including the broadcasting authority referred to in section 192.

Financial and Fiscal Commission

220. Establishment and functions

(1) There is a Financial and Fiscal Commission for the Republic which makes recommendations envisaged in this Chapter, or in national legislation, to Parliament, provincial legislatures and any other authorities determined by national legislation.

(2) The Commission is independent and subject only to the Constitution and the law, and must be impartial.

(3) The Commission must function in terms of an Act of Parliament and, in performing its functions, must consider all relevant factors, including those listed in section 214(2).

221. Appointment and tenure of members

(1) The Commission consists of the following women and men appointed by the President, as head of the national executive:

(a) A chairperson and deputy chairperson;

(b) three persons selected, after consulting the Premiers, from a list compiled in accordance with a process prescribed by national legislation;

(c) two persons selected, after consulting organised local government, from a list compiled in accordance with a process prescribed national legislation; and

(d) two other persons.

(A) National legislation referred to in subsection (1) must provide for the participation of—

(a) the Premiers in the compilation of a list envisaged in subsection (1) *(b)*; and

(b) organised local government in the compilation of a list envisaged in subsection (1) *(c)*.

(2) Members of the Commission must have appropriate expertise.

(3) Members serve for a term established in terms of national legislation. The President may remove a member from office on the ground of misconduct, incapacity or incompetence.

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222. Reports

The Commission must report regularly both to Parliament and to the provincial legislatures.

Central Bank

223. Establishment

The South African Reserve Bank is the central bank of the Republic and is regulated in terms of an Act of Parliament.

224. Primary object

(1) The primary object of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic.

(2) The South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters.

225. Powers and functions

The powers and functions of the South African Reserve Bank are those customarily exercised and performed by central banks, which powers and functions must be determined by an Act of Parliament and must be exercised or performed subject to the conditions prescribed in terms of that Act.

Provincial and Local Financial Matters

226. Provincial Revenue Funds

(1) There is a Provincial Revenue Fund for each province into which all money received by the provincial government must be paid, except money reasonably excluded by an Act of Parliament.

(2) Money may be withdrawn from a Provincial Revenue Fund only—

(a) in terms of an appropriation by a provincial Act; or

(b) as a direct charge against the Provincial Revenue Fund, when it is provided for in the Constitution or a provincial Act.

(3) Revenue allocated through a province to local government in that province in terms of section 214(1), is a direct charge against that province's Revenue Fund.

(4) National legislation may determine a framework within which—

(a) a provincial Act may in terms of subsection (2) *(b)* authorise the withdrawal of money as a direct charge against a Provincial Revenue Fund; and

(b) revenue allocated through a province to local government in that province in terms of subsection (3) must be paid to municipalities in the province.

227. National sources of provincial and local government funding

(1) Local government and each province—

(a) is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it; and

(b) may receive other allocations from national government revenue, either conditionally or unconditionally.

(2) Additional revenue raised by provinces or municipalities may not be deducted from their share of revenue raised nationally, or from other allocations made to them out of national government revenue. Equally, there is no obligation on the national government to compensate provinces or municipalities that do not raise revenue commensurate with their fiscal capacity and tax base.

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(3) A province's equitable share of revenue raised nationally must be transferred to the province promptly and without deduction, except when the transfer has been stopped in terms of section 216.

(4) A province must provide for itself any resources that it requires, in terms of a provision of its provincial constitution, that are additional to its requirements envisaged in the Constitution.

228. Provincial taxes

(1) A provincial legislature may impose—

(a) taxes, levies and duties other than income tax, value-added tax, general sales tax, rates on property or customs duties; and

(b) flat-rate surcharges on any tax, levy or duty that is imposed by national legislation, other than on corporate income tax, value-added tax, rates on property or custom duties.

(2) The power of a provincial legislature to impose taxes, levies, duties and surcharges—

(a) may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across provincial boundaries, or the national mobility of goods, services, capital or labour; and

(b) must be regulated in terms of an Act of Parliament, which may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.

229. Municipal fiscal powers and functions

(1) Subject to subsections (2), (3) and (4), a municipality may impose—

(a) rates on property and surcharges on fees for services provided by or on behalf of the municipality; and

(b) if authorised by national legislation, other taxes, levies and duties appropriate to local government or to the category of local government into which that municipality falls, but no municipality may impose income tax, value-added tax, general sales tax or customs duty.

(2) The power of a municipality to impose rates on property, surcharges on fees for services provided by or on behalf of the municipality, or other taxes, levies or duties—

(a) may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across municipal boundaries, or the national mobility of goods, services, capital or labour; and

(b) may be regulated by national legislation.

(3) When two municipalities have the same fiscal powers and functions with regard to the same area, an appropriate division of those powers and functions must be made in terms of national legislation. The division may be made only after taking into account at least the following criteria:

(a) The need to comply with sound principles of taxation.

(b) The powers and functions performed by each municipality.

(c) The fiscal capacity of each municipality.

(d) The effectiveness and efficiency of raising taxes, levies and duties.

(e) Equity.

(4) Nothing in this section precludes the sharing of revenue raised in terms of this section between municipalities that have fiscal power and functions in the same area.

(5) National legislation envisaged in this section may be enacted only after organised local government and the Financial and Fiscal Commission have been consulted, and any recommendations of the Commission have been considered.

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230. Provincial and municipal loans

(1) A province may raise loans for capital or current expenditure in accordance with national legislation, but loans for current expenditure may be raised only when necessary for bridging purposes during a fiscal year.

(2) National legislation referred to in subsection (1) may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.

230A. Municipal loans

(1) A Municipal Council may, in accordance with national legislation—

(a) raise loans for capital or current expenditure for the municipality, but loans for current expenditure may be raised only when necessary for bridging purposes during a fiscal year; and

(b) bind itself and a future Council in the exercise of its legislative and executive authority to secure loans or investments for the municipality.

(2) National legislation referred to in subsection (1) may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.[1]

27.1 Introduction*

(a) Public Finance as a Creature of the Final Constitution, Statute, Institutions, Regulations and Practice

1 Constitution of the Republic of South Africa, 1996 (Act 108 of 1996)('Final Constitution' or 'FC').

The structure of public finance in South Africa is created by a surprisingly few provisions in FC Chapter 13. These provisions support (and sometimes constrain) a mature body of legislation, policy, institutions and practice that has developed in the last ten years. The rapid development of this public finance regime has been promoted by a confident and assertive National Treasury, itself a product of public finance legislation.

The two primary finance statutes enacted in the last decade are the Public Finance Management Act[2] ('PFMA') and the Local Goverment: Municipal Finance Management Act[3] ('MFMA'). Each of these acts has produced important regulations — the oft-amended Treasury Regulations for Departments, Trading Entities, Constitutional Institutions and Public Entities[4] ('Treasury Regulations') and the recently-promulgated Municipal Supply Chain Management Regulations,[5] Municipal Investment

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Regulations,[6] and Municipal Public-Private Partnership Regulations.[7] In addition to the MFMA and the PFMA, another particularly important Act is the Division of Revenue Act ('DORA'). DORA is enacted each year to allocate 'equitable share' and other intergovernmental grants and is typically accompanied by a long memorandum describing developments financial and conceptual in South African public finance. Several other Acts create public finance institutions and regulate public finance: the Borrowing Powers of Provincial Governments Act,[8] the Financial and Fiscal Commission Act[9] and the Intergovernmental Fiscal Relations Act.[10] Finally, there is a large body of guidance and practice notes generated under the PFMA and the annual inter-governmental fiscal reviews. We draw on these instruments to more fully understand FC Chapter 13 and the system of public finance it supports.

2 Act 1 of 1999.

3 Act 56 of 2003.

4 Originally published as Government Notice No 345 *Government Gazette* 22219 (9 April 2001), subsequently published in amended form in Notice R 740 *Government Gazette* 23463 (25 May 2002) and Notice R 225 *Government Gazette* 27388 (15 March 2005) and most recently amended by Notice R 146 *Government Gazette* 29644 (20 February 2007).

5 Notice 868 of 2005 in *Government Gazette* 27636 (30 May 2005).

6 Notice No R 308 *Government Gazette* No 27431 (1 April 2005).

7 Notice No R 309 *Government Gazette* No 27431 (1 April 2005).

8 Act 48 of 1996.

9 Act 99 of 1997.

10 Act 97 of 1997.

(b) Structure of the Chapter

The structure of this chapter attempts to follow a notional 'life cycle' for public funds. That cycle begins with the raising of revenue by the three spheres of government and then considers the allocation of responsibility for public expenditure across governments, the control of budgeting and expenditure, the monitoring and withholding of public funds by national regulators and the intervention by regulators in moments of financial crisis. Chapter 13 does not follow this structure. Indeed, it is difficult to discern an underlying structure in its eighteen provisions. Nevertheless, Chapter 13 covers and controls all these issues.

Because of the lack of case law or literature that considers Chapter 13, our intention is to discuss some basic questions about the structure of South Africa's fiscal system contemplated by the Final Constitution.[11] We also cover (belatedly and in less detail) some of the institutions that have been established to regulate and to shepherd South Africa's public funds — including the Financial and Fiscal Commission and the Central Bank. In addition, the chapter explores the regulatory authority of national government over financial matters in other spheres of government.

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27.2 Raising revenue

(a) Sources of Revenue

When it comes to sources of revenue, the language of FC Chapter 13 is terse. FC ss 227(1) and (2) identify three sources of revenue, namely 'revenue raised nationally';[12] 'other allocations from national government revenue';[13] and 'additional revenue raised by provinces or municipalities'.[14] 'Revenue raised nationally' is synonymous with what is termed 'equitable share' and is allocated between the three spheres of government. Prior to allocation, this revenue is not yet 'national government revenue', even though it is received into the National Revenue Fund. Only when national government has received its portion of equitable share, through a constitutionally controlled allocation process, is this revenue called 'national government revenue'. The other spheres of government may receive 'other allocations' from this national government revenue in the form of conditional or unconditional grants (terms later to be elaborated). In practice, however, these other allocations are always conditional. Finally, provinces and municipalities may raise 'additional revenue' of their own — subject to limitations set out in FC Chapter 13.

(b) Raising National Revenue

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11 Such a structure must determine among other things the percentage of total government expenditure made by sub-national governments, the size and character of inter-governmental transfers and the level of fiscal autonomy of sub-national governments. See E Yemek 'Understanding Fiscal Decentralisation in South Africa' *IDASA Occasional Paper* (July 2005) 3.

12 FC s 227(1)*(a)*.

13 FC s 227(1)*(b)*.

14 FC s 227(2).

The Final Constitution is very clear on how revenue is raised (sometimes called 'revenue assignment'). As indicated above, South Africa's fiscal structure is premised on primary collection of revenue by the national government. This revenue is supplemented by some additional revenue raised by provincial governments and local governments. Because Chapter 13 nowhere mentions national government's revenue-raising powers, and mentions provincial and municipal powers in a way that restricts their powers to those expressly mentioned, it is clear that national government has plenary revenue-raising powers. In practice, revenue is raised nationally through several different sources — personal and corporate income tax, value added tax and customs duties. These are all forms of tax that provinces and municipalities are expressly prevented from imposing.[15]

(c) Raising Provincial Revenue

Provincial revenue-raising powers are the most limited of the three spheres of government. Provinces may not impose national forms of taxes — income tax, value-added tax, general sales tax and customs duties; nor may Provinces impose municipal forms of tax, that is, rates on property.[16] Provinces are left with the

capacity to raise revenue through 'other taxes, levies and duties' and 'flat-rate surcharges on the tax bases of any tax, levy or duty that is imposed by national legislation'.[17] Provincial taxation powers are further circumscribed by FC s 228(2):

> The power of a provincial legislature to impose taxes, levies, duties and surcharges *(a)* may not be exercised in way that materially and unreasonably prejudices national economic policies, economic activities across provincial boundaries, or the national mobility of goods, services, capital or labour; and *(b)* must be regulated in terms of an Act of Parliament, which may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.

The national legislation contemplated in FC s 228(2) *(b)* has been enacted in the form of the Provincial Tax Regulation Process Act.[18] Aside from repeating the limitation imposed in FC s 228,[19] the most important purpose of the Act is to regulate the process that a province must follow prior to imposing a provincial tax.[20] The only extant provincial tax of which the authors are aware is the Cape fuel levy.[21] This tax was approved by the National Treasury in mid-2006. Although other provincial taxes have been mooted from time-to-time, none have been enacted. FC 227(2) prevents

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15 See FC ss 228(1) and 229(1)*(b)*.

16 See FC s 228(1).

17 See FC s 228(1).

18 Act 53 of 2001.

19 See Provincial Tax Regulation Process Act s 2(1).

20 See Provincial Tax Regulation Process Act s 3.

21 See National Treasury *Provincial Budgets and Expenditure Review: 2002/03–2008/09* (2004) 6.

additional revenue raised by provincial taxes from being deducted from their equitable share. At the same time, the national government is not required to compensate provinces which fail to 'raise revenues commensurate with their fiscal capacity and tax base'.

(d) Raising Municipal Revenue

There are two primary sources of local government funding: inter-governmental transfers and own revenue. Inter-governmental transfers can be further divided into equitable share and grants from government departments ('other allocations'). Own revenues ('additional allocations') are raised through the imposition of user charges (tariffs) and local taxes (rates on property and, previously, RSC levies).[22] The power to raise municipal own revenues is set out in FC s 229(1) *(a)*: 'a municipality may impose rates on property and surcharges on fees for services provided by or on behalf of the municipality'.[23] In terms of FC s 229(1) *(b)*, municipalities

may also impose 'other taxes, levies and duties appropriate to local government'[24] if authorised by national legislation.[25] However, FC s 229(1) *(b)* adds the proviso that 'no municipality may impose income tax, value-added tax, general sales tax or customs duty'. Furthermore, the fiscal powers of municipalities are limited in that they 'may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across municipal boundaries, or the national mobility of goods, services, capital or labour';[26] and that they 'may be regulated by national legislation'.[27] A striking feature of FC s 229 is that it does not empower municipalities to impose fees or charges for services. The heading of FC s 229, 'Municipal Fiscal Powers and Functions', suggests a deliberate omission of charges for services — the imposition of such charges not being the expression of a municipal fiscal power. This view is buttressed by the fact that the local Goverment: Municipal Systems Act[28] treats fees for services separately from taxes, levies and duties.[29] Indeed, the tendency to treat rates and fees as distinct has been called 'a

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22 The memorandum to the Municipal Fiscal Powers and Functions Bill explains why RSC levies were phased out (at 15). The bill is available at http://www.treasury.gov.za (accessed on 9 May 2007) ('Municipal Fiscal Powers and Functions Bill').

23 The meaning of 'rate' in the context of FC s 229(1)*(a)* has been elaborated in *Gerber v MEC for Development Planning and Local Government, Gauteng* 2003 (2) SA 344 (SCA) ('*Gerber*') at para 23. *Gerber* emphasizes the requirement that a rate be calculated in relation to the size or value of properties and not on a flat basis. Ibid at para 24.

24 The distinction between a rate and a levy is alluded to in *Gerber. Gerber* (supra) at para 28. A rate is proportionate to the size or value of a property; a levy is a flat amount for erf.

25 The national legislation is being developed in the form of the Municipal Fiscal Powers and Functions Bill.

26 See FC s 229(2)*(a)*.

27 See FC s 229(2)*(b)*.

28 Act 32 of 2000.

recurring theme of the Systems Act'.[30] It might be argued that taxation, as contrasted with fees for services, requires an express empowering provision. By contrast, the municipal capacity to impose user fees is a well-entrenched, long-standing practice that may fall within the description of an 'implied power' in terms of FC s 156(5).

The unsettling omission of charges for services in the Final Constitution is accentuated by the somewhat awkward treatment of user fees in the Systems Act. Prior to amendment, it required Municipal Councils to adopt and to implement tariff policies on the levying of fees for municipal services, but set out the actual power to charge fees for services in passing in a separate chapter of the Act.[31] This lacuna in the Systems Act was subsequently rectified by the insertion in 2002 of a new section 75A.[32] This section enables municipalities to 'levy and recover fees, charges or tariffs in respect of any function or service of the municipality'. Based on our earlier conclusion that tariffs are not covered in FC s 229, it is not clear that a tariff is a tax, levy or duty that the Systems Act could introduce through FC s 229(2)*(b)*. And yet, courts considering the meaning of FC s 229 and the Systems Act do not appear to have been especially vexed by this potential problem.[33]

Municipal tariff setting is politically and legally complex.[34] The Final Constitution is clear that setting prices for services is a political matter vested in Municipal Councils and is not capable of delegation.[35] Notwithstanding what may be viewed as an affirmation of local democratic control over municipal pricing, the Systems Act allows the national Minister responsible for local government to regulate limits on

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29 See Systems Act s 4(1)*(c)*.

30 See *Rates Action Group v City of Cape Town* 2004 (5) SA 545 (C) at para 73.

31 See Systems Act s 4(1)*(c)*(i).

32 The amendment was made by the Local Government Laws Amendment Act 51 of 2002 s 39. It is possible that prior to the amendment of the Systems Act, the power to impose tariffs arose from section 10G(7)*(a)*(ii) of the Local Government Transition Act 209 of 1993. See *Rates Action Group v City of Cape Town* 2004 (5) SA 545 (C) at para 62.

33 See *Rates Action Group v City of Cape Town* 2006 (1) SA 496, (SCA) 501 ('*Rates Action Group SCA*') (The Supreme Court of Appeal considered whether a municipality has the power to charge for a service by imposing a rate. The court accepted, without hesitation, that the Systems Act is the regulatory legislation contemplated in FC s 229(2)*(b)*.)

34 Because spatial patterns in South Africa are still a proxy for race, tariff and rating decisions which impact different areas disproportionately tend to have discriminatory impacts. Two cases have considered equality challenges in this area: *Rates Action Group v City of Cape Town* 2004 (5) SA 545 (C) ('*Rates Action Group HC*') and *Pretoria City Council v Walker* 1998 (2) SA 363 (CC), 1998 (3) BCLR 257 (CC) ('*Walker*'). *Rates Action Group HC* found that the discrimination arising from a shift towards property rates as a mechanism for paying for services was not unfair discrimination within the meaning of the Final Constitution. *Rates Action Group HC* (supra) at para 111. By contrast, the Court in *Walker* found that a practice of imposing different charges on consumers in the 'old' Pretoria and consumers in former black townships did constitute unfair discrimination. *Walker* (supra) at para 81.

35 See FC s 160(2)*(c)*.

tariff increases[36]— a power that the Minister has never exercised. The intersecting political control of pricing at both municipal and national level has historically raised concerns about municipal contractual commitments. It is not unusual for contracts with service providers to include provisions that require tariffs to escalate at an agreed rate. The question that arises is whether these contractual undertakings are binding if, at some time *after* conclusion of the contract, tariffs are levied by a Municipal Council at lower levels than the contract requires or if an agreed tariff escalation is precluded by the Minister under the Systems Act. The MFMA has attempted to answer both questions in the affirmative. In respect of the latter question, section 43(3) of the MFMA provides that if a municipality has entered into a contract which 'provides for an annual or other periodic escalation of payments to be made by the municipality under the contract, no determination of the upper limits of a municipal tax or tariff applies to that municipality in so far as such upper limits would impair the municipality's ability to meet the escalation of its payments under the contract'. While the MFMA may appear to settle contractual concerns that flow from potential ministerial intervention in municipal tariff setting, some may argue that section 43(3) does not, in fact, achieve this intended purpose.[37]

The next question is whether a Municipal Council can bind itself to tariff escalations set out in a contract with a service provider? This question is

particularly interesting in light of the Constitutional Court's decision in *Fedsure Life Assurance Ltd & Others v Greater Johannesburg Transitional Metropolitan Council & Others* ('*Fedsure*'). For our purposes, the most important holding in *Fedsure* is that tariff setting is a legislative act.[38] In light of *Fedsure,* a Municipal Council may not be able to fetter its legislative discretion by making a contractual undertaking to escalate tariffs at an agreed level. Several interesting questions arise here. First, municipalities as executive bodies may enter into agreements in which they undertake that a certain revenue will be generated from the provision of a service. In our view, such an agreement this is not an undertaking about how the Municipal Council will legislate, but an undertaking that in the event of future legislation that disturbs the revenue stream, the municipality bears the risk of financial loss to the service provider. The MFMA expressly allows for such undertakings. MFMA s 48(1)*(c)* allows a municipality by resolution of its Municipal Council to provide security for 'contractual obligations of the municipality undertaken in connection with capital expenditure by other persons on property, plant or equipment to be used by the

36 See Systems Act s 86A(1)*(c)*.

37 The provision postulates 'municipal payments' to service providers, presumably, in the form of a fee for services. However, it is not unusual for contracts to remunerate service providers by transferring to them the revenue collected from consumers. System Act s 81(2)*(a)*(vi) expressly allows service providers to be remunerated in this way. The effect of such provisions is to transfer to the service provider the risk of non-payment or short-payment by consumers (so-called 'collection risk'). Indeed, it is particularly in the case of such contracts that investors would be concerned about the prospect of a ministerial cap on tariff increases. However, on a strict interpretation, s 43(3) of the MFMA may not apply to those contracts which do not involve municipal payments (in the sense of a service fee) to service providers. However, it might be argued that the transfer of revenue from the primary account of the municipality to a service provider does constitute a municipal payment for the purposes of s 43(3).

38 1999 (1) SA 374 (CC), 1998 (12) BCLR 1458 (CC) at para 45 (The Constitutional Court held '[t]hat when a legislature whether national, provincial or local, exercises the power to raise taxes or rates, or determines appropriations to be made out of public funds, it is exercising a power that under our Constitution is a power peculiar to elected legislative bodies.')

municipality or such other person for the purpose of achieving the objects of local government in terms of section 152 of the Constitution'. MFMA s 48(2)*(g)* then explains that such security includes an 'undertaking to retain revenues or specific municipal tariffs or other charges, fees or funds at a particular level or at a level sufficient to meet its financial obligations'. Since such a contractual undertaking is made by the municipality *qua* executive, it does not constrain the municipality *qua* legislature. Accordingly, this provision should be read as authorising the municipality to indemnify the lender against the political risk of future tariff reductions. There is some indication in the case law that this interplay of contractual commitment and legislative power forms part of a normal set of dilemmas that characterise the budget process.[39] Hence, while the case law has emphasised that Municipal Councils are democratically elected deliberative bodies which are subject to political considerations in adopting budgets,[40] the MFMA makes it clear that the political process involved in adopting budgets and setting tariffs cannot ignore or subvert contractual undertakings that bind the municipality.

A second point is that even if *Fedsure* characterises tariff setting as a legislative act (and hence insulates it from administrative review), legislation is not immune from constitutional challenge. Indeed, in *Fedsure*, the Constitutional Court developed the idea that the 'rule of law' is generally understood to be a fundamental principle of constitutional law.[41] According to the legality principle developed in *Fedsure*, every exercise of government power is subject to the law and the Final Constitution, and the state may perform no function beyond that conferred on it by law.[42] Soon after *Fedsure*, the Constitutional Court developed the rule of law doctrine further in *New National Party of SA v Government of the RSA & Others*.[43] Yacoob J, writing for a majority of the Court, stated that that there must be:

> a rational relationship between the scheme which [Parliament adopts] and the achievement of a legitimate governmental purpose. Parliament cannot act capriciously or arbitrarily. The absence of such a rational connection will result in the measure being unconstitutional.[44]

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39 The imperative to balance a municipal budget, and a consideration of a range of financial pressures, persuaded the Cape Provincial Division to find that a 19% increase in the levy in respect of property rates violated certain equality rights, but that the violation was ultimately justifiable. See *Lotus River, Ottery, Grassy Park Residents Association and Another v South Peninsula Municipality* 1999 (2) SA 817 (C) 833B. The decision shows that courts may be sensitive to the narrow parameters that confine legislative decisions in respect of tariff setting. Since a municipality may not budget for a year-end deficit on its operating accounts, a contractual undertaking in terms of s 48(2) *(g)* may compel a Municipal Council *qua* legislature — by a combination of statutory duty and contractual obligation — to maintain the tariffs at the required level. If it fails to increase tariffs, the contractual commitment may produce a year-end operational deficit.

40 See *Rates Action Group HC* (supra) at para 17; *Fedsure* (supra) at para 41.

41 See *Fedsure* (supra) at para 56.

42 For more on the legality principle and the rule of law doctrine, see F Michelman 'The Rule of Law, Legality, and the Supremacy of the Constitution' in S Woolman, T Roux, J Klaaren, A Stein & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, February 2005) Chapter 11.

43 1999 (3) SA 191 (CC), 1999 (5) BCLR 489 (CC).

The principle of legality or the rule of law doctrine provides an alternative basis for reviewing primary legislation in addition to inconsistency with the Bill of Rights or the procedural provisions of the Final Constitution. Many constitutional principles fall within the more basic rubric of legality. A Municipal Council which legislates in conflict with its own contractual undertakings, the imperatives of sustainability and its own tariff policy by-laws may act with an impermissible legislative arbitrariness. This conclusion would be more easily reached if the legislation caused significant prejudice to service providers and was not strictly necessary to protect the interests of consumers. The principle of legality and the rule of law doctrine are designed to produce stable and credible legislative institutions, and could perform a useful role in the highly politically-charged setting of tariff increases.

A final technical point arises out of *Fedsure*. The amended Systems Act in section 75A(2) empowers municipalities to levy tariffs 'by resolution passed by the municipal council with a supporting vote of a majority of its members'. This procedure had been previously imposed by section 10G(7)*(a)*(ii) of the Local Government Transition Act.[45] However, recall that *Fedsure* characterised tariff-setting as a legislative act: presumably conducted by enacting municipal legislation. It seems to us that, on a reasonable reading of *Fedsure*, tariffs cannot be levied by resolution. This conclusion is strengthened by considering section 12 of the Systems Act, which carefully regulates the process of enacting by-laws. The effect of

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OS 03-07, ch27-p14

section 75A(2) is to remove these procedural controls in respect of tariff setting. It is not at all clear why the Systems Act would reduce the formality of municipal decision-making in the politically sensitive case of tariff setting. If this analysis is correct, then the proper procedure for tariff setting is uncertain. Since Systems Act s 75A(2) may be constitutionally suspect in light of *Fedsure*, municipalities should take the cautionary measure of enacting tariffs in by-laws and not just by resolution.

27.3 Allocating revenue

(a) Responsibility for Expenditure

While the Final Constitution is clear on how revenue is raised and which spheres of government are responsible for doing so, it struggles, notoriously, to allocate responsibility for public expenditure (also known as 'expenditure assignment'). This is really a struggle about functional allocation: namely, what functions should be allocated to which spheres of government. The link we have drawn between expenditure assignment and functional allocation is not made explicit in the Final Constitution. However, because every allocation of functional responsibility involves expenditure, the link between expenditure assignment and functional allocation has been enshrined in the phrase 'finance follows function' and given the recent imprimatur of the legislature.[46] Moreover, some have proposed an ideal sequencing of function, finance and functionaries in which 'sub-national governments should

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44 Ibid at para 19.

45 In terms of Local Government Transition Act 209 of 1993 s 10G(7)*(a)*(ii): '[a] municipality may by resolution supported by a majority of the members of the council levy and recover levies, fees, taxes and tariffs in respect of any function or service of the municipality.'

46 See Division of Revenue Act 7 of 2003 s 27(2).

first be given clarity about their functions and associated expenditure responsibilities and based on these, the proper assignment and design of tax instruments and transfer systems should be done.'[47] When the link between expenditure assignment and functional allocation is severed, so-called 'unfunded mandates result'. Unfunded mandates occur when municipalities become responsible for national or provincial functions without formal assignments. Sections 9 and 10 of the Systems Act have attempted to prevent unfunded mandated of this kind.[48]

(b) The Functional Allocation

The job of functional allocation belongs to schedules 4 and 5 of the Final Constitution which are ill-suited to the task. The language used in the schedules is vague and technically imprecise and often elides critical differences between the separate elements of a service. (For example, the term 'reticulation', used in the context of electricity, elides the difference between 'generation', 'transmission' and

'distribution'.[49]) The schedules create porous boundaries between spheres of government and in some cases such as 'provincial roads' and 'municipal roads' create vertically integrated functions with question-begging dividing lines.[50] In these cases, the schedules deliberately prevaricate on where the dividing line should be. Finally, several functions fall within what might be termed the 'plenary' legislative and executive powers of national government and are neither listed nor mentioned.[51] These elisions and omissions have created uncertainty about where responsibility falls for key functions. For example, the allocation of responsibility for water and energy resources is unclear. In practice, they have become concurrent national and local functions.[52] Perhaps the drafters of the Final Constitution imagined that the functional allocation would be resolved over time through the natural evolution of best practices. Since functional allocation is a highly complex process, the drafters may have had no alternative in the early 1990s but to accept that

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47 See J Ahmad, S Devarajan, S Khemani & S Shah 'Decentralization and Service Delivery' *World Bank Policy Research Working Paper 3603* (May 2005) 12. See also See E Yemek 'Understanding Fiscal Decentralisation in South Africa' *IDASA Occasional Paper* (July 2005) 6.

48 For more on this issue, see § 27.3*(g)* infra.

49 The meaning of 'reticulation' is pivotal in allocating responsibility between national and local governments for electricity provision and has featured centrally in the reform of the electricity distribution industry. Its meaning was about to be considered by the Pretoria High Court in litigation between the City of Cape Town and the National Electricity Regulator, when another installment in the ever unfolding narrative of political control of the City prematurely settled the litigation.

50 See IDASA 'Local Government Powers and Functions' *IDASA Occasional Papers* (February 2004) at 3.

51 National Treasury's 'Trends in Intergovernmental Finances: 2000/01–2006/07' (2004), refers at 2 to 'National government's exclusive functions' and lists national defence, the criminal justice system, higher education, water and energy resources and administrative functions such as home affairs and the collection of national taxes. However, these functions are not listed in the Constitution which contains no schedule of exclusive national functions. It is accurate to say that the national sphere enjoys 'plenary' legislative powers (an implicit list of exclusive national powers) subject to a list of concurrent provincial and legislative powers set out in Schedule 4 of the Final Constitution and a smaller list of exclusive provincial powers set out in Schedule 5.

experience and a future national legislative process would resolve the matter. Although this resolution has occurred, to some extent, it has placed significant strain on our system of co-operative government.[53] A detailed dissection of the

schedules would take us away from a focus on FC Chapter 13 and will not be further pursued.[54]

An important difference exists between provincial and municipal governments in respect of functional allocation. Provinces are responsible for highly capital intensive, typically non-revenue generating, social services: health care (including academic and regional hospitals as well as primary health care), schooling, housing and roads.[55] And yet they have few of their own tax instruments for raising the requisite funds for these functions. Municipalities, by contrast, provide services that typically are revenue generating — water, sanitation, electricity and waste collection — and have the tax and other revenue-raising powers required for funding those services.[56]

A final point is that functional allocation is not static. Through assignment it is possible to reallocate functional responsibility from one sphere of government to another — typically 'downward' to municipalities. The primary current example is housing. The Housing Act ('Housing Act')[57] envisages the accreditation of municipalities to assume housing responsibility.[58] The assignment of functions to municipalities is carefully regulated in the Systems Act (which ensures that the

52 For example, in the case of water resources, bulk water systems are currently being transferred to municipalities (examples include assets owned by various Water Boards including Botshelo Water, Lephelle Water, iKangala Water and Amatole Water) and there are existing cases of municipal ownership of bulk assets and involvement in bulk water provision (the primary example being the City of Cape Town). However, Water Boards still continue to provide bulk water as their primary function under the Water Services Act.

53 A good example is housing. Although housing couples naturally with municipal services, the function was allocated to national government and provincial government as a concurrent function. As a legal matter, municipalities can only become responsible for housing provision if the function is assigned or if municipalities enter into contracts with national and provincial government. Although assignments are possible under the Housing Act 107 of 1997, they have not occurred to date. Nevertheless, even in the absence of contracts, several municipalities have become responsible for housing provision. In principle, their lack of constitutional competence has a range of highly complex implications. See K McLean 'Housing' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, July 2006) Chapter 55, 55-24 – 55-26.

54 For discussions elsewhere in this treatise on problems associated with functional allocation, see V Bronstein 'Legislative Competence' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, June 2004) Chapter 15; V Bronstein 'Conflicts' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, July 2006) Chapter 16; C Murray & O Ampofo-Anti 'Provincial Executive Authority' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, March 2007) Chapter 20.

55 National Treasury *Trends in Intergovernmental Finances: 2000/01 — 2006/07* (August 2004) 5.

56 Further important differences between provincial and municipal governments are explored below. See § 27.5*(c)* infra, for a discussion of the difference between provincial borrowing and municipal borrowing.

57 Act 107 of 1997.

financial implications of the assignment are vetted by the Financial and Fiscal Commission) and by the annual Division of Revenue Acts (which affirm the 'finance follows function' principle).[59] It is a curious fact that these controls can be side stepped with ease through so-called 'agency agreements' in which municipalities assume contractual responsibility for provincial or national functions. This alternative to assignment, also called inter-governmental delegation, is not precluded by legislation. Indeed, the Final Constitution expressly allows for it in FC s 238*(b)*. FC s 238*(b)* empowers an executive organ of state in any sphere of government to 'exercise any power or perform any function for any other executive organ of state on an agency or delegation basis'. These arrangements are

temporary in nature and do not transfer the so-called 'authority role' for the function (that is, the responsibility — among other things — for levying tariffs and receiving revenues or grant money).[60] The danger is that municipalities will assume responsibility for functions without necessarily securing the associated revenue. In the case of housing, where municipal responsibility has mushroomed in the absence of assignment, the state of affairs is highly problematic.[61]

(c) Imbalances Between Revenue and Expenditure

Most South African revenue is raised nationally. Expenditure responsibility, however, is assigned across the three spheres of government. Because the fiscal system is characterised by centralised taxation and decentralised service delivery, there are imbalances between revenue and expenditure termed 'vertical fiscal imbalances'.[62] The greatest fiscal imbalance is in the provincial sphere: provinces raise only a fraction of the revenues that they are required to expend. In this section, we discuss

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58 Housing is not a local government matter listed in Part B of FC Schedule 4 and 5 respectively. Housing is therefore not a municipal function or service. However, s 9 of the Housing Act 107 of 1997 expressly sets out a clear role for local government in housing delivery. This role is largely supportive of the other spheres of government, and allows municipalities to act as developers and to enter into joint ventures with private developers in executing national housing programmes. See Housing Act s 9(2)*(a)*. See, further, McLean 'Housing' (supra) at Chapter 55.

59 See, example, Division of Revenue Act 7 of 2003 s 27(2).

60 As organs of state have begun to contract out their institutional functions, South African legislation has introduced a distinction between an 'authority role' and a 'service provider role'. The former role cannot be contracted out and covers areas of essential executive and legislative responsibility. Acting as an authority usually implies the following responsibilities: the statutory responsibility for administering the function; planning to ensure that the function is effectively administered; determination of user fees or the imposition of taxes (such as property rates) to pay for the provision of the service; the entitlement to receive grant funds; developing policy in relation to the function such as service levels and pricing structures; preparing legislation that relates to undertaking the function (in the municipal context, these would be by-laws); contracting with and monitoring service providers; and ownership of the fixed assets associated with the function. See IDASA 'Local Government Powers and Functions' *IDASA Occasional Papers* (February 2004) 6. For examples of where this distinction is implicit or explicit, see Systems Act ss 11(3) and 81; Division of Revenue Act 1 of 2005 s 9(3)*(b)*; Water Services Act 108 of 1997 s 19; and National Land Transport Transition Act 22 of 2000 s 10.

61 For further discussion, see McLean 'Housing' (supra) at Chapter 55.

62 See E Yemek 'Understanding Fiscal Decentralisation in South Africa' *IDASA Occasional Paper* (July 2005) 18.

the equitable share mechanism created by FC section 214 to correct this imbalance[63] and the attempts of provinces to augment revenues through borrowing.[64]

Before we begin this discussion, it is necessary to clarify the technical language that is used to describe grants. Grants may be conditional or unconditional, direct or indirect, or in cash or in kind. A grant is conditional if conditions are used to direct the spending of the grant in receiving municipalities or provinces, whereas it is unconditional if it has only limited conditions relating to the transfer. In the case of a direct grant, the entire grant flows directly from the transferring department to the receiving municipality or department; whereas in the case of an indirect grant, the grant flows via an intermediary (for example, a provincial department to a municipality). Finally, grant funds in a grant in kind are directly

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administered by the transferring department; whereas the money in cash grants is transferred directly to the receiving municipality or Department. These three main distinctions produce the six kinds of grant that are used in South Africa.[65]

In order fully to describe a grant, each of these three main distinctions will be necessary. The language of 'conditional' and 'unconditional' grants is used in FC s 227(1)*(b)*. The other distinctions have developed through use. It is worth mentioning that only equitable share is an unconditional grant, that is, no conditions are imposed on its use.[66]

(d) Equitable Division of Revenue

Imbalances between revenue-raising powers and expenditure responsibility are corrected by intergovernmental grants which allocate revenue across the three spheres. The most important of these grants is 'equitable share' which is mandated and controlled by Chapter 13. The result of the vertical fiscal imbalance for provinces is a massive transfer of nationally-raised revenue to the provinces. In fact, the bulk of equitable share revenue is allocated to provinces. By contrast, because municipalities have their own taxation powers and source revenue through user fees, the legislature has tended to allocate a smaller portion of equitable share to municipalities[67] and has largely treated municipalities as financially autonomous and capable of financial failure.[68] The equitable share of

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national revenue is allocated to each sphere based on a formula which is designed to maximise allocations in proportion to levels of indigency (among other factors).[69]

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63 See § 27.3*(d)* infra.

64 See § 27.5*(c)* infra.

65 See P Whelan 'The Local Government Grant System Paper One: A Researcher's Guide to Local Government Grants' *IDASA Occasional Papers* (July 2003) 7.

66 Even though equitable share is unconditional, DORA 2005 imposes duties on the transferring Department and the receiving municipality in respect of these grants. A key requirement is that accounting officers submit information to the transferring Department as part of the monthly budget reports required in terms of MFMA s 71.

The instrument for allocating nationally raised revenue, and sharing it equitably between spheres of government, is the annually-enacted Division of Revenue Act ('DORA'). The process for enacting DORA and the content of the Act are prescribed in FC s 214. Enacting DORA requires consultation with provincial governments, organised local government (that is, the South African Local Government Association) and the Financial and Fiscal Commission. The consultation process is regulated by the Intergovernmental Fiscal Relations Act.[70] This Act creates two fora for consultation: namely a Budget Council and a Local Government Budget Forum.[71] The former is the body in which the national government and the provincial governments consult on (among other things), 'any fiscal, budgetary or financial matter affecting the provincial sphere of government'.[72] The latter is the body in which the national government, the provincial governments and organised local government consult on (among other things), 'any fiscal, budgetary or financial matter affecting the local sphere of government'.[73] It is an interesting feature of the Act that it creates separate consultation fora to settle provincial and local equitable share. Separate consultation processes are certainly not required in FC s 214(2). The important consequences of two separate consultation processes is that one happens *before* the other. Under these circumstances, it has been suggested that because

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67 For the 2005/06 financial year, provinces received 57.7% of total revenue collected nationally; while municipalities received only 4.7%. See E Yemek 'Understanding Fiscal Decentralisation in South Africa' *IDASA Occasional Paper* (July 2005) 5. See also Chapter 2 of National Treasury's 'Trends in Intergovernmental Finances: 2000/01 — 2006/07' (2004). Some additional transfers are made from provinces to municipalities so that an average figure of 14% has been suggested for the proportion of municipal budgets consisting of national and provincial transfers. See IDASA 'Local Government in Budget 2005' (9 May 2005) 154 *Budget Briefs* available at http://www.idasa.org.za/ (accessed on 19 April 2007). However, where a municipality has limited sources of own revenue, the proportion of its budget dependent on national allocations can be significantly higher than the average (over half and up to 92%). See National Treasury *Trends in Intergovernmental Finances: 2000/01 — 2006/07* (2004) 30, Table 3.9.

68 The MFMA makes provision for financial failure — a form of government insolvency — and prohibits long-term borrowing for operational purposes. Although the treatment of provincial government is slightly ambiguous, in practice the national and provincial spheres of government are not capable of financial failure. See, further, § 27.5*(c)* infra.

69 The formula for calculating equitable share is calculated using a formula that determines the entitlement of each municipality. The formula has recently been revised in Division of Revenue Act 1 of 2005 ('DORA 2005') and consists of four main components. Instead of several 'windows' which fund different services, the new basic services component supports only poor households earning less than R800 per month and recognises water supply, sanitation, refuse removal and electricity supply as the core services to be funded. Another component the institutional support element, also develops the previous 'I Grant'. This support element offers a 'base allocation' which goes to every municipality in the new basic services component. This base allocation takes account of the size of the municipality the cost of maintaining councilors in their legislative and oversight role. A problem with the application of the formula in practice is that it is based on the data in census 2001 which, in the intervening years since 2001, has become less accurate in its measures of indigency.

70 Act 97 of 1997.

71 See Intergovernmental Fiscal Relations Act s 2 and s 5, respectively.

72 See Intergovernmental Fiscal Relations Act s 3*(a)*.

73 See Intergovernmental Fiscal Relations Act s 6*(a)*.

the Budget Council meets before the Local Government Budget Forum, the local government portion of equitable share tends in practice to be a *fait accompli*.[74] If one assumes that the different spheres of government compete for equitable share, the prospect of provincial discussions having priority over local discussions is troubling, even if justified by practical considerations.

In addition to procedural requirements, the annual enactment of DORA is also subject to substantive requirements. FC s 214(2) requires that national parliament take into account several prescribed factors, namely:

> *(a)* the national interest; *(b)* any provision that must be made in respect of the national debt and other national obligations; *(c)* the needs and interests of the national government, determined by objective criteria; *(d)* the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them; *(e)* the fiscal capacity and efficiency of the provinces and municipalities; *(f)* developmental and other needs of provinces, local government and municipalities; *(g)* economic disparities within and among the provinces; *(h)* obligations of the provinces and municipalities in terms of national legislation; *(i)* the desirability of stable and predictable allocations of revenue shares; and *(j)* the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria.

It is clear from the above factors that national interests will prevail — particularly national debt and other national obligations.[75] Indeed, when FC s 214 turns its attention to provinces and municipalities, it emphasizes their obligations in terms of national legislation.[76] As regards provinces and municipalities, FC 214 focuses on the provision of 'basic services',[77] performance of allocated functions,[78] fiscal capacity and efficiency,[79] 'developmental and other needs'[80] and national statutory obligations.[81] Mixed in with these factors are principles such as the need for 'stable and predictable allocations of revenue shares',[82] the need to correct economic

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74 See P Whelan 'The Local Government Equitable Share' *IDASA Occasional Papers* (February 2004) 8.

75 See FC ss 214(2)*(a)* to *(c)*. As we explore in § 27.5*(c)* below, national government cannot fall into financial failure and hence it can undertake long-term borrowing for operational reasons. FC s 214*(b)* also supports this notion by indicating the priority of national debt obligations.

76 See FC s 214(2) *(h)*.

77 See FC s 214(2)*(d)*.

78 See FC s 214(2)*(d)*.

79 See FC s 214(2)*(e)*.

80 See FC s 214(2) *(f)*.

81 See FC s 214(2) *(h)*.

82 See FC s 214(2) *(i)*.

disparities within and among the provinces (so-called 'horizontal imbalances'),[83] and the need to respond flexibly to emergencies and 'other factors based on similar objective criteria'.[84]

There is an internal tension in FC s 214. On the one hand, it acknowledges that the allocation of revenue is a matter of political judgment and, accordingly, makes the vehicle for allocation an act of Parliament. On the other hand, the section attempts to super-impose on this political process a layer of objectivity and justification. Whether it succeeds in doing so is another matter. Some have suggested that resource distribution across sub-national governments cannot be explained by efficiency and equity considerations alone: for these critics, the interests of central political agents are additional and significant determinants of DORA outcomes.[85] In short, it may be argued that notwithstanding the language

of objectivity in FC s 214, the practice of determining the prioritisation for funding remains largely a matter of political judgement.[86] This criticism is belied, to some extent, by the memorandum accompanying DORA. The memorandum offers careful and well-argued justifications for DORA's distributions. Indeed, the formula for equitable share is detailed and sophisticated and enhances the predictability and 'own revenue' properties of equitable share. It is arguable that what FC s 214 produces (and intends to produce) is a political judgment constrained by considerations of efficiency and equity.

(e) Other Allocations

The expression 'other allocations' is the language used in the Final Constitution to describe the forms of intergovernmental grants aside from equitable share. In practice, other allocations are always conditional grants: the conditions specify financial management and institutional requirements, the purpose of the expenditure and the required outcomes from the expenditure.[87] What this means in practice is that municipalities have little discretion with respect to how they spend funds received through conditional grants. Hence if Parliament were to increase conditional grant levels in relation to equitable share, this shift would indicate, rather roughly, that Parliament was not supporting local autonomy or decentralisation.[88] Research indicates that this is not so.[89]

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83 See FC s 214(2) *(g)*.

84 See FC s 21492) *(j)*.

85 See J Ahmad, S Devarajan, S Khemani & S Shah 'Decentralization and Service Delivery' *World Bank Policy Research Working Paper 3603* (May 2005) 7.

86 See P Whelan 'The Local Government Grant System Paper Two: Evaluating the Local Government Grant System' *IDASA Occasional Papers* (July 2003) 6.

87 See P Whelan 'The Local Government Grant System Paper One: A Researcher's Guide to Local Government Grants' *IDASA Occasional Papers* (July 2003) 8.

88 See IDASA 'Local Government in Budget 2005?' (9 May 2005) 154 *Budget Briefs* 7, available at http://www.idasa.org.za/ (accessed on 19 April 2007).

When it comes to conditional grants, there are three broad categories — capital grants, capacity building and restructuring grants and grants in kind. The current trend is towards the consolidation of grants. Hence the municipal infrastructure grant ('MIG') was created in 2003 to consolidate all funds for municipal infrastructure (capital grants).[90] If the primary purpose of equitable share is to cover the operational costs of providing services to indigent households; the primary purpose of MIG is to eliminate basic infrastructure backlogs.[91]

(f) Compliance with grant conditions

Supervising compliance with grant conditions is a key role of National Treasury. We have already mentioned that the Final Constitution introduces a distinction

between conditional and unconditional allocations in FC s 227(1)*(b)*. It provides no further content to the notion of a conditional allocation. The elaboration of the conditions and their enforcement falls to DORA. In terms of DORA, National Treasury may withhold conditional allocations if there is a 'serious or persistent material breach of the measures contemplated in section 216(1) of the Constitution'. Conduct relevant to determining whether a serious breach of FC s 216(1) has been committed encompasses 'non-compliance with the conditions to which an allocation is subject and the mismanagement of an allocation'.[92] It must be emphasised that the enforcement of grant conditions does not apply to equitable share. Stopping equitable share allocations to provinces is carefully controlled in FC ss 216(3) to (5). In terms of these controls, the transfer of equitable share may not be stopped for more than 120 days; the decision to stop equitable share is subject to parliamentary approval and the intervention of the Auditor-General who must report to Parliament; and before a decision is taken to stop a transfer, the affected province has the right to a hearing before a parliamentary committee. Moreover, the question of whether there has been a breach of the standards that would warrant stopping equitable share is justiciable.[93] Conditional grants can be stopped without meeting these requirements.[94]

Interestingly, the protections accorded to equitable share in FC ss 216(3) to (5) only apply to provincial equitable share. Equitable share allocated to municipalities

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89 Ibid at 7. See, further, § 27.8 infra.

90 A formula is used to allocate MIG across sectors (eg water and sanitation, electricity and so on) and across municipalities. The B Component (basic residential infrastructure) represents the largest component of MIG and within this component the largest allocation is to water and sanitation.

91 See National Treasury *Trends in Intergovernmental Finance 2000/2001 — 2006/07* (2004) 31–32.

92 See, for example, DORA 2001 s 23(3)*(d)*.

93 See *Ex Parte Chairperson of the Constitutional Assembly: In Re Certification of the Constitution of the Republic of South Africa, 1996* 1996 (4) SA 744 (CC), 1996 (10) BCLR 1253 (CC)('*First Certification Judgment*') at para 283. The regulatory role of National Treasury in relation to inter-governmental grants is explored in § 27.6*(a)* infra.

94 See § 27.6*(a)*, infra, 'Stopping Transfers of Grants and Equitable Share'.

is protected by MFMA s 39. MFMA s 39 introduces process requirements for stopping equitable share that are the same as those found in FC s 216. It is not clear why the Final Constitution has protected provincial equitable share allocations and not municipal allocations. MFMA s 39 has, in any event, neutralised this difference.

(g) Unfunded mandates

The term 'unfunded mandate' is used to describe an expenditure assignment that is not funded. In other words, unfunded mandates occur where a government agency has the responsibility of conducting a function but lacks suitable revenue raising capacity or does not receive a grant necessary for the performance of the function. Unfunded mandates are unacceptable within any fiscal structure; hence the principle that 'finance follows function'. This principle has been given the legislature's imprimatur of approval through DORA.[95] DORA requires that equitable share allocations for the funding of a particular function must be paid to the

organ of state that is responsible for the function. Conditional grants, both operating and capital, also follow function. The principle that finance follows function can be taken a step further: it implies that the organ of state responsible for the function should be allocated any revenue-raising powers *associated with the function*. While such powers must be consistent with national fiscal policy, they would typically include the right to charge users of the service.

The danger of an unfunded mandate typically arises in the context of intergovernmental assignments and delegations, both of which involve the transfer of responsibility for the performance of a function between spheres of government. However, there is a fundamental distinction between assignments and delegations: the former permanently transfers responsibility for the function; the latter merely transfers a temporary contractual responsibility.[96] It is important to distinguish assignments and delegations in respect of intergovernmental grants. While it will often be necessary for the delegating authority to pay operating or capital funds to the municipality undertaking the service on their behalf, such payments do not represent transfers between spheres of government in terms of DORA. They are payments for the provision of a service, and the applicable provisions of the PFMA govern compliance.[97]

27.4 The budget process

(a) Introduction

The Final Constitution treats budgeting in three provisions of FC s 215. The first provision articulates abstract virtues to be satisfied by budgets and budget processes. The second provision envisages regulatory national legislation. The third

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95 See, for example, Division of Revenue Act 7 of 2003 s 27(2).

96 See IDASA 'Local Government Powers and Functions' *IDASA Occasional Papers* (February 2004) 8.

97 Typically an agency agreement will constitute a 'future financial commitment' regulated by PFMA s 66 and will require authorisation by the Act and the signature of the Minister. See PFMA s 66(2)*(a)*). Furthermore, the department's accounting officer would have to comply with various obligations under PFMA s 38 if it was going to transfer funds to the municipality including written assurances from the municipality in respect of its financial management and control systems. PFMA s 38(1) *(j)*.

provision sets out primary content requirements for budgets. The rather technical treatment of budgeting in these provisions — in which the language of management predominates — belies a complex political process,[98] the failure of which undermines government.[99] Budgets, as financial plans, show how government's

resources will be generated and used over the fiscal period, and are the key instruments for promoting national objectives, strategies and programs. Our discussion in this section fills out these provisions and attempts to convey the centrality of the budget process in public finance.

(b) Constitutional Budgeting Principles

FC s 215(1) imposes a set of abstract principles on national, provincial and municipal budgets and on budgetary processes, namely that they 'must promote transparency, accountability and the effective financial management of the economy, debt and the public sector.' Because the national legislation envisaged in FC s 215(2) is designed to 'give effect' to FC s 215(1), it is possible to test judicially the extent to which national legislation (and the practice of all governments) satisfy FC s 215(1)'s rather abstract principles.

Transparency

Although the word 'transparency' is rather widely used, in the Final Constitution and in public finance legislation,[100] there has been no judicial consideration of its meaning in the context of public finance legislation and apposite public finance provisions in the Final Constitution. Discussions of the meaning of transparency in other contexts are not illuminating for our purposes.[101] Transparency reflects the government's candour about its structures, functions and operations. International instruments such as the Code of Good Practices[102] on Fiscal Transparency set out in the IMF Manual on Fiscal Transparency[103] ('the Code') provide useful guidance on the meaning of transparency. Three key ideas emerge from the Code: first, the need for

98 The act of budget-making is legislative in nature, whether it occurs at national, provincial and local level. See *Fedsure Life Assurance Ltd v Greater Johannesburg Transitional Metropolitan Council* 1999 (1) SA 374 (CC), 1998 (12) BCLR 1458 (CC) at para 45 (Constitutional Court held that the new constitutional order confers on local government the status of an autonomous and distinct component of government, such that the municipal councils are legislative assemblies entitled to carry out legislative acts, which acts include levying taxes and adopting budgets (that is, using the Court's language, determining 'appropriations to be made out of public funds.')

99 PFMA s 29 deals with a failure to pass a budget. In summary, the province is limited to spending as per the previous budget, and has limitations on how much it can spend in the first six months in which the budget should have been passed, and in each following month. There are no constitutional penalties for a failure to pass a budget.

100 See, for example, FC ss 41, 57, 70, 195, 215 and 216 and the objects clause in PFMA s 2.

101 See *Minister of Health and Another NO v New Clicks & Others* 2006 (2) SA 311 (CC), 2006 (1) BCLR 1 (CC). Chaskalson P refers to transparency, but does not discuss or describe what it means. Sachs J likewise refers to transparency, but refuses to be drawn on the content of principles transparency.

102 Note that this Code is implemented on a voluntary basis.

103 International Monetary Fund, Fiscal Affairs Department *Manual on Fiscal Transparency* (2001).

clarity on the roles and responsibilities in budget-making with clear mechanisms for the co-ordination and management of budgetary and extra-budgetary activities; second, the need for a clear legal and administrative framework for fiscal management where public spending is governed by comprehensive laws, and the need for openly available administrative rules where revenue raising measures have an explicit legal basis; and third, the requirement that the public be provided with full information on the past, current, and projected fiscal activity of government and that the budget documentation should specify fiscal policy objectives, the macro-economic framework, the policy basis for the budget, and identifiable major fiscal risks.

Our view is that South African legislation and practice meets this standard for

transparency. The elaborate oversight mechanisms found in the PFMA[104] and the MFMA[105] largely correspond to each of the three requirements in the Code as regards the budget process. As regards the implementation of the budget, the PFMA sets out the roles and the responsibilities of various office-bearers in monitoring expenditure and in achieving spending priorities and service delivery goals.[106] Stringent financial reporting and information requirements enable the National Treasury to track public spending per vote and at all levels of government. Monthly reports on expenditure at all levels of government are standard.[107] Thus, deviations from the budget, whether through under-spending, overspending, or wasteful spending are timeously noted

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104 The national budget-making process is slightly different from the spheres in so far as the national government also undertakes revenue sharing discussions as part of its budget-making process. Chapter 4 of the PFMA introduces national and provincial budgets, but the details of the process are set out in Part 3 of the PFMA Regulations. The regulations are aimed at assisting the accounting officers of departments (national and provincial) to fulfill their responsibilities in relation to budget making. To this end, there are prescriptions as to content as well as format. Chapter 6 of Part 3 of the PFMA Regulations provides, for example, that national and provincial budgets must conform to the formats determined by the National Treasury (regulation 6.2.1). As regards content, departments are limited in their ability to provide for roll-overs (regulation 6.4), and require approval of their treasury before introducing new transfers and subsidies to other institutions (regulation 6.3.1*(b)*). At the provincial level, the budget is tabled before the provincial legislature by the MEC for Finance in the form of a money bill. The money bill is called the Provincial Appropriation Bill. This bill is then discussed by committees of the provincial legislature, with provision for public comment on their reports on the draft Bill. The committees report back to the legislature with their recommendations on adoption of the Bill.

105 At the level of local government, each municipal council is required in terms of MFMA s 16 to 'approve an annual budget for the municipality before the start of the financial year'. Prior to the legislative act of budget-making lies a consultative process where budgets are determined. The Minister for Finance, acting with the concurrence of the Minister for Provincial and Local Government, may prescribe the format of municipal budgets and their supporting documents. The budget preparation process at local government level is headed by the Mayor and consultation with a variety of stakeholders is envisaged. Local and district municipalities are required to engage in budget-related consultations, and all municipalities are required to engage in consultation with the provincial treasury and, when requested, with the National Treasury. See MFMA s 21(2)*(d)*. Subsequent to the tabling of a local budget, a municipality is required in terms of MFMA s 23 to consider the views of, among others, the local community, the National Treasury and relevant provincial treasury.

106 See PFMA s 32, where monthly reports are required; PFMA s 39 which sets out the accounting officers' responsibilities in respect of budgetary controls; and PFMA s 40, on accounting officers' reporting responsibilities.

107 See PFMA s 32 and MFMA s 71.

and quick responsive action can be taken in order to control out-of-budget expenditure and to enforce limits on deviation from the budget. Independent regulatory oversight is also provided by the Auditor-General.[108] Although the legislative framework in which budgeting

takes place has been criticized,[109] the criticism has focused on the allocations of roles and responsibilities by the Final Constitution and not on than the budget process itself.

In addition to legislative prescriptions, a key facet of current government practice is the rolling three-year Medium-Term Expenditure Framework ('MTEF'). This projection of macro-economic assumptions, revenue and expenditure publicizes the government's fiscal policies, spending priorities and expenditure. National Treasury introduced the MTEF for the 1998/99 fiscal year and has entrenched the practice of demonstrating how revenue and spending will develop over the medium term.[110] The MTEF system clearly promotes the virtues articulated in FC s 215(1), particularly transparency and effective financial management through predictability.

Accountability

Accountability requires those responsible for discharging public office to account for or to take responsibility for their actions.[111] In developing this idea, we would suggest that there is an internal setting and an external setting for accountability. On the internal side, public officials are accountable to the executive for their conduct and performance such that 'they can and should be held accountable to *(i)* obey the law

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108 For more on the Auditor-General, see S Woolman & Y Schutte 'Auditor-General' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, December 2005) Chapter 24B. In terms of FC s 193, the Office of the Auditor-General is required to: 'audit and report on the accounts, financial statements and financial management of *(a)* all national and provincial state departments and administrations; *(b)* all municipalities; and *(c)* any other institution or accounting entity required by national or provincial legislation to be audited by the Auditor-General.' The powers and duties of the Auditor-General are set out in the Public Audit Act 25 of 2004 (Section 29 provides that the Auditor-General may carry out investigations and special audits if the Auditor-General considers it to be in the public interest or upon the receipt of a complaint or request.).

109 See IDASA 'How Transparent is the Budget Process in South Africa?' (1 October 2002) 109 *Budget Briefs* available at http://www.idasa.org.za/ (accessed on 19 April 2007):

> [S]orting out national and provincial roles and responsibilities and identifying who is accountable for what is by no means a simple task. The allocation of roles and responsibilities is complicated by the following factors: firstly, the constitution requires the equitable division of nationally collected revenues between national, provincial and local government; and secondly, it assigns joint or concurrent responsibilities for a number of important functions to the national and provincial spheres. While there has been progress in clarifying roles, they are still not well known or understood. As a result media, civil society, the public at large and even people within government, struggle to come to grips with the division of roles and responsibilities and have a poor understanding of who is responsible for what. This obviously impedes stakeholders from holding government to account.

110 The MTEF is not expressly prescribed in the Final Constitution or the PFMA. It was introduced in a budget speech by the Minister of Finance in 1998. The Minister stated the goals of the MTEF as follows: (1) to strengthen political decision-making in the budget process by linking budget allocations and service delivery; (2) to strengthen co-operative governance and decision making; (3) to enhance efficiency in spending so as to improve service delivery; and (4) to enable planning over the medium term. See T Manuel *Budget Speech of 1998* (1998), available at http://www.treasury.gov.za/.

and not abuse their powers, and (ii) serve the public interest in an efficient, effective and fair manner'.[112] Internal monitoring of its own performance, and exposure of failures and misdeeds, is a powerful tool against corruption within the executive. Several actions and mechanisms have been introduced in the PFMA and the MFMA to hold public officials and public servants accountable

for meeting their individual responsibilities.[113] Other institutions, such as the Office of the Public Protector, are also intended for this purpose.[114] A consideration of whether the Public Protector is adequately performing this task is dealt with elsewhere in this treatise.[115]

The external setting of accountability considers whether government as an institution is being held accountable for meeting its strategic planning goals and spending priorities. Only when the structure and the functions of government are apparent can it discharge this second form of accountability. Chapter 1 of the *Manual on Fiscal Transparency* states that '[e]stablishing clear roles and responsibilities for government and the rest of the public sector is a key aspect of fiscal transparency, because it provides a basis on which accountability for the design and implementation of fiscal policy can be assigned'.[116]

Effective Financial Management

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111 C Malena, R Forster & J Singh 'Social Accountability: An Introduction to the Concept and Emerging Practice' *Social Development Papers, Participation and Civic Engagement Paper No 76* (December 2004) 31–42.

112 Ibid at 2.

113 One example is the responsibilities of accounting officers set out in PFMA s 38. These responsibilities include ensuring that the relevant department or institution has and maintains effective, efficient and transparent systems of financial and risk management and internal control; reporting on the particulars of any unauthorised, irregular or fruitless and wasteful expenditure to the relevant treasury; and taking effective and appropriate disciplinary steps against any official who fails to comply with the PFMA or makes or permits unauthorised, irregular or fruitless and wasteful expenditure. The financial misconduct provisions in Chapter 10 define financial misconduct. They also provide for disciplinary proceedings against officials guilty of an act of financial misconduct, and offences and penalties for officers guilty of an offence of financial misconduct. Similarly, the MFMA s 32 provides for liability for political office bearers, accounting officers and officials in respect of unauthorised, irregular or fruitless and wasteful expenditure and requires reporting to the MEC for local government in the relevant province as well as to the Auditor-General. The accounting officer is required to report to the South African Police Service in the event that the expenditure constituted a criminal offence or if theft or fraud have occurred.

114 The Public Protector has the power to investigate and report on a wide range of activities within the public service and to take appropriate remedial action. Such remedial sction is limited in the Public Protector Act to mediation, conciliation and negotiation. The Public Protector may also offer advice on other appropriate remedies. As with the Auditor-General, the Public Protector plays an important role in accessing information and providing public reports on specific instances of alleged public service maladministration or corruption.

115 For more on the Public Protector, see M Bishop & S Woolman 'Public Protector' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, December 2005) Chapter 24A.

116 International Monetary Fund *Manual on Fiscal Transparency* (2001)('IMF *Manual*').

The third and final constitutional principle is that of effective financial management of the economy, debt and the public sector.[117] The National Treasury sets financial management norms and standards for state departments. It monitors their performance and reports any deviations to the Auditor-General. The principle of effective fiscal management requires the establishment of a legal and administrative framework for fiscal management, which, in turn, implies a system

that regulates budgetary and extra-budgetary activities, taxation and ethical standards of behavior.[118] We have shown that the legislative framework in South Africa systematically sets out the roles and the responsibilities of state institutions as regards budgeting, spending, and reporting on public. This legislative framework offersd a performance management assessment framework for budgeting and financial management.[119] The essential elements of the legislative reform process that gave rise to this oversight framework have been described at length elsewhere in the secondary literature.[120]

Municipalities are subject to the Treasury norms and standards contemplated in FC s 216(1)*(c)* as well as significant national regulation and supervision. Municipalities, however, assume responsibility for their own effective financial management in the budget process.

(c) Legislation Regulating Budgets

FC s 215(2)*(a)* requires that national legislation prescribe the form of national, provincial and municipal budgets. The 'form' of the budget is something more than the functional layout of the document, although the layout too has been prescribed.[121] The legislation has understood its task in FC s 215(2)*(a)* in substantive terms and the tendency has been to provide for the minimum content of budgets.[122] At national and provincial level, budget formation is guided by the PFMA and the

117 See I Abedijan 'Fiscal and Monetary Policy Management in South Africa' *1994-2005 Pan-African Investment and Research Services* (October 2005) 11, available at http://www.aprm.org.za/docs/APROct05.pdf (accessed on 4 May 2006)(Provides a history of fiscal policy in post-apartheid South Africa and a review of the reform process undertaken by the government.)

118 IMF *Manual* (supra) at 26.

119 Abedijan (supra) at 11.

120 Ibid: 'The main aims of these legislative reforms may be highlighted as follows: *(a)* establish an appropriate link between strategic objectives and expenditure plans; *(b)* ensure fiscal discipline within the constraints of what can be afforded; *(c)* promote the efficient use of resources, by decentralising and delegating decisions to where they are best made; *(d)* improve incentives and empowering managers to make effective decisions – while at the same time keeping public sector executives accountable for their managerial decisions. *(e)* introduce transparency and promotion of accountability; and, *(f)* introduce accessibility of information and budget estimates.'

121 A unified approach makes sense in so far as monitoring of diverse forms of budgets is logistically challenging. Coherence promotes greater accountability and transparency in respect of the budgets as the opportunity for comparison between municipalities becomes possible.

122 See PFMA s 27(3) for national and provincial budgets and MFMA s 17 for municipal budgets.

Treasury Regulations. At local level, this process is governed by the MFMA and National Treasury guidelines.[123]

The Final Constitution requires that national legislation provide a schedule for when national and provincial budgets must be tabled. The PFMA accomplishes this task by requiring the Minister for Finance to table the annual budget (national) for a financial year in the National Assembly before the start of that financial year.[124] Provincial legislatures are required by the same provision to table

the provincial annual budget for a financial year in the provincial legislature not later than two weeks after the tabling of the national budget. The MFMA regulates the timing of municipal budgets, requiring such budgets to be tabled 90 days ahead of the new financial year.

FC s 215(2)*(c)* also requires each sphere of government to show the sources of revenue and the way in which proposed expenditure will comply with national legislation. The specific nature of these requirements are reflected in MFMA s 17 for municipal budgets and PFMA s 27(3) for national and provincial budgets.

(d) Content of Budgets

Requirements relating to the content of budgets are prescribed in FC s 215(3):

> Budgets in each sphere of government must contain *(a)* estimates of revenue and expenditure, differentiating between capital and current expenditure; *(b)* proposals for financing any anticipated deficit for the period to which they apply; and *(c)* an indication of intentions regarding borrowing and other forms of public liability that will increase public debt during the ensuing year.

Estimates of Revenue and Expenditure

Revenue referred to in the constitutional provision refers to all money collected by the government in the course of its operations. For accounting purposes, receipts are divided into taxes, sales, transfers, fines, interest, dividends and rent on land as

123 There are many budget guidelines available for local government. One example is the *MFMA Circular No 28 — Budget Content and Format for the 2006/07 MTREF* available at http://www.treasury.gov.za/legislation/mfma/circulars/circular 2028.aspx (accessed on 9 March 20079). This circular provides guidance on content and format for municipal budget documentation for the 2006/07 financial year.

124 See PFMA s 27.

well as financial transactions in assets and liabilities.[125] Expenditure is categorized[126] and referred to as 'payments' and is divided into three broad categories: namely current payments, transfers and subsidies and payments for capital assets.

Current payments encompass compensation of employees, payment for goods and services,[127] interest and rent on land[128] and financial transactions in assets and liabilities.[129]

Transfers and subsidies include funds that are transferred by government to other institutions, businesses and individuals. This item encompasses payments for which no goods or services are received in return. The category is further subdivided into the recipients of funding, separating transfers from expenditure controlled directly

125 See National Treasury *Budget Review — 2006* (2006), available at http://www.treasury.gov.za (accessed on 21 April 2007):

> *Taxes* are classified according to the type of activity on which they are levied, including income, profits, consumption of domestic goods and services, and international trade. *Sales* are disaggregated into sales of capital assets and other sales. Transfers are unrequited receipts; i.e. the party making the transfer does not receive anything of similar value directly in return. These are classified according to unit, for example, other government units, private corporations, households, etc. *Fines* consist of all compulsory receipts imposed by a court or quasi-judicial body. *Interest, dividends and rent on land* includes all revenue associated with ownership of financial assets and land.

Ibid at Annexure D, 'Government Accounts' 205.

126 Each government payment is classified in two ways, according to its functional and economic characteristics:

> The main function of the economic classification is to categorize transactions according to type of object or *input*, for example, compensation of employees, interest payment, etc. This is crucial, as data must be classified this way for calculation of the surplus or deficit, as well as government's contribution to the economy in the form of output, value added and final consumption. The functional classification is complementary to the economic classification. It serves to distinguish transactions by policy purpose or type of outlay. This is also referred to as expense by *output*. Its main purpose is to facilitate understanding of how funds available to government have been spent. Examples would be health, education, administration, judicial services, and so on. The broad categories in the functional classification are listed below: *General government services* refer to those indispensable activities performed by the state, the benefits of which cannot be allocated to specific groups, businesses or individuals. These include fiscal management, general personnel management, and conduct of external affairs, public order and safety. *Protection services* include all services that ensure the safety and security of communities, namely defence, police, justice and prisons. *Social services* are supplied directly to the community, households or individuals, and include education, health care, social security and welfare, housing, community development and recreational and cultural activities. *Economic services* cover government expenditure associated with the regulation and more efficient operation of the business sector. This category incorporates government objectives such as economic development, the redressing of regional imbalances and employment creation. Economic services provided to industries include trade promotion, geological surveys and the inspection and regulation of particular industries.

Ibid at 207.

127 According to the National Treasury, '[t]his item refers to all government payments in exchange for goods and services, but excluding capital assets and goods used by government for construction of and improvements to capital assets'. *Budget Review — 2006* (supra) at 205.

128 Ibid at 205: 'This item is defined as payment for the use of borrowed money (interest on loans and bonds) and use of land (rent). It is distinguished from the repayment of borrowed money, which is classified under *financing.*'

by departments (which would fall under current payments). The category includes current as well as capital transfers. The National Treasury has reported that

> [i]n the past, capital expenditure included capital transfers. This led to ambiguity, because these numbers could be interpreted as exaggerating the actual contribution to capital formation made by government. By including capital transfers with other transfers, a much clearer picture is provided of government spending on capital.[130]

The third category, 'payment for capital assets', otherwise referred to as capital expenditure, represents expenditure on capital works: such expenditure may cover capital goods or durable goods, and assets such as roads and bridges, dams, power plants, schools and hospitals. This category also covers purchases of new assets, as well as extensions and improvements to existing assets and includes own-account construction. Own-account construction occurs when government units engage in capital projects on their own account.[131] Capital expenditure is stated as a separate item because it shows government's contribution to capital formation and its spending on new infrastructure, including improvements or extensions to existing infrastructure. Capital assets are divided into five categories: buildings and other fixed structures, machinery and equipment, cultivated assets, software and other intangible assets and land and sub-soil assets.[132]

OS 03-07, ch27-p31

Differentiating between capital and current expenditure

FC s 215(3)*(a)* requires a distinction between capital and current expenditure. Presumably, this distinction is aimed at improving accountability.[133] Critics argue that such a regime allows governments to hide deficits, especially if annual capital depreciation costs were not charged as current expenses, a normal accounting practice. Another view is that capital budgeting might encourage governments to use debt to finance capital expenditures since most public capital projects that might benefit society do not generate revenues that can be directly seen to cover depreciation and interest expense. Moreover, some capital expenditures are not easy to account for on an accrual basis because of the difficulties in measuring the depreciation of public capital.

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129 Ibid: 'This item consists mainly of lending to employees and public corporations for policy purposes. The reason for expensing this payment rather than treating it as financing is that, unlike other financial transactions, the purpose of the transaction is not market oriented.'

130 Ibid at 206.

131 Ibid.

132 Ibid.

133 A capital expenditure account should include the flows and stocks related to public assets and liabilities setting out clearly the net capital position of the government. Without capital budgeting, proponents argue that deficit-constrained governments would defer major expenditures on capital programs and maintenance, since the benefits of such expenditures would not be immediate relative to the costs that would be incurred. According to proponents of this approach, governments would be more willing to invest in infrastructure if capital expenditures were accounted for separately over the life of an asset. See J Mintz & R Preston (eds) *Capital Budgeting in the Public Sector* (1993) available at http://strategis.ic.gc.ca/epic/internet/ineas-aes.nsf/en/ra00003e.html (accessed on 22 June 2006).

Proposals for financing any anticipated deficit

This category, identified in FC s 215(3)*(b)*, refers principally to government debt, whether raised through government bonds, direct loans, foreign loans or otherwise. In the budget, the category 'financing' sets out 'all financial transactions other than *financial transactions in assets and liabilities*, which are included as part of receipts and payments. Items recorded under *financing* reflect the sources of funds obtained to cover a government deficit or the use of funds available from a government surplus.'[134] The main items in this category include government borrowing, repayments of the principal component of loans incurred in previous periods, and transactions in government deposits and cash balances.[135] In our view, the terms 'proposals for financing' and 'an indication of intentions regarding borrowing' in FC ss 215(3)*(b)* and *(c)* are a reference to the fact that the debt has not been not raised at the time the budget is drafted.

27.5 Spending public funds

Expenditure has many dimensions: control of revenue funds and bank accounts, contracting, liabilities and security, borrowing, investments and wrongful expenditure. Very few of these issues are covered in FC Chapter 13. Chapter 13 covers only national and provincial revenue funds, procurement, government guarantees, and municipal and provincial loans. Some important issues relating to so-called

'sub-sovereign' liability are suggested but not developed in Chapter 13. These issues have been left for parliament and government to resolve through legislation and regulation. We discuss the manner of government's resolution of these expenditure issues in the remainder of this section.

(a) The Revenue Funds

The treatment of the revenue funds in the Final Constitution has a practical importance that requires further elaboration. There are two dimensions regulating the flow of funds in and out of the revenue funds. The first is that *all* revenue raised by national government must be paid into the National Revenue Fund.[136] This proposition does not mean that national government has only one bank account, but that all money is accounted for in one government-controlled fund and all money is deemed to have been paid out of the same fund. This first dimension impacts outsourcing and security arrangements in which service providers and lenders often seek to exercise control over the flow of revenue.[137] The second dimension controls withdrawals from the funds. It is a constitutional principle — which might be termed the *appropriation principle* - that no funds can be withdrawn from a National or Provincial Revenue Fund under the Final Constitution, unless they are 'appropriated' in terms of an Act of Parliament, or a Provincial Act, or are paid by way of a 'direct

134 See National Treasury *Budget Review — 2006* Annexure D 'Government Accounts' (supra) at 206 (Items under 'financial transactions in assets and liabilities' represent transactions in items on the balance sheet.)

135 Ibid.

136 FC s 213(1). One exception is permitted, namely that of money reasonably excluded by an Act of Parliament.

charge' which is provided for in the Final Constitution or an Act of Parliament or a Provincial Act.[138] This requirement is reflected in PFMA ss 11(1) *(b)* (i) and (ii) and MFMA s 15. 'Appropriation' and 'direct charge' are not defined in the Final Constitution or the public finance legislation.

We understand an 'appropriation' to be an authorisation made by an Act of Parliament directing payment out of the National Revenue Fund for specific purposes.[139] Appropriations are divided into votes. These votes determine the funds available to be spent in a financial year. Parliament debates and votes on how these funds will be spent. By contrast, a 'direct charge' constitutes an authorised payment from the National Revenue Fund for which no appropriation is necessary. Liabilities or payment obligations which involve direct charges must be paid regardless of whether or not they have been budgeted for in the national

budget. This arrangement has important implications for non-national spheres of government and creditors. For example, a province's equitable share is a direct charge against the National Revenue Fund (see FC s 213(3)) and gives provinces a measure of financial autonomy *vis a vis* the national budget process. The PFMA has also elevated payments 'under a guarantee, indemnity or security' to the level of direct charges.[140] The intention behind the elevation of direct charges is to give government creditors an assurance of immediate payment that need not be mediated by a future legislative process. Prior obligations of the national government are also direct charges against the national revenue fund.[141]

The provincial revenue funds are similarly regulated. Each province has a provincial revenue fund into which all revenue raised by the province is paid.[142] Money is withdrawn by way of appropriations or direct charges. This process is provided for in the province's constitution, if it has one, or other provincial

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137 For example, borrowings are sometimes secured by the inflow of a revenue stream. The creditor has an interest in isolating this inflow of revenue from other income streams of government. Often, a separate bank account will be established for this revenue stream. This separate account satisfies the requirement that the money must first be paid into the revenue fund, before being paid out in terms of an authorized appropriation, while also satisfying the creditor's requirement that the revenue be kept separate from other revenue of the branch of government involved in the deal.

138 See FC ss 213 and 226 (Apply to appropriations from the national and provincial revenue funds respectively.)

139 National Treasury describes direct charges as a statutory appropriation. These are called statutory or standing appropriations because they are funds that have already been earmarked, by prior legislation, for these purposes and are therefore not available for other regular annual expenditures. All other appropriations are made by vote and are referred to as 'votes'. See National Treasury *Budget Review — 2001* (2001) 46, available at http://www.treasury.gov.za (accessed on 22 April 2007).

140 See PFMA s 70(2)*(a)*.

141 The direct charges raised in the 2006 national budget are the state debt cost, provincial equitable share, skills development funds, other statutory amounts, and standing appropriations. See National Treasury Budget Review — 2006.

142 FC s 226(1).

legislation.[143] Direct charges against a provincial revenue fund include revenue allocated through a province to local government in that province in terms of FC s 214(1), that is, equitable share.[144] Once again, this arrangement gives municipalities autonomy *vis a vis* the provincial budget process. Provincial direct charges are further regulated by FC s 226(4)*(a)*. It provides that national legislation may determine a framework within which a provincial Act may in terms of subsection (2) *(b)* authorise the withdrawal of money as a direct charge against a Provincial Revenue Fund. This provision was introduced by the Constitution of the Republic of South Africa Second Amendment Act 61 of 2001 and is presumably designed to maintain national regulatory control over direct charges at provincial level. We are not aware of any legislation enacted under FC s 226(4).

There is no municipal revenue fund. However, a primary municipal bank account is required by the MFMA.[145] The regulation of the primary municipal account in the MFMA has in common with national and provincial revenue funds the requirement that all money for the provision of municipal services be paid into this account.[146] One clear difference between national and provincial revenue funds and municipal funds if that there is no equivalent of a direct charge at municipal level on the primary municipal bank account.

(b) Contracting

Government contracting is regulated by FC s 217. The section is often-cited in the case law although the individual virtues it imposes on government contracting

have not been judicially considered. Aside from the elevation of competition to a constitutional requirement and the allowance made for affirmative procurement, FC s 217 has little practical impact on government contracting. The process of contracting is regulated in an ever-growing body of South African legislation that covers standard procedural and substantive controls[147] and affirmative procurement.[148] In practical terms, the constitutional provisions that are most significant for contracting are those that regulate payments from the revenue funds and those that control borrowing and guarantees.[149]

(c) Government Borrowing

143 FC s 226(2).

144 FC s 226(3).

145 MFMA s 8.

146 See MFMA s 8(2).

147 Process and substance controls are set out in the Municipal Supply Chain Management Regulations Notice 868 of 2005 *Government Gazette* 27636 (30 May 2005), the PFMA and regulation 16A of the Treasury Regulations. In addition, various practice notes have been issued under the PFMA. Practice Note Number SCM 1 of 2003 provides general conditions of contract ('GCC') and standardised bidding documents. Practice Note Number SCM 2 of 2003 provides threshold values for the invitation of price quotations and competitive bids. Practice Note Number SCM 3 of 2003 provides detailed guidelines on the appointment of consultants. In addition, policy statements have been published by National Treasury. See, eg, National Treasury 'Policy Strategy to Guide Uniformity in Procurement Reform Processes in Government' (September 2003).

We have placed government borrowing within this section dealing with expenditure because it is not a source of funding recognised in FC s 227. It neither moves through the inter-governmental system nor is it an own source of revenue. Borrowing is also typically tied directly to expenditure. Most other sources of revenue, such as taxes and unconditional grants, flow into a pool of funds that is subsequently allocated for expenditure. Although the treatment of borrowing in the Final Constitution is sparse, the text does set out principles that have implications far wider than borrowing per se.

Borrowing for capital and current expenditure

FC s 230 was amended by the Republic of South Africa Second Amendment Act[150] and subsequently bifurcated into two rather important provisions dealing, separately, with provincial loans and municipal loans. Both provisions allow provincial and municipal borrowing for capital and current expenditure but restrict borrowing for current expenditure such that these loans 'may be raised only when necessary for bridging purposes during a fiscal year'. This seemingly innocuous

qualification has profound implications, particularly for municipalities. In order to understand these implications, it is necessary to explain the distinction between capital and current expenditure.

'Capital expenditure' is undefined in the legislation, but has an accounting definition alluded to in regulation 6.7.1*(d)* of the Treasury Regulations.[151] The Economic Reporting Format referred to in regulation 6.7.1*(d)* is set out in Annexure A to the 'Budget 2006 — National Medium Term Expenditure Estimates'. In this document 'capital assets' are defined 'either as a) goods that can be used continuously or repeatedly in production for at least a year and from which future economic benefits or service potential are expected to flow to the owner of the asset or b) land and sub-soil'. In summary 'capital expenditure' is government expenditure on assets that last for a year or more, such as buildings, land, infrastructure and equipment or immovable property. 'Current expenditure', by contrast, largely means salaries and wages, goods and services utilised by the government, and transfers and subsidies.[152] In effect, it deals with those expenses not related to expenditure for capital assets. Finally, the phrase 'bridging purposes' or the equivalent, 'bridging finance', is not defined in the PFMA or the Treasury Regulations. In the Borrowing Powers of Provincial Governments Act ('BPPG'),[153] the phrase is defined as 'funds raised during a financial year in the Republic and denominated in rand to finance

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148 Affirmative procurement is regulated (not always coherently) by the Preferential Procurement Policy Framework Act 5 of 2000, the Preferential Procurement Regulations, 2001 (Government Notice No R 725 *Government Gazette* No 22549 (10 August 2001)), the Broad-Based Black Economic Empowerment Act 53 of 2003 and the recent codes issued under the BEE Act.

149 For a detailed treatment of FC s 217, see P Reyburn & G Pennfold 'Public Procurement' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, December 2003) Chapter 25.

150 Act 61 of 2001.

151 Regulation 6.7.1*(d)* states that 'Capital expenditure referred to in the PFMA is the same as payments for capital assets in the new Economic Reporting Format.'

current expenditure in anticipation of the receipt of current revenue during that particular financial year, and includes an overdraft on a bank account.'

Given these various meanings for *capital expenditure* and *current expenditure*, FC s 230 and 230A make municipal and provincial financial failure a genuine possibility because neither may raise long-term loans to avoid deficits in current expenditure. It is important to note that default of this kind is not envisaged for

national government. The Final Constitution nowhere prohibits national government from raising long-term loans for current expenditure. PFMA s 71*(a)* expressly allows such loans.[154] National legislation has placed a somewhat less onerous gloss on these provisions and, at the same time, has introduced important differences between provincial borrowing and local borrowing.

Provincial Borrowing

In principle, provincial borrowing is subject to the same constraints as municipal borrowing: namely, long-term loans cannot be raised for current expenditure. This restriction finds it way into national legislation such as the BPPG.[155] One reason for the restriction at the provincial level may be that Provinces are primarily funded through equitable share, a revenue source that tends to expand to meet expenditure requirements. However, it may also be argued that the Final Constitution does not support provincial fiscal autonomy. Indeed, while FC s 214(2)*(b)* expressly requires that deliberations around equitable share — that culminate in DORA allocations — take account of national debt and national obligations, there is no equivalent mention of provincial debt or local debt. Accordingly, there is no constitutional guarantee that the legislature will cater appropriately for the debt and other obligations of provincial governments. However, the tendency of equitable share to meet provincial expenditure needs is reflected in BPPG s 2 which concerns the establishment and responsibilities of the Loan Co-ordinating Committee. Section 2*(c)* provides that the Committee 'shall in its deliberations take account of the total debt of each provincial government and the bodies controlled by it and of their contingent

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152 For the more detailed accounting treatment of current expenditure, see National Treasury *Budget 2006 Medium Term Expenditure Estimates* (2006) Annexure A 6. For a statutory definition of capital expenditure, see the Borrowing Powers of Provincial Government Act 48 of 1996 ('Any payment by a provincial government for the procurement of new or existing tangible or intangible assets with a value higher than a prescribed value and with a normal life expectancy of more than one year, and includes- payment for the acquisition of goods and services for the purpose of improving, prolonging the expected working life of, and rebuilding or reconstructing an existing fixed asset; a capital transfer to another person or body; the granting and payment of a money loan of which the proceeds will be used by the recipient of such a loan for capital expenditure; any other expenditure which is from time to time classified by regulation as a capital expenditure; the repayment of an outstanding loan which is due for redemption or conversion, provided that the proceeds of such conversion shall be used for the financing of expenditures contemplated in subparagraphs *(a)*, *(b)*, *(c)* and *(d)*, but excludes a payment by a provincial government in connection with the normal maintenance of a capital asset intended to keep such asset in its original state of repair.')

153 Act 48 of 1996.

154 This section provides that the Minister may borrow money in terms of PFMA s 66(2) to 'finance national budget deficits'.

155 Act 48 of 1996.

liabilities, risks, and ability to service their debt, and which shall report thereon to the Commission'. In short, it is arguable that provincial equitable share is intended to render provincial borrowing largely unnecessary. While this makes the prospect of provincial financial failure unlikely, it has the further consequence of restricting provincial borrowing.[156]

Having provided a legislative basis for maintaining provincial solvency, the BPPG whittles down the enabling constitutional provision for provincial borrowing in FC s 230(1) and imposes legislative barriers to provincial borrowing that are not provided for in the Final Constitution. One extraordinary limitation set out in BPPG s 3(3) provides that, '[a] provincial government shall not commit itself to any financial product other than bridging finance, loans or such other

product as may be prescribed, which creates *an interest or any other exposure* of a financial or equivalent kind' (emphasis added). The Act provides no definition of what is meant by either 'financial product' or 'an interest'. If one confines one's analysis to the four corners of the English text, it is difficult to determine precisely what was intended by BPPG s 3(3).

However, the Afrikaans text of the Act offers some insight. The Afrikaans text suggests that the provincial government cannot bind itself to a 'financial product' which creates 'rente' or 'any other exposure of a financial or equivalent kind'. If one were to make use of the *ejusdeum generis* rule as an aid to interpretation, it would suggest that the 'other exposure' shares some common denominator with 'rente'. 'Rente' signifies not 'an interest' of a generalised nature, but 'interest' in the sense of 'interest which is payable'. The 'other exposure' would therefore be an exposure to the payment of something that is similar to interest (in the form of 'rente') such as finance charges and the like.

If interest is taken to mean a form of finance charge, then BPPG s 3(3) is highly restrictive of provincial borrowing. It would extend to loans for capital expenditure which are not limited by FC s 230.

A further limitation to provincial borrowing should be mentioned in this context. This limitation is on the borrowing powers of provincial public entities. In terms of PFMA s 66, only provincial government business enterprises may be authorised to borrow money for capital expenditure.[157] The determining factors in the classification of a provincial government business enterprise are the fact that it is not funded from the provincial revenue fund, and that it carries out business activities in accordance with ordinary business principles.

The effect of the limitations in the BPPG and the PFMA is that a province may only carry out capital expenditure by funding the expenditure itself, by entering into a public private partnership ('PPP') agreement or by setting up a business enterprise that has sufficient revenues to borrow money. In this regard, many provinces do not have the ability to raise finance in the market cheaply. Furthermore, provincial government business enterprises are not easy to establish, and the authorisation to borrow follows scrutiny by National Treasury. As a result, provinces have limited

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156 The interaction between the BPPG and the PFMA warrants mention. PFMA s 66(1)*(c)* clearly subjects provincial loans to the limits set out in the BPPG. This restriction does not apply to other future financial commitments including guarantees, suretyships and other financial transactions.

157 Certain provincial public entities may be authorised to borrow money for bridging purposes.

access to the borrowing market. The legislative barriers to provincial revenue raising and borrowing may have had an impact on the service delivery ability of provincial government. Provincial goverment is incentivised in this way to collaborate with the private sector on capital expenditure projects, either through PPP projects or joint ventures that involve private investment outside of the PPP framework.

Municipal Borrowing

National Treasury has developed a highly coherent framework for municipal borrowing. A key document is National Treasury's 'Policy Framework for

Municipal Borrowing and Financial Emergencies' ('the Municipal Borrowing Policy') which was gazetted in 2000.[158] The policy emphasises the need to enhance municipal access to private capital markets but stresses,

> that in pursuing this goal, central government wishes to avoid the apartheid-era practice of generally underwriting municipal borrowing and, in effect, transferring municipal liabilities onto itself. Government's central objective is not to produce a short-term inflow of 'soft' or subsidised funds to municipalities. It is, rather, to develop a sustainable market for municipal debt where risk is properly priced. In the long term an environment needs to emerge where loan finance becomes increasingly available and decreasingly costly to municipalities because the regulatory and institutional frameworks encourage appropriate behaviours, municipalities are increasingly well managed, and ancillary market facilitators are increasingly active.[159]

National Treasury's vision (as set out in the policy document) has four core elements: the restriction on borrowing for current or operational expenditure; the prohibition of sovereign guarantees for municipal borrowing;[160] the expansion of permitted forms of municipal security; and the creation of an institutional framework for municipal default and bankruptcy.[161] FC s 230A provides constitutional support for the first and third of these elements.[162] FC s 230A(1)*(a)* allows Municipal Councils to raise loans for capital or current expenditure, but allows loans for current expenditure to be 'raised only when necessary for bridging purposes during a fiscal year'. The MFMA expresses this restriction by creating a distinction between long-term and short-term debt and restricting the uses of long-term debt. Hence, MFMA s 46(1) states that, '[a] municipality may incur long-term debt . . . only for the purpose of *(a)* capital expenditure on property, plant or equipment to be used for the purpose of achieving the objects of local government . . .; or *(b)* re-financing existing long-term debt.' The key consequence of these provisions is that municipalities may not borrow to avoid operational deficits and hence can default on their financial obligations for financial reasons. Furthermore, this outcome is not softened by national legislation as is the case with provincial borrowing. Indeed, section 153(1)*(c)* of the MFMA provides

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158 The Borrowing Policy was published in Government Gazette No 21423 (28 July 2000).

159 Ibid at 6.

160 See § 27(5)*(c)* infra, under the heading 'Sub-Sovereign Debt'.

161 See § 27(6)*(c)* infra.

162 FC s 230A is the result of an amendment introduced through Constitution of the Republic of South Africa Amendment Act 34 of 2001.

expressly for default in a detailed chapter dealing with financial problems. The provision states that '[a] municipality may apply to the High Court for an order . . . to terminate the municipality's financial obligations to creditors, and to settle claims in accordance with a distribution scheme referred to in section 155'

A further key element is set out in FC s 230A(1)*(b)*. According to the section, a 'Municipal Council may, in accordance with national legislation . . . bind itself and

a future Council in the exercise of its legislative and executive authority to secure loans or investments for the municipality'. The national legislation referred to is the MFMA which provides impressive security provisions. In terms of MFMA s 48(2), appropriate security includes, 'ceding as security any category of revenue or rights to future revenue [which would include equitable share] . . . undertaking to retain revenues or specific municipal tariffs or other charges, at a particular level or at a level sufficient to meet its financial obligations . . . undertaking to make provision in its budgets for the payment of its financial obligations, including capital and interest . . . agreeing to restrictions on debt that the municipality may incur in future until the secured debt is settled or the secured obligations are met'. These provisions allow for a fettering of legislative and executive discretion and indicate how seriously the national legislature considers the issue of political risk in respect of municipal borrowing.[163] The scope of the constitutional and MFMA provisions are, however, limited to security for loans and investments, and do not extend to security for the payment of monies in respect of general contracts.

FC s 230A is not undercut by national legislation. There is no equivalent of the BPPG at municipal level and borrowing for capital expenditure occurs and is encouraged.[164] Indeed, National Treasury considered limiting the amount of long-term debt (for example, by prescribing ratios of the debt service burden to revenues) and chose not to do so.[165] Furthermore, the security arrangements permitted in FC s 230A(1)*(b)* and the MFMA are expansive and are presumably intended to counter-balance the exclusion of national and provincial guarantees.[166]

Sub-Sovereign Debt

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163 In a speech given by the National Minister of Finance on the Second Reading Debate on the Municipal Finance Management Bill on the 11th September 2003, it is stated that the intention of the insertion of section 230A was to reduce the risk premium for municipalities when they borrow funds. The Minister referred to national government's commitment to facilitating a municipal borrowing market and allowing municipalities to lower their costs of borrowing for capital expenditure and to attract investors. Accessed from http://www.treasury.gov.za/comm_media/speeches/2003/2003091101.pdf (accessed on 9 March 2009).

164 See National Treasury (2004) 33.

165 See Municipal Borrowing Policy (supra) at 16.

166 MFMA s 48 provides a long list of legitimate security options in s 48(2). However, certain restrictions should be noted. For example, a municipality may undertake to effect payments directly from a source to secure payment of a debt, however, s 8(2) provides for categories of money to be paid directly into the primary bank account of the municipality. A further example pertains to the s 48(4) restrictions over the way that security over capital assets may limit their availability in service provision.

An issue closely aligned to the question of borrowing for current expenditure is that of national government guarantees for provincial and municipal debt. This critical issue follows from the premise that the national government cannot fail financially, while municipal governments can. National guarantees of municipal debt would insulate municipalities from financial failure, if they were possible.

The Final Constitution allows this matter to be settled by national legislation.[167] National legislation sets its face emphatically against national or provincial guarantees for municipal debt. However, the terms national legislation employs in barring such guarantees are rather peculiar. MFMA s 51 states that '[n]either the national nor a provincial government may *guarantee* the debt of a municipality or municipal entity except to the extent that Chapter 8 of the Public Finance Management Act provides for such guarantees'.[168] The PFMA regulates financial management in the national government and provincial governments and Chapter 8 relates to the loans, guarantees and other commitments of these governments. Chapter 8 of the PFMA does not expressly provide at all — let alone to some extent — for national or provincial governments to guarantee the debts of municipalities. It is curious that the drafter of the MFMA refers to Chapter 8 of the PFMA in this context, knowing full well that the PFMA does not provide for such guarantees. It is possible that the drafters of the MFMA anticipated an amendment of Chapter 8 of the PFMA which has not yet occured. As things stand, however, the MFMA and the PFMA, read together, prohibit national and provincial guarantees of municipal debt.

Further clarification of terminology used in this context illuminates other important issues involving municipal debt. The term 'sub-sovereign' is used to describe municipal debt that is explicitly or implicitly guaranteed by national or provincial governments. In circumstances where a local government is a 'sub-sovereign', creditors understand that the sovereign will not allow for municipal financial failure, and under these circumstances the municipal credit rating will be the same as that of the national or provincial governments that guarantee their debts. The MFMA (in Chapter 13 and elsewhere) makes it clear that South African municipalities are not sub-sovereign in this sense.

27.6 Monitoring and witholding public funds

167 See FC s 218(1).

168 Given that the prohibition in the MFMA relates to guarantees it is necessary to provide a brief parenthetical background on the meaning of the word 'guarantee' which, in the context of South African law, is ambiguous. A distinction is made in South African law between the contract of indemnity, which imposes an *original* obligation to make good any loss suffered by a creditor — and the obligation of a surety, which is *accessory* to that of the principle debtor. Documents which are often called 'bank guarantees' are not contracts of suretyship at all but are promises to pay conditional upon the happening, or non-happening, of a stated event. See *Hazis v Transvaal & Delagoa Bay Investment Co Ltd* 1939 AD 372, 384; *SA Warehousing Services (Pty) Ltd and Others v South British Insurance Co Ltd* 1971 (3) SA 10 (A). When the word 'guarantee' is used in a contract it may mean either indemnity or suretyship. It is a question of interpretation in which the use of the word is not viewed in isolation. See *List v Jungers* 1979 (3) SA 106 (A). The question to be answered is whether 'guarantee' means indemnity, or suretyship, or both, in the context of the MFMA. In our opinion it means both those legal concepts since the tenor of the statute is to instill the need for financial probity and responsibility in local government by way of making certain transactions independent of aid from national or provincial government. Consequently, the widest meaning should be given to the word since that reading, in our view, gives effect to the legislative intention.

(a) Regulation by National Treasury

The final stop on the pathway through raising, allocating, budgeting and spending public funds is monitoring, withholding and regulating the use of public funds. This legally and politically complex area involves a primary regulatory role for National Treasury and (perhaps surprisingly) an important intervention role by provinces during moments of municipal crisis.

Because the functioning of National Treasury must be established through legislation, two questions arise: first, whether the Final Constitution has a particular vision of National Treasury's role (in FC s 216 and elsewhere); and second, whether the legislation that establishes National Treasury's role is in keeping with this constitutional vision. These questions are important because National Treasury is, arguably, the most important government department, and its role is, at times, contested.

The Scope of National Treasury's Regulatory Role

FC Chapter 13's vision for National Treasury seems to be a narrow one. However, to understand even the limited role contemplated by FC Chapter 13, a basic command of the lexicon is necessary. The phrase 'treasury control' relates to rather formal matters set out in the sub-provisions of FC s 216(1). FC s 216(1)*(a)* relates to 'generally recognised accounting practice' (sometimes known as 'GRAP') which is one of many forms of accounting treatment.[169] 'Uniform expenditure classifications' referred to in FC s 216(1)*(b)* is expanded in the MFMA into 'uniform expenditure and revenue classification systems'.[170] Such classification systems are presumably designed to standardise financial information in budgets and reports. Finally, the 'treasury norms and standards' mentioned in FC s 216(1)*(c)* appear to relate in practice to informational requirements around financial, budget and fiscal matters.[171] FC s 216(2) then provides a powerful (although blunt) remedial tool to enforce the accounting treatment, expenditure classification and treasury norms and standards envisaged in FC s 216(1) — namely stopping inter-governmental grants.[172] Both the scope of National Treasury's current role and the remedial instruments used to enforce compliance with its measures would appear to have expanded beyond their modest beginnings in FC s 216.

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Stopping Transfers of Grants and Equitable Share

The Final Constitution limits the stopping of funds in terms of FC s 216(2) to breaches of generally recognised accounting practice, uniform expenditure classifications and uniform treasury norms and standards. This power is reflected in MFMA s 5(2)*(e)*. It is important to distinguish stopping funds under FC s 216(2) and interventions under FC ss 100 and 139. The former reflect an enforcement measure

169 GRAP is prescribed for municipalities in MFMA s 122(3).

170 See MFMA s 5(2)*(c)*(ii).

171 See, eg, DORA Act 7 of 2003 s 5(7).

172 Only National Treasury may stop equitable share. Once equitable share is allocated to local government and transferred via a provincial revenue fund, it must be paid to the municipalities in that province. See FC s 226(3).

designed to achieve compliance with formal National Treasury Standards. By contrast, FC ss 100 and 139 posit serious executive failures that require direct intervention with serious political consequences.

FC s 216(2) is triggered by 'serious or persistent material breach' of the measures set out in FC s 216(1). The Constitutional Court, in *First Certification Judgment*, heard a challenge to the provision that alleged that the provision would encroach upon the legitimate autonomy of provinces.[173] In affirming the certifiability of FC s 216, the Court mentioned that the exercise of the power to stop the transfer of funds would be subject to the external controls in FC s 216(3) to (5) and '[t]he question whether there has been a serious or persistent material breach of the provisions would also be justiciable'. The issue has not arisen since and has not been subject to judicial consideration.

The phrase, 'serious or persistent material breach', is a standard triggering phrase. It appears in FC s 139(5), in the equivalent MFMA provision dealing with financial problems,[174] and in the Division of Revenue Act.[175] Whereas MFMA s 140 sets out criteria for determining when there has been a 'serious or persistent material breach' of *financial commitments,* the Final Constitution does not offer similar criteria for a breach of FC s 216(1). As was suggested by the Constitutional Court in the *First Certification Judgment*, the phrase is intended to create a high threshold for the FC s 216(2) remedy which can be invoked *only* if there has been a serious or persistent material breach. The word 'persistent' suggests continuing in some action 'against opposition' and may indicate a remedy of last resort. Furthermore, not only must the breach of the standard in FC s 216(1) be 'serious' but it must be a 'material breach'. These separate requirements indicate that not only must the breach be related to a fundamental aspect of FC s 216(1) — and thus material — but that this material breach must be a serious material breach. This rather awkward formulation clearly indicates a high threshold of non-compliance before FC s 216(2) applies. Furthermore, even if these standards are met, provincial transfers may not be stopped for more than 120 days at a time, and the stopped transfer must be approved by Parliament.[176] Failure by Parliament to approve a decision to stop the transfer will cause the order to stop the transfer to lapse retrospectively.[177]

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If the exercise of FC s 216(2)-powers is justiciable, then a related issue is whether the remedy can be used to enforce compliance with statutory requirements that do not relate directly to FC s 216(1). Since national legislation harnesses FC s 216(2) for its own purposes, this question is not an abstract inquiry. The PFMA, which establishes National Treasury, allows for a withholding of funds 'in terms of section

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173 See *Ex Parte* Chairperson *of the Constitutional Assembly: In Re Certification of the Constitution of the Republic of South Africa, 1996* 1996 (4) SA 744 (CC), 1996 (10) BCLR 1253 (CC)('*First Certification Judgment*') at para 279.

174 See MFMA s 139.

175 See DORA 7 of 2003 s 30 and DORA 1 of 2005 s 39.

176 See FC ss 216(3)*(a)* and 216(4).

177 See FC s 216(3)*(b)*.

216(2) of the Constitution, to address a serious or persistent material breach *of this Act* by a department, public entity or constitutional institution' (emphasis added).[178] Because many aspects of the PFMA go beyond formal treasury standards (such as approval of disposals of assets, or approval of contracts or corporate plans), one could argue that the FC s 216(2) remedy has been torn from its proper context.[179] Similarly, DORA uses the remedy in FC s 216(2) to enforce compliance with the conditions of inter-governmental grants.[180] Again, this purpose is not contemplated by FC s 216(1). Equitable share is a constitutional entitlement the allocation of which is settled by national parliament. The view that the power of National Treasury to stop transfers is limited to the enforcement of the matters set out in FC s 216(1) is supported by the Constitutional Court's affirmation of the external controls related to the FC s 216(2) remedy. Under these circumstances, we would suggest that the use of the FC s 216(2) remedy to enforce statutory (and not constitutional standards) goes beyond the powers envisaged for National Treasury in FC s 216.

Economic and Contract Regulation

The second case in which National Treasury powers may have expanded beyond the contemplation of the drafters of FC s 216 is the regulatory role of National Treasury. Although the Final Constitution does not describe National Treasury as *regulating* public finance, we think it useful to use this term and intend by it three mechanisms of control, namely: standard setting; monitoring of compliance with the standard and enforcement of the standard. These three mechanisms are set out (explicitly or implicitly) in FC s 216. FC s 216(1) contemplates the introduction of generally recognised accounting practice, uniform expenditure classifications; and uniform treasury norms and standards; and FC s 216(2) compels National Treasury to 'enforce compliance with the measures established in subsection (1)'. Monitoring of compliance is not mentioned in FC s 216, but is implicit as an intermediate step between introducing and enforcing the standard.

The difficulty is that the legislation — the MFMA and the PFMA — and the practice indicates significant National Treasury involvement not only in matters suitable for uniform standards but specific executive and legislative decisions. A representative sample of the actual powers of National Treasury under national

legislation includes the following: the authorisation of public private partnership agreements pursued by national and provincial government;[181] recommendations on whether a municipality should enter into 'contracts having future budgetary implications',[182] recommendations on whether a municipality should form a municipal entity;[183] the delegation of powers by the council to an executive committee or executive mayor or chief financial officer of decisions to make

178 See PFMA s 6(2)*(f)*.

179 See also PFMA s 18(2) *(g)* (Gives a similar power to Provincial Treasures vis-a-vis provincial departments and public entities.)

180 See, eg, DORA 7 of 2003 s 22.

181 See Treasury Regulations reg 16.

182 See MFMA s 33.

investments on behalf of the municipality may only be made within a policy framework determined by the Minister of Finance;[184] the delegation of powers by the accounting officer for a department, trading entity or constitutional institution may be limited or controlled by the National Treasury;[185] the limit of councillors and officials on a governing board of a municipal entity;[186] commenting on price increases of bulk resources for the provision of municipal services;[187] the approval of three-year borrowing programmes submitted by certain public entities (national government business enterprises or major public entities);[188] and approving the corporate plans of certain public entities (which would include such matters as dividend policy).[189] The powers accorded to National Treasury are accentuated by drafting which in some cases vests an untrammelled discretion in National Treasury to approve transactions[190] or exempt agencies from compliance with regulations or legislation.[191] Furthermore, while National Treasury may only have the power to comment or make recommendations, its approval powers are so significant that agencies may have the perception that they depart from Treasury recommendations at their peril. The result is that in practice National Treasury exercises a power in respect of transactions and plans that may come close to a veto. A power of this kind involves a far more interventionist role for National Treasury in executive decision making than FC s 216 suggests.

183 See MFMA s 84.

184 See Systems Act s 60(2).

185 See PFMA s 44(2)*(a)*.

186 See Systems Act s 93E.

187 See MFMA s 42.

188 See Treasury Regulations reg 29.1.3*(a)*.

189 See PFMA s 52.

190 An important example is the approval power of National Treasury vis-à-vis PPPs. The definition of 'public private partnership' in reg 16 of the Treasury Regulations is important because it acts as a filter — only those transactions that are 'PPPs' will be subject to the somewhat onerous requirements set out in reg 16. The latest definition of 'public-private partnership', as set out in regulation 16 of the Treasury Regulations, means a commercial transaction between an institution and a private party in terms of which the private party (among other things) 'assumes substantial financial, technical and operational risks in connection with the performance of the institutional function and/or use of state property'. The difficulty is that 'substantial risk' is a rather porous filter. In practice, a discretion is exercised by the PPP Unit of the National Treasury which establishes the scope of Regulation 16. Neither the PFMA nor the regulations guide the exercise of this discretion or even expressly acknowledge it. Although National Treasury formally exercises weaker powers vis-à-vis municipal PPPs, the practice is likely to be akin to national and provincial PPPs.

191 For example, in terms of MFMA s 170, the National Treasury 'may on good grounds approve a departure from a treasury regulation or from any condition imposed in terms of this Act'.

Our conclusions here must be stated carefully. One can make a strong argument that this interventionist role of National Treasury exceeds the rather narrow and formal role contemplated in FC s 216. However, it is also possible that National Treasury is performing the regulatory role allocated to national government in several other provisions of the Final Constitution, rather than performing the role strictly allocated to National Treasury in FC s 216. Indeed, FC s 216 itself does not state that the role of National Treasury is limited to the enforcement of the matters in FC s 216(1). If FC s 216 does not limit enforcement matter to those enumerated in FC s 216(1), then an expanded role for National Treasury is not problematic — provided that the expanded role is itself defensible under the Final Constitution as a national regulatory role. This proviso raises a question that requires a more general assessment of how the spheres of government interact and whether national economic regulation through the National Treasury is consistent with the executive autonomy of provinces and municipalities. An argument that National Treasury's role ought to be restricted to formal regulation of norms and standards is buttressed by the idea that sub-national spheres of government have executive authority and constitute the government within their sphere.[192] Indeed, in the case of local government, the Final Constitution is at pains to assert the 'right' of a municipality to govern, on its own initiative, 'the local government affairs of its community'.[193] National and provincial governments 'may not compromise or impede a municipality's ability or right to exercise its powers or perform its functions'.[194] It might be argued that a limited and formal role is envisaged for National Treasury because a more extensive role — such as price controls, approval of contracts and approval of budgets — may undermine the autonomy of the non-national spheres of government.

However, an interventionist role for National Treasury does not necessarily compromise the exercise of municipal powers and functions. Indeed, it may serve to enhance them by protecting macro-economic stability and local government structures. In short, the Final Constitution cannot be read as requiring national government to adopt a 'hands off' regulatory approach in the face of executive incapacity or failure. Indeed, the Constitutional Court, in its certification of the Final Constitution, described the 'support' role of national and provincial governments vis-à-vis local government as a 'considerable' competency facilitating a 'measure of provincial government control over the manner in which municipalities administer' their functions.[195] The dilemma of how to regulate sub-national

governments in a decentralized structure is further considered below and indicates that the choice of how intrusively to regulate is as much strategic as legal.

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192 On co-operative government and the independence and interdependence of the three spheres of government, see, generally, S Woolman, T Roux & B Bekink 'Co-operative Government' in S Woolman, T Roux, J Klaaren, A Stein, M Chaskalson & M Bishop (eds) *Constitutional Law of South Africa* (2nd Edition, OS, June 2004) Chapter 14.

193 See FC s 151(3).

194 See FC s 151(4).

195 See *Ex Parte Chairperson of the Constitutional Assembly: In Re Certification of the Constitution of the Republic of South Africa, 1996* 1996 (4) SA 744 (CC), 1996 (10) BCLR 1253 (CC)('*First Certification Judgment*') at para 371.

(b) Provincial Role in Regulating Public Finance

FC s 216 establishes the National Treasury in order to enforce public finance standards. Although there are provincial treasuries which are also given a regulatory role under national legislation, our view is that provinces have no general supervisory role in respect of finance. It is a cliché of the new constitutional framework that municipalities are no longer creatures of provincial ordinance.[196] As a result, provincial local government ordinances have a rather ambiguous status. Our view, based on a reading of Chapter 13 and the constitutional schedules, is that financial regulation of municipalities is no longer a provincial legislative competence and that provincial ordinances regulating this area are impliedly repealed. This conclusion eviscerates lengthy provisions in provincial ordinances dealing with, among other things, procurement, contracting, budgeting and borrowing. All this legislation conflicts now with so-called 'new-order' legislation and in our view is redundant. Many provinces, lead by Gauteng, have enacted repeal legislation to harmonise their statute book with new-order legislation.[197]

MFMA s 5 spells out the new role of provinces *under national legislation* in regard to financial regulation of municipalities. MFMA s 5(4) states that '[t]o the extent necessary to comply with subsection (3), a provincial treasury *(a)* must monitor— *(i)* compliance with [the MFMA] by municipalities and municipal entities in the province; (ii) the preparation by municipalities in the province of their budgets; (iii) the monthly outcome of those budgets; and (iv) the submission of reports by municipalities in the province as required in terms of this Act; *(b)* may assist municipalities in the province in the preparation of their budgets; *(c)* may exercise any powers and must perform any duties delegated to it by the National Treasury in terms of [the MFMA]; and *(d)* may take appropriate steps if a municipality or municipal entity in the province commits a breach of [the MFMA].' Although, in our view, the Final Constitution has ended the provincial role in regulating municipal finance, it still strongly affirms the intervention role of provinces in the case of municipal financial failure.

(c) Intervention Powers of the Provinces

In addition to the intervention powers of national government and parliament under FC s 216(2), the provinces (and not national government in the first instance) are given an important power of intervention under FC s 139. There is an interesting legislative history to FC s 139 which has a direct bearing on municipal borrowing and financial autonomy.

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The existing version of FC s 139 was introduced by the Constitution of the Republic of South Africa Second Amendment Act 3 of 2003. The original FC s 139 provided for provincial supervision. This supervision entailed issuing directives and, in more serious cases, assuming responsibility for the relevant obligation. However it was something of a blunt tool and perhaps an ineffective one as well. In particular, it did not clarify the extent to which an intervening province could assume municipal executive and legislative powers in order to restore service provision. Furthermore, in the context of municipal borrowing, it did not appreciate that because it is not

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196 See *Fedsure Life Assurance Ltd v Greater Johannesburg Transitional Metropolitan Council* 1999 (1) SA 374 (CC), 1998 (12) BCLR 1458 (CC) at para 38.

197 See, for example, the Gauteng Local Government Laws Amendment Act 1 of 2006.

legally or practically possible to liquidate a municipality, the ability of creditors to satisfy their claims in the event of default is likely to be closely tied to the restoration of the fiscal position of the municipality to normality. This appreciation comes through strongly in National Treasury's Policy on Municipal Borrowing. The policy sees the development of an institutional framework for municipal default and bankruptcy as a fuller expression of a decentralised framework for municipal finance. Hence,

> . . . the corollary of moving towards a modern, decentralised framework for municipal finance where moral hazard is minimised, capital is allocated efficiently, risk is properly priced and incentives for prudent financial management are real is a clear legal and institutional framework for dealing with municipal default and bankruptcy.[198]

The Municipal Borrowing Policy then develops and affirms the idea of a judicially authorized administrative agency with some independence from the executive. This agency oversees fiscal and financial 'turn-arounds' analogous to judicial managements in the private sector but designed for the particular circumstances of the municipal sector.[199] The agency, suitably equipped with the necessary powers, would develop and implement municipal turn-around plans. Chapter 13 of the MFMA gives full legal expression to this idea by establishing and regulating the Municipal Financial Recovery Service.[200] A key dilemma for the drafters of the constitutional amendment, in developing the idea of a Municipal Financial Recovery Service, was how to deal with a case where a financial recovery plan was developed for the municipality, but a Municipal Council could not or would not act in accordance with the plan. Because financial recovery would require the adoption or adjustment of budgets, and the determination of tariffs and taxes (all legislative functions under *Fedsure*), a Municipal Council could frustrate implementation of the recovery plan. Originally, the Municipal Borrowing Policy contemplated that the Municipal Financial Recovery Service would have 'all the powers of a municipal council' including its legislative powers. Accordingly, an early version of the Constitution of the Republic of South Africa Amendment Bill, 2001 added a new section 155(8) to the Final Constitution

which stated that: '[n]ational legislation may provide for the exercise of executive and legislative authority on behalf of a municipal council to the extent necessary — *(a)* to govern the municipality when the council for any reason cannot function; or *(b)* to resolve a serious and persistent financial emergency in the municipality.' This amendment was not made, arguably because the drafters were self-conscious about the prospect of a non-elected body enacting legislation. The dilemma was resolved through the Constitution of the Republic of South Africa Second Amendment Act 3 of 2003 which inserted the current version of FC s 139. The amended section empowers the provincial executive in FC s 139(5) to 'dissolve the Municipal Council, if the municipality cannot or does not approve legislative measures, including a budget or any revenue-raising measures, necessary to give effect to [a] recovery plan'. Hence, the current section affirms municipal legislative powers, but allows for dissolution of municipal councils if these powers are inappropriately exercised during times of crisis. On dissolution, an administrator gives effect to the recovery plan

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198 The Municipal Borrowing Policy (supra) at 31.

199 Ibid.

200 See MFMA ss 157–162.

(including approving a temporary budget and required revenue-raising measures) until a new Municipal Council is elected.[201] Arguably, dissolution of a Municipal Council, rather than enactments on its behalf, is an appropriate balance between municipal political autonomy and the need to manage municipal financial crises. Once the constitutional amendment had been passed, it was possible to enact the MFMA which elaborated a detailed framework on municipal borrowing and financial emergencies.

The text of FC s 139 requires interpretation, an exercise that would take us away from our focus on Chapter 13 of the Final Constitution. There is already analysis elsewhere of some of the key textual issues, including the meaning of the phrase which triggers intervention under FC s 139(1), namely that a 'municipality cannot or does not fulfil an executive obligation in terms of the Constitution or legislation'.[202]

The MFMA Treatment of Intervention

The MFMA has turned the provisions of FC s 139 into a lengthy and important chapter. The Final Constitution distinguishes three types of financial problem: first, a case in FC s 139(1) where 'the municipality cannot or does not fulfil an executive obligation in terms of the Constitution or legislation'; second, a case in FC s 139(4) where 'a municipality cannot or does not fulfil an obligation in terms of the Constitution or legislation to approve a budget or any revenue-raising measures necessary to give effect to the budget'; and third, a case in FC s 139(5) where as a result of a crisis in its financial affairs, [the municipality] is

in serious or persistent material breach of its obligations to provide basic services or to meet its financial commitments, or admits that it is unable to meet its obligations or financial commitments'. The Final Constitution makes provincial intervention discretionary in the first case and mandatory in the latter two cases. The MFMA offers a more fine grained account of these distinctions in chapter 13. It terms the first case a 'financial problem' and sets out the steps a provincial executive may take in response to such a problem. These steps are termed 'discretionary provincial interventions' in MFMA s 137. The third case is called a 'financial crisis' and requires (as prescribed in the Final Constitution) 'mandatory provincial interventions' under section 139 of the MFMA. The second case is treated separately in section 26 of the MFMA (and is not further considered here). The MFMA sets out criteria that describe when a municipality is in a financial crisis[203] or when it has encountered a serious financial problem.[204] A very important factor in the determination that there is a financial crisis rather than a serious financial problem is that the municipality has failed to make '*any* payment to a lender as and when due'.[205] Because a financial crisis has more serious consequences than a financial problem, the MFMA makes a failure to provide payment to a lender or an investor more serious than a simple

201 See FC s 139(5) *(b)*.

202 See J De Visser *A Legal Analysis of Provincial Intervention in a Municipality* (1999) 6, LLM Thesis, University of the Western Cape, available at http://www.sn.apc.org/users/clc/localgovt/thesisjdv.rtf (accessed on 22 April 2007)(Discussing the legal framework for provincial intervention in terms of FC s 139.)

203 See MFMA s 140.

204 See MFMA s 138.

non-payment of a debt to other creditors. This distinction elevates the status of lenders and creates a more enabling regulatory environment for municipal borrowing.

As suggested above, each kind of intervention results in differing consequences for the municipality. While a discretionary intervention in response to a serious financial problem may result in nothing more than a directive from the province to the municipality to act or refrain from acting in a particular manner, a mandatory intervention in response to a financial crisis requires the province to request the intervention of the Municipal Financial Recovery Service[206] which is required to draw up a financial recovery plan.[207] Provinces are given wide powers

of intervention: including the right to intervene in the provision of services as well as the right to dissolve a Municipal Council and appoint an administrator. These rights are essentially the last form of protection afforded to a local community, whose social welfare and development the municipality is considered to have failed to serve.

It is important to note that although financial crises prompt *mandatory* provincial interventions, it is necessary for provincial executives to determine that the conditions of a financial crisis have, in fact, been met. These are the conditions described in FC s 139(5): namely, that as a result of a crisis, the municipality is in 'serious or persistent material breach of its obligations to provide basic services or to meet its financial commitments'. The factors that indicate that this criterion is met are set out in section 140 of the MFMA. It should be stressed that even though the provincial executive must make the assessment that the criterion for a financial crises has been met, this assessment does not make the intervention 'discretionary'. The provincial executive must make a finding of fact based on the indicators set out in section 140(2). Once it has been determined that the facts exist, the provincial executive is compelled to act under section 139 of the MFMA. This point is strengthened by examining the factors set out in section 140(2) which intend, in our view, to make the trigger for a mandatory intervention objective.[208]

(d) Municipal Financial Failure

205 See MFMA s 140(2)*(a)*(emphasis added). Because the indicator relates to 'any payment' it would presumably include part payments (such as cases where interest was paid but not installments relating to the principal amount).

206 This service forms part of the National Treasury in terms of MFMA s 157.

207 MFMA s 142 sets out the requirements for financial recovery plans. These documents are aimed at securing the municipality's ability to meet its obligations to provide basic services or dischange its financial commitments. The first aim is to identify the problems of the municipality, and then to design a response that puts the municipality in a sound and sustainable financial condition as soon as possible. The Financial Recovery Plan identifies those human and financial resources needed to achieve the aims of the Plan. The Plan also identifies what needs to be done for its implementation. The Plan may call for the liquidation of assets other than those needed for the provision of the minimum level of basic municipal services and may provide for debt restructuring or debt relief. If a recovery plan is prepared in a mandatory provincial intervention, then s 146(1)*(a)* lays down that the municipality must implement it and report to the MEC for finance in the province about its implementation. See s 146(1)*(c)*. National intervention is contemplated to meet a situation where the province does not adequately perform any of the mandatory intervention obligations. In such cases the national executive enjoys the powers and functions of the provincial executive. See 150(2)*(a)*.

It is a striking feature of South African public finance that municipal financial failure is possible. We do not use the word 'insolvency' to describe municipal financial failure because municipalities cannot be 'wound up'. Indeed, the purpose of debt relief is to provide a form of protection from creditors in the absence of which a financial recovery plan may fail.[209] However, the MFMA does make provision for a municipality to apply to the High Court for an order 'to terminate the municipality's financial obligations to creditors, and to settle claims in accordance with a distribution scheme referred to in section 155'.[210] In short, the MFMA creates a process that is akin in some respects to insolvency. Prior to termination of financial obligations, provision is made for lesser forms of relief: where a municipality is unable to meet its financial commitments, it may, in terms of section 152, apply to the High Court for an order to stay all legal proceedings by persons claiming money from it (or a municipal entity) for a period not exceeding 90 days. Provision is also made for extraordinary relief in the form of a suspension of the municipality's financial obligations or a portion of such obligations until the municipality can meet those obligations.[211]

To our knowledge the provisions of chapter 13 of the MFMA have not been applied — even though provincial interventions under the Final Constitution have occurred. Instead, National Treasury and the Department of Provincial and Local Government have focused on capacity building initiatives and rescue plans for weak municipalities. Project Consolidate is the best known of such plans.[212] The question that arises is whether, notwithstanding the provisions of the MFMA, national government would 'rescue' a municipality to prevent its financial failure. Even though MFMA s 51 prohibits national and provincial guarantees of municipal debt, it would, in principle, be possible for national government to provide additional equitable share to a municipality in order to enable to the municipality to discharge its financial obligations. Section 6(3) of the Division of Revenue Act 1 of 2005 empowers '[t]he national government [to] appropriate a portion of its equitable share or excess revenue to make further allocations in an adjustments budget to municipalities, as a conditional or an unconditional allocation'. However, it is uncertain whether national government will exercise this power to assist municipalities with financial problems and we do not wish to speculate in this regard.

27.7 Other institutions

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208 See, eg, MFMA s 140(2)*(c)*, which quantifies the extent of the failure, or MFMA s 140(2)*(a)* which refers to 'any payment', that is, at least one payment.

209 See MFMA s 153(2)*(b)*.

210 See MFMA s 153(1)*(c)*.

211 See MFMA s 153(1)*(b)*.

212 Project Consolidate is a program implemented by the Department of Provincial and Local Government to assist local government with the following: basic service delivery and infrastructure; local economic development; municipal transformation and institutional development; municipal financial viability; and good governance and community participation. See Department of Provincial and Local Government *Project Consolidate: A Hands on Local Government Engagement Programme for 2004-2006* (May 2004)('*DPLG Project Consolidate*').

(a) Financial and Fiscal Commission

FC Chapter 13 creates the Financial and Fiscal Commission and the Central Bank. For our purposes, the former is a more important organisation. The Financial and Fiscal Commission is established in terms of FC s 220. The Financial and Fiscal Commission Act clarifies its functions, powers and composition.[213] Its purpose is to act as an impartial and independent body which makes recommendations and gives expert advice to organs of state in the national, provincial and local spheres of government on financial and fiscal matters. These matters would include the fiscal policies of government, whether national, provincial or local; the role of province in raising revenue through taxation; borrowing by local and provincial governments; and fiscal allocations. The body is constituted in terms of FC s 221 from members appointed by the President. However, the Premiers of provincial government and organized local government participate, to some extent, in the appointment process.

In fulfilling its constitutional mandate, the Commission focuses primarily on intergovernmental revenue sharing and fiscal issues that arise from DORA.

DORA may not be passed until the Commission has been consulted and its recommendations considered. The recommendations of the Commission are presented to both Houses of Parliament and provincial legislatures and address the following issues: the equitable division of revenue as between national, provincial and local government; the determination of the equitable share of each province; and other allocations including the conditions on which they are made.[214] Secondary functions have been allocated to the Commission in the Borrowing Powers of Provincial Governments Act and the Intergovernmental Fiscal Relations Act. In terms of the former Act, the Commission may make recommendations regarding loans to provincial governments by national government as well as the total interest a provincial government may incur on its debt in a financial year. In respect of the latter act, the Commission may be represented at meetings of the Budget Council and may make recommendations on revenue sharing and the allocation of money.[215] This Act also provides for the Commission to provide input on DORA prior to its enactment in terms of FC s 214(2).

Assessments of the Commission have been mixed. One assessment is that the Commission has lost influence since 1994:

> Several countries, such as India and South Africa, have adopted independent commissions to oversee and protect fiscal transfers from the center to the sub-national from political vagaries. But, the performance of these commissions have been mixed. In the case of India, many states have not implemented state level finance commissions. In South Africa, the Financial and Fiscal Commission, while playing an important role in the initial years of the new democracy, has progressively lost its influence as the country made its transition from conflict years.[216]

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213 Act 99 of 1997.

214 Intergovernmental Fiscal Relations Act 97 of 1997 s 9(1).

215 For a discussion on Budget Council and the Local Goverment Budget Form, see § 27.3*(d)* supra.

216 See J Ahmad, S Devarajan, S Khemani & S Shah 'Decentralization and Service Delivery' *World Bank Policy Research Working Paper 3603* (May 2005) 7.

(b) Central Bank

The central bank, known as the South African Reserve Bank, is contemplated in FC s 225 and regulated by the South African Reserve Bank Act.[217] The primary object of the South African Reserve Bank, as set out in FC s 224(1), is the protection of the value of the currency in the interest of balanced and sustainable economic growth in the Republic. From this constitutional mandate, the Bank has understood its mission as ensuring 'the achievement and maintenance of price stability'.[218] The Reserve Bank is co-responsible for formulating South Africa's

monetary policy, and is largely responsible for implementing this policy. The Final Constitution requires the Reserve Bank to perform this function and its other functions independently and without fear, favour or prejudice. However, it also provides that there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters. The Reserve Bank and the National Treasury together constitute the monetary authority in South Africa.

The South African Reserve Bank acts as the central bank for the country and its banking institutions. It thereby provides so-called 'accommodation' to various banks.[219] The Reserve Bank is the custodian of the statutory cash reserves which all registered banks are required to maintain, and it provides facilities for clearing and settlement of inter-bank obligations. In addition, the Reserve Bank is the custodian of the greater part of South Africa's gold and other foreign exchange reserves, controls the South African Mint Company, and issues banknotes printed by the South African Bank Note Company, a wholly owned subsidiary of the Bank.

27.8 Local government in South Africa's fiscal structure

(a) Decentralised structure

In considering the place of local government in South Africa's fiscal structure, the key question is whether FC Chapter 13 envisages fiscal and other forms of decentralisation. The question has practical importance: decentralised systems imply, among other things, a high-level of autonomy in respect of sub-national spending decisions. This autonomy would, in turn, have implications for the nature of the inter-governmental grant system and the nature of national regulation of sub-national budgeting and spending. In considering the extent of decentralisation in South Africa, the literature postulates a continuum from 'deconcentration' (the lowest level of decentralisation), through 'delegation' to 'devolution' (the highest level of decentralisation).[220] This terminology is somewhat unreliable and is not always used consistently. Nonetheless, it is clear that the Final Constitution does contemplate a level of decentralisation that is closer to the devolution end of the

217 Act 90 of 1989. FC s 225, provides that: 'the powers and functions of the South African Reserve Bank are those customarily exercised and performed by central banks, which powers and functions must be determined by an Act of Parliament and must be exercised or performed subject to the conditions prescribed in terms of that Act.'

218 See 'Mission Statement of the South African Reserve Bank' at http://www.reservebank.co.za/ (accessed on 20 April 2007).

219 See http://www.reservebank.co.za/internet/Publication.nsf/ (accessed on 22 April 2007) for clarification of the Reserve Bank's system of accommodation.

continuum. There are four components that define the fiscal dimensions of decentralization: '*(i)* allocation of expenditure responsibilities by central and local tiers of government; (ii) assignment of taxes by government tiers; (iii) the design of an intergovernmental grant system; and (iv) the budgeting

and monitoring of fiscal flows between different government tiers.'[221] When applied to South Africa, these criteria yield fairly clear conclusions: sub-national governments are directly elected; they have a constitutional responsibility for service delivery, a constitutional entitlement to nationally-raised revenue and the autonomy to formulate their own budgets and determine their own expenditure priorities (within broad strategic objectives). On this basis, it is fair to conclude that the Final Constitution does contemplate fiscal decentralisation.[222] Indeed, some commentators have called this conclusion 'self-evident'.[223] Actual fiscal practice, however, is not clearly aligned with this constitutionally-mandated structure.

Although it might be argued that the push towards decentralisation and local financial accountability is supported by the constitutional provisions earlier described, the extent to which municipalities have been forced into financial autonomy post-1994 is also an expression of policy choice. In other words, it would have been possible for more money to have been transferred to local government — particularly through equitable share — without sacrificing key aspects of decentralisation. Not surprisingly, these choices and the associated pressures on municipalities of cost recovery, credit control and disconnection of services have been the subject of sustained criticism in the literature.[224] Failures in the delivery of municipal services have been exacerbated by 'unfunded mandates' that have widened the gap between functional allocation and funding.[225] Some national government departments have acknowledged these problems. For example, a leading policy document cites among the challenges facing local government, 'financial and capacity constraints within local government and [t]he uncoordinated devolution of powers and functions to local government by national and provincial government.'[226]

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220 See P Whelan 'The Local Government Grant System — Paper Two: Evaluating the Local Government Grant System' *IDASA Occasional Papers* (July 2003) 5. See also Ahmad et al (supra) at 12.

221 See Whelan 'The Local Government Grant System' (supra) at 8.

222 See E Yemek 'Understanding Fiscal Decentralisation in South Africa' *IDASA Occasional Paper* (July 2005) 5. See also Whelan 'The Local Government Grant System' (supra) at 5.

223 See Whelan 'The Local Government Grant System' (supra) at 5.

224 See, eg, DA McDonald & J Pape *Cost Recovery and the Crisis of Service Delivery* (2002); G Hart *Disabling Globalization: Places of Power in Post-Apartheid South Africa* (2002); P Bond *Unsustainable South Africa* (2002).

225 See § 27.3*(g)* supra.

226 DPLG *Project Consolidate* (supra) at § 7.3 *(g)*.

(b) The Shift to Intervention

As under-funded municipalities with inadequate capacity have produced disappointing performance, the constitutional model of decentralised service provision has become contested. It is arguable that national government has become less convinced that the benefits of local democracies outweigh the costs of inadequate

service delivery.[227] The result, in our view, has been ambiguous patterns of law-making and governmental practice. Some momentum away from decentralisation is clearly discernible. We have suggested a shift in national legislation towards economic regulation of local government.[228] At the level of policy it is possible to show significant national intrusion. For example, the policy of free basic services ('FBS'), which is a centre piece of municipal service provision, can be read as a *national* policy on municipal services rather than the expression of local democratic will.[229] At the level of operations and asset ownership, the Cabinet decision to shift from municipal provision of electricity to regional provision through six regional electricity distributors ('REDs') — all of which will be public entities under the PFMA — is a significant shift away from decentralized provision of a core municipal service.[230]

However, the basic decentralized model remains deeply entrenched. At a legislative level, efforts to amend the Final Constitution in order to allow for legislative authority to be exercised *on behalf of* a municipal council in times of financial crisis have not succeeded[231] and the PPP regime under the MFMA envisages a weaker role for National Treasury in respect of municipal PPPs than is the case for national and provincial PPPs. Indeed, the prospect of municipal financial failure under the MFMA clearly underscores the significant financial autonomy accorded to local government. Other indications of the survival of decentralisation include the assertive role of organised local government[232] and the fact that in comparison to conditional grants, the proportion of equitable share is increasing — a trend that

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227 It should be recalled that the premise for decentralization is that, 'devolving decision making power and responsibilities increases citizens engagement in local governance decisions and makes local governments more efficient and accountable. This implies that decentralization shifts power to citizens and local governments (elected and administrative) thereby enhancing their capacities to make effective choices — that is, to translate their choices into desired actions and outcomes'. See U Raich 'Fiscal Determinants of Empowerment' *World Bank Policy Research Working Paper 3705* (September 2005) 5. Poor municipal service provision has tested this justification for decentralisation.

228 See § 27.6*(a)* supra.

229 This assessment is suggested in passing by Paul Whelan. See P Whelan 'Local Government and Budget 2004' *IDASA Occasional Papers* (June 2004) 6–7, fn 3.

230 A media statement issued on 26 October 2006 by EDI Holdings (Ltd) (the government body which oversees restructuring of the electricity distribution industry) expressed the strong belief that 'the regulation of a large, monopolistic integrated national system such as the Electricity Distribution Industry should be conducted by a professional independent regulator reporting to central government, rather than by hundreds of municipalities'. The statement is available at http://www.ameu.co.za/library/restructuring (accessed on 24 April 2007).

231 See § 27.6*(c)* supra.

increases municipal financial autonomy.[233] In addition, the approach of creating funding windows within

equitable share, andhence diminishing its unconditional nature has not survived in the current formula for equitable share. Furthermore, the Department of Water Affairs and Forestry has strongly affirmed the authority function of municipalities in its cabinet-approved proposals for institutional reform of the water sector. In doing so the Department has departed from the 'top-down' approach favoured for the restructuring of the electricity distribution industry.[234]

The question is whether municipal failures, when they have occurred, are related to inadequate access to finance — whether by way of an adequate tax base, sufficient inter-government grants or access to the money markets — or whether there are inherent structural deficiencies in the South African model of fiscal decentralisation. The former problem is arguably resolved by municipal capacity building, increased equitable share and national strategies to reduce poverty. These issues demonstrate a dilemma around decentralisation that is particularly acute in its earlier phases and is well-described in the literature:

> [d]uring the early phases of decentralization, as lower-tier governments adapt to their new responsibilities, the results in terms of service delivery may be disappointing. How can we distinguish between weak outcomes because of the transition and weak outcomes because of a fundamental flaw in the design of decentralization? In addition, decentralization opponents can use any early disappointing outcomes to build political momentum to slow down or even reverse decentralization. If the problem is one of transition, then how can these political forces be balanced by those who favor decentralization, even if they have little to show for it at the start? One obvious approach to managing the politics of decentralization is try to show early results on service delivery. This leads to a second dilemma. In order to show early results, it may be necessary to intervene and provide resources and technical assistance to lower-tier governments in ways that are different, and perhaps even inimical, to the long-run, sustainable success of decentralized service delivery.[235]

The indicators of momentum towards and away from decentralisation may suggest that National Treasury and the South African Parliament ought to confront these dilemmas directly. Because Chapter 13 and Chapter 7 of the Final Constitution give decentralisation a constitutional imprimatur, the pressure to improve service provision has favoured solutions that preserve the basic autonomy of local

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232 Local Government is organised through the South African Local Government Association ('SALGA'). SALGA has been assertive on issues that impact financial autonomy or viability. A good example is the reform of the South African electricity distribution industry ('EDI') in which municipalities individually, and through SALGA, have actively engaged national policy formation.

233 See IDASA 'Local Government in Budget 2005?' 154 *Budget Briefs* 7 (9 May 2005), available at http://www.idasa.org.za/ (accessed on 19 April 2007).

234 See Strategic Framework for Water Services s 3 (September 2003), available at http://www.info.gov.za/otherdocs/2003/waterstrat.pdf (accessed on 24 April 2007). The document states that '[p]rovision of water services is the constitutional responsibility of local government. Developmental and democratic local government is in the best position to make accountable decisions related to how services should be provided, taking into account the social and environmental aspects of water services.' Ibid at 10.

235 See Ahmad et al (supra) at 22.

government while attempting to enhance service provision. These solutions have included a separation between the authority role and the service provision role, restructuring of the electricity and water sectors, grant funding to support national policy initiatives and increasingly interventionist regulation of service provision. At times, the outcomes have not been optimal. From the national perspective, the

unconditional nature of equitable share does not make it optimal as a funding instrument for free basic services. Other devices, such as the separation of the authority and provider role, are very useful in reconciling local democratic will with the urgent need to improve service provision.

Chapter 13, and the legislation it has spawned, is central to an understanding and a resolution of these debates. At times, as we have shown, Chapter 13 and the Final Constitution do not settle key questions, such as where to allocate responsibility for public expenditure. Leaving these questions unsettled has inflamed the decentralisation debate. In other cases, the provisions of Chapter 13 are unambiguous. Local government is politically responsible for determining its own budget. It has its own revenue base. It has a right to a share in nationally raised revenue and to be involved in decision making around the allocation of nationally-raised revenue. No doubt, until service provision has stabilised, municipal autonomy will ebb and flow and the constitutional model of decentralised service provision will be tested in legislation and in practice.