



## NATIONAL TREASURY

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### **An Input by the National Treasury to the Self-Assessment Report for the African Peer Review Mechanism**

This input has been prepared by the National Treasury in response to the following questions contained in the APRM master questionnaire:

#### **Section 2: Economic Governance and Management**

Under objective 1: *Macroeconomic policies that support sustainable development*, we have responded to question 1 to 5 (of which question 4 only addresses those programmes of relevance to the National Treasury).

Under objective 2: *Implement sound, transparent and predictable government economic policies*, we have contributed to question 1 and 2.

Under objective 3: *Promote sound public financial management*, we have answered question 1.

Under objective 4: *Fight corruption and money laundering*, we have responded to question 3.

#### **Section 4: Socio Economic Development**

Under objective 1: *Promote self-reliance in development and build capacity for self-sustained development*, we have contributed to question 1.

#### **Standards and Codes**

An overview of South Africa's compliance with a list of international Standards and Codes is provided in Annex B.

## **SECTION 2: Economic Governance and Management**

*OBJECTIVE I: Promote macroeconomic policies that support sustainable development*

### **Question 1: Extent to which your country's macroeconomic policy framework sound and supportive of sustainable development**

Since 1994, South Africa has achieved a level of macroeconomic stability not seen in the country for 40 years.<sup>1</sup> The budget deficit has come down from 9.5 percent of GDP in 1993 to fractionally over 1 percent in 2002/03 and total public-sector debt has fallen from over 60 percent of GDP in 1994 to 36 percent of GDP in 2004.

The economy remained stagnant for much of the decade before 1994, growing by just 1 per cent a year, fall below the rate of population growth. Since 1994, the economy had accelerated gradually with growth averaging 3 per cent in the late 1990s, reaching over 5 per cent in 2005 (first 3 quarters).

These advances have created opportunity for real increases in expenditure on social services, reduce the costs and risks for investors and have therefore laid the foundation for increased investment and growth.

Using national accounts data, van der Berg et al (2005) found that poverty remained at a high level of about 41 percent between 1993 and 2000 (using a R 3000 per capita poverty line), but had fallen to 37 percent by 2004.

The decline in poverty since 2000 can be attributed to a number of factors, especially the expansion of the social grant system as well as modest improvements in job creation in recent years.<sup>2</sup> Public transfers in the form of child support, old age and disability grants, amongst others, have expanded by R 22 billion in 2000-prices; an increase of more than 70 percent in real terms, or a doubling of the estimated collective income of the poorest quintiles in 2000. It now exceeds R 1000 per poor person per annum.

Indications are that the labour absorbing capacity of the economy is improving. Employment growth over the past five years (of just under 3 percent) has been broadly in line with GDP growth of about 3 percent. The current upward trend in GDP growth (of around 4 percent) should be sufficient to prevent further increases in the unemployment rate or the number of people in poverty.

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<sup>1</sup> Ten Year Review, page 33

<sup>2</sup> Van der Berg et al (2005) *Trends in poverty and inequality since the political transition*, TIPS - UN/WIDER - DPRU Annual Forum, Johannesburg, December 2005

Government's economic and social policies aim to effect social change and redistribution to reverse the effects of Apartheid. The expansion of the group of people who have ownership and stewardship of the economic to include larger proportions of black people and women are key objectives of government.

A detailed description of the macroeconomic environment is provided annually in the Medium Term Budget Policy Statement and the Budget Review. Both documents are available on the website of the National Treasury:

<http://www.treasury.gov.za>

### **Real GDP growth per capita over the past 5 years**

The economy has grown at a rate of 3.3 percent per annum, on average, since 1994, compared to negative per capita growth in the decade before. National accounts data suggest that since 2000, income per capita has been rising by about 2.2 per cent a year. Though growth has been steady, it has been below the average of other developing countries during the same period.

There are signs that economic growth rates are accelerating. Real GDP grew by 3.7 percent in 2004, and 5.1 percent in the first three quarters of 2005, driven by strong domestic demand. Growth in household consumption was supported by rising disposable income, a large reduction in interest rates (the main central bank interest rate has been lowered by 6½ percentage points since mid-2003) and by wealth effects from rising housing- and stock prices.

### **Average inflation over the past 5 years**

South Africa adopted a formal inflation-targeting framework in February 2000, following a period of "informal inflation targeting" by the South African Reserve Bank. Considerable emphasis has been placed on the attainment of price stability since then.

Inflation has stayed within the official 3-6 percent target band since September 2003, and is expected to remain so during 2005-2006. CPIX inflation fell from a peak of 11 percent in late 2002 to the lower end of the target in February 2005, before edging up to a peak of 4.8 percent in August 2005.

The continued strengthening of the rand during 2004 helped contain inflationary pressures and softened the impact of higher oil prices. Despite some short term inflationary pressures emanating from the higher oil prices, inflation remains firmly under control and is expected to remain within the inflation target range of 3 to 6 per cent.

The biggest success of the inflation targeting framework has been lower volatility in interest rates, leading to more predictability and certainty for all participants in the economy.

### **Debt and fiscal deficit to GDP over the past 5 years**

Fiscal policy has been the driving wedge of our economic, political and social transformation since 1994.

Since 1994, public debt has declined from 49.2 percent to 34.4 percent of GDP and debt service costs have declined from 4.7 percent to 3.5 percent, freeing up resources to be spent on social and economic infrastructure. A sound fiscal stance has helped to bring interest rates down, lower debt service costs and provide a platform for an expansionary fiscal stance that is sustainable, predictable and growth enhancing.

### **Share of fiscal deficit financed by the Central Bank over the past 5 years**

There has been no monetisation of public debt. Central Bank borrowing is not used to finance the fiscal deficit. Government's net borrowing requirement is financed primarily through domestic loans while foreign borrowing is modest.

A detailed description of the National Government borrowing strategy is available in the Medium Term Budget Policy Statement and the Budget Review on [www.treasury.gov.za](http://www.treasury.gov.za).

### **Developments in the Rand exchange rate over the past 5 years**

The South African currency has shown a high degree of volatility since 1994. In particular, the currency experienced three phases of rapid depreciation, in 1996, 1998 and 2001. Since the episode of market stress in late 2001, the rand has appreciated by over 50 percent through late 2004 and has remained much more stable since then.

The South African Reserve bank (SARB) does not intervene in currency markets to manage the exchange rate, but has bought foreign exchange at times of rand strength to improve its international reserves position. Gross international reserves increased from the equivalent of 70 percent of short-term external debt at end-2003 to an estimated 178 percent as of end-June 2005. Including gold, total gold and foreign exchange reserves reached US\$20 billion by the end of 2005. The higher level of reserves was an important factor in Moody's decision to upgrade South Africa's foreign currency sovereign rating to Baa1 in early 2005. Standard and Poor's upgraded South Africa's long-term sovereign credit rating to BBB+ in August 2005.

## **Credit to both private and public sectors over the past 5 years**

Banking institutions' loans and advances extended to the private sector have been particularly robust over the past year (a twelve-month growth rate of some 23 per cent was recorded in July 2005), supported by rising levels of income and expenditure, strong business and consumer confidence, the buoyancy of the fixed property and securities markets, and lower interest rates. Mortgage advances in particular displayed rapid growth on the back of a housing boom. The greater part of banks' credit extension flows to the household sector.

## **Share of total budget allocations to social sectors over the past 5 years**

An extensive reconfiguration of the public finances has allowed Government to move resources towards areas of priority, making the budget more pro-poor and better oriented towards building both human and physical capital as essential ingredients for long-term growth and redistribution.

National budgets have been increasingly redistributive, channelling significantly resources to the poor through rising social spending on social grants, municipal and social services, and community infrastructure such as water and sanitation, schools, clinics, multipurpose centres, police stations and roads.

Poor and marginalised communities are often excluded from economic opportunities because of their level of education, physical location, health profile or poor access to information. Government's social development strategy rests on a balance between income support and direct services, which aims to address the causes of social exclusion.

The main elements of the social development strategy are:

- Means tested social grants to pensioners, children, people with disabilities and caregivers backed up with contributory social security funds such as the Unemployment Insurance Fund, Compensation Funds and the Road Accident Fund.
- Clean water and electricity and the extension of sanitary services to those presently reliant on unhygienic sanitary means.
- Quality education and health care to equip people with the basic skills required to enter the labour market, to increase levels of nutrition and improve the health profile of the nation.
- Housing in an environment that supports social cohesion and access to transport linkages and other basic services.
- Reducing the level of crime, particularly violent crime, so that communities can feel secure and confident to go to school or work or to socialise and play sport.

Total budget allocations are consistent with these policy objectives.

Table 2: Consolidated national and provincial expenditures by type of service

2004/05 – 2008/09

R million	2004/05	2005/06	2006/07	2007/08	2008/09
		Outcome	Medium term estimates		
<b>Social services</b>	<b>199 099</b>	<b>224 670</b>	<b>251 991</b>	<b>278 326</b>	<b>305 168</b>
Education	75 014	82 103	91 194	101 708	112 816
Health	41 867	48 121	53 492	58 539	64 553
Welfare and social security	62 863	72 843	82 187	89 985	97 244
Housing and community development	19 355	21 603	25 118	28 093	30 555
<b>Protection services</b>	<b>63 241</b>	<b>71 889</b>	<b>77 181</b>	<b>82 793</b>	<b>89 912</b>
Defence and intelligence	22 359	25 399	25 702	26 696	29 076
Justice, police and prisons	40 882	46 490	51 479	56 098	60 835
<b>Economic services</b>	<b>49 067</b>	<b>56 997</b>	<b>69 630</b>	<b>76 567</b>	<b>83 817</b>
Water and related services	5 786	6 712	8 158	9 041	10 100
Agriculture, forestry and fishing	7 429	9 951	11 223	12 619	13 519
Transport and communication	17 754	19 843	25 990	28 298	30 407
Other economic services	18 098	20 491	24 260	26 609	29 791
<b>Administration</b>	<b>25 217</b>	<b>28 090</b>	<b>38 970</b>	<b>42 642</b>	<b>48 186</b>
<i>Of which: Local government equitable share</i>	<i>7 678</i>	<i>9 643</i>	<i>17 815</i>	<i>19 821</i>	<i>22 508</i>
<b>Total</b>	<b>336 624</b>	<b>381 646</b>	<b>437 772</b>	<b>480 329</b>	<b>527 082</b>

A Fiscal Incidence Analysis conducted by a team of academics at the University of Stellenbosch in 2004 shows that the proportion of spending on social services that goes to the poorest 40 percent of the households has risen from 53.6 percent to 59.3 percent between 1995 and 2000. The areas where most progress has been made in directing resources towards the poorest are in social security, education, land restitution and housing.

The number of people receiving social grants has risen from 7.9 million in 2003 to about 10 million in 2005. By the time that the child support grant is expected to all children up to the age of 14, about 12 million people will be receiving direct income support from Government. These means-tested grants are a critical part of Government's effort to alleviate poverty and develop communities, providing children with higher levels of nutrition and the resources necessary to attend school.

At the beginning of 2003, 67 percent of the income of the poorest 20 percent of the population came from social grants. Without social grants, 38 percent of the elderly would be classified as extremely poor and 56 percent as poor. The old age grant reduces this to 2.5 percent in extreme poverty and 23 percent who remain poor. The number of children in households classified as extremely poor was reduced from 13 percent to 4 percent by the child support grant in 2003. This is likely to have declined even further as the number of children

who receives grants has grown drastically in recent years, from 2 million in 2003 to above 6 million in 2005.

As a country, South Africa has done well to increase access to education and health care for the poor. However, while spending is far more equitably distributed, quality is often lacking. Allocations to fund social policy objectives must focus on improving the quality of these services.

### **Describe steps taken by the country to make the macroeconomic framework sound and supportive of sustainable development**

In 1994, the new South African government was faced with a daunting economic reform task. Isolation from the world economy had resulted in a stagnating economy characterised by poor and sometimes even negative growth, while the apartheid legislation had left deep clefts in the socio-economic structure of the country. The government was therefore faced with a double transformation challenge: A predominantly social one concerned with removing the gross inequalities that apartheid had inflicted on the South African society, with a particular focus on the upliftment of many millions of people living in poverty, and an economic one directed at simultaneously pulling the economy out of its recessionary slump in order to be able to finance the required redistribution required by the former imperative.

The initial Reconstruction of Development Programme (RDP) set out the primary content of government's strategy to deal with this dual challenge. An economic programme, the Growth, Employment and Redistribution (GEAR), was adopted in 1996 to provide an economic framework which could deliver the RDP goals. Since 2001, fiscal policy has generally been expansionary allowing for significant real increases in public expenditure financed from lower interest costs and strong revenue growth.

While economic growth rates have remained modest, it masks the large structural changes that the South African economy has undergone since the political transition. Once an exporter of predominantly primary goods, South Africa is increasingly moving towards exporting higher value added goods and thus diversifying its aggregate export base.

Since 2000, an expanded social grant system and improving labour market prospects have had major, positive impacts on poverty reduction. During the past four years, government has increased grant payments by R 22 billion in 2000 Rand values: an increase of more than 70 percent in real terms. While social grants play a positive role in the development of better livelihoods of poor households, an increase in employment and successful entrepreneurial ventures are key elements of our long-term poverty reduction strategy. The government's main objectives in the period ahead are to accelerate growth,

lower unemployment, improve social conditions, and address wealth disparities, within a low inflation environment.

Government's approach includes: (i) maintaining macroeconomic stability and a sound financial system; (ii) increasing saving through facilitating access to financial services; (iii) fostering growth by improving the regulatory environment for private sector development (particularly of SMEs), reforming state-owned enterprises and increasing their investment in infrastructure (including through public-private partnerships); and (iv) reducing unemployment through accelerated economic growth, skills-development and public works programs, and possibly some amendments to labor legislation. Priorities also include improving social conditions by ensuring appropriate budget allocations for social needs and moving ahead with their programs for Broad Based Black Economic Empowerment (BEE) and land reform. In addition, the government is continuing with its gradual approach to relaxing exchange controls.

## Question 2: What is the accuracy of Government's macroeconomic projections?

A new set of macroeconomic projections is undertaken quarterly, based on the most recent data releases. Of these four projections, two are published: one in February as part of the annual Budget Review and Fiscal Framework and one in October as part of the Medium Term Budget Policy Statement (MTBPS).

To compile the forecasts, the National Treasury collects information and makes projections on a number of key exogenous variables. These include the oil price, gold price, world growth and world inflation.<sup>3</sup>

The accuracy of the forecast is dependent on the preliminary historical data estimates, the extent to which the data is revised as new data become available and accuracy of the assumptions underlying the model. In general, the projections have been fairly accurate, as shown in the table below.

Table 3: Growth Projections (Budget Forecast v Actual)

	2001 BR		2002 BR		2003 BR		2004 BR		2005 BR	
	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast	Actual
2000	3.0	4.2								
2001	3.5	2.7	2.2	2.7						
2002	3.7	3.6	2.3	3.6	3.0	3.7				
2003	3.3	2.8	3.3	2.8	3.3	2.8	1.9	3.0		
2004			3.6	3.7	3.7	3.7	2.9	4.5	3.7	4.5
3 quarters of 2005									4.3	5.1

Table 4: Inflation Projections (Budget Forecast v Actual)

	2001 BR		2002 BR		2003 BR		2004 BR		2005 BR	
	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast	Actual
2001	6.6	6.6								
2002	5.3	9.3	6.9	9.3	10.0	9.3				
2003	4.7	6.8	5.8	6.8	7.7	6.8	6.8	6.8		
2004			4.7	4.3	4.8	4.3	4.8	4.3	4.3	4.3
3 quarters of 2005									4.0	3.9

<sup>3</sup> This information is inputted into the National Treasury Quarterly Macroeconomic model (NTQM). The model is a mid-sized structural macro-econometric model, developed over the past five years and contains twenty estimated equations and about 200 different variables. The model is utilised to generate a forecast of a number of key macroeconomic variables, in particular output growth, inflation, the current account and the currency. These projections are subjected to a rigorous internal review process and are finally approved by the Director General and Minister for publication and for use as the basis of the Government's fiscal planning.

## **Adequacy and reliability of macroeconomic statistics**

South Africa has adequate coverage of macroeconomic indicators. Statistics South Africa is improving its capacity to produce quality macroeconomic statistics on a regular basis.

### **If current projections for real GDP growth and government revenue for the next year are higher than what was realised for the past 5 – 10 years, give reasons thereof (sic).**

Over the past ten years, real GDP growth has averaged approximately 3 percent and government revenue growth has averaged approximately 3.3 percent. The current projection is for growth to rise to over 5 percent per annum and revenue to rise by over 6 percent in 2008.

This reflects a substantial improvement in South Africa's growth performance, as the economy has been significantly restructured and has become more competitive. In addition, growth momentum for the forthcoming year should come from strong increases in both public and private investment as Government (and public companies) focuses on improving infrastructure, a slightly more expansionary fiscal and monetary policy stance, and a supportive international environment. Higher growth rates and efficiency gains in tax collection are behind the expected increases in fiscal revenue.

### **Describe the extent to which the Government takes account of independent advice/analysis in assessing the macroeconomic outlook and provide any independent reports of [the] macroeconomic outlook.**

In formulating its forecast, the Government pays careful attention to the views of market economists and analysts, as well as economic forecasts from independent agencies such as the South African Reserve Bank, the Bureau of Economic Research at the University of Stellenbosch, the International Monetary Fund, the Organisation for Economic Co-operation and Development and the Economist Intelligence Unit.

In general, the Government's forecasts are in line with the forecasts from external sources, and often the Government forecasts prove to be more accurate. To date no completely independent report has been undertaken on the accuracy of the Government's forecasts. However, the Government continually monitors the accuracy of its forecasts and is in close contact with other leading forecasters to ensure that its methods are up-to-date and accurate.

Furthermore, post-budget seminars and other more regular consultations with leading analysts provide a platform for public scrutiny of Government's forecasts.

### **Question 3: What sectoral or microeconomic policies has your country developed and implemented to promote economic growth and sustainable development?**

Detailed descriptions of Government's sectoral and microeconomic policies is the Budget Review, the Medium Term Budget Policy Statement, and the Estimate of National Expenditures. All documents are available on:

<http://www.treasury.gov.za>

To sustain and further increase the rate of growth and to accelerate the pace of employment creation, economic policy priorities will focus on:

- Increasing investment in public and private infrastructure, with particular focus on unblocking the transport logistics system, providing for long-term water and energy needs and extending social and municipal services.
- Lowering the cost of doing business, including addressing regulatory concerns of business and simplifying tax arrangements for small businesses.
- Producing more skilled people through increased investment in education and technical training, investing in research and development and making it easier to import skilled labour.
- Extensive land restitution and redistribution programmes to boost land ownership amongst the historically disadvantaged as well the introduction of the Broad-based Black Economic Empowerment programme to raise the level of black and female ownership in the economy.
- Improving the quality of public service delivery with particular emphasis on reducing the level of crime, providing quality education, health and municipal services to the poor and extending basic services to citizens.

The freight logistics system has been identified as an obstacle to lower business costs and to faster growth in exports. Addressing these infrastructural deficiencies is an important part of Government's strategy to accelerate growth and raise the level of exports. Transnet have announced about R49,5 billion in infrastructure investment over the next five years, mainly in the areas of ports development and rail. The long-term energy and water needs of a growing population and expanding economy must be met. Last year, the Department of Water Affairs announced preliminary plans to build 20 major dams over the next twenty years. Eskom has announced about R110 billion in spending on refurbishing mothballed power stations and to raise generation capacity by 5 300 megawatts to about 41 500 megawatts.

National Treasury is currently coordinating the implementation of the Infrastructure Delivery Improvement Programme (IDIP), which is aimed at improving the effective delivery of infrastructure in provinces.

There are four key performance areas that IDIP is expected to influence, namely the development of appropriate capacity for infrastructure planning and delivery management (people, skills, and systems); infrastructure plans that provide a clear measure of needs, supply, backlogs, and prioritisation of projects; development of contracts, or service level agreements, that provide clear measures of performance of Implementing Agents including Public Works and contractors; and improvement in the quality of information reported on infrastructure projects.

South Africa's shortage of skilled labour negatively affects economic growth. The 2005 Budget provides about R1 billion to improve the capacity of further education and training colleges to train more people in areas critical to the economy. Changes to the immigration laws also provide scope for attracting skilled labour. However, the long-term solution to the skills deficit lies in improving the quality of school education.

Fiscal policy will continue to be supportive of economic growth through increased public spending, especially on infrastructure, moderate tax relief to businesses and individuals, a sustainable deficit and a stable tax burden.

#### **Question 4: What has your country done to increase domestic resource mobilization including public and private savings and capital formation, and reduce capital flight?**

The Government has embarked on several programmes and legislative reforms. These include:

- **Retirement Fund reform** where Government seeks to build on the strengths of the established environment, while progressively addressing past deficiencies. Among other things, the reform is aimed at encouraging individuals to provide for their own retirement, encouraging retirement funding to be part of the remuneration contract, the retention of purchasing power of pensions and improving standards of fund governance.
- The introduction of **second and third tier banking** legislation with a view to expanding financial services to especially the poor and competition within the industry.
- Work on a **deposit insurance scheme** has progressed and should be completed soon.
- Government launched its **first retail bond to individual** investors in May 2004 in line with Government's policy of increasing access to a variety of investment products to all.

Transformation of the financial sector plays an important enabling role in broadening economic participation. Through the Financial Sector Charter, the financial sector has committed itself to policies aimed at increasing the low income sector's access to financial services (the Mzansi initiative has brought an estimated additional 1 to 2 percent of the population into the formal banking system within its first 12 months of operation), finance for housing, financing of black economic empowerment transactions, targeted investment as well as increased financing for small and medium enterprises.

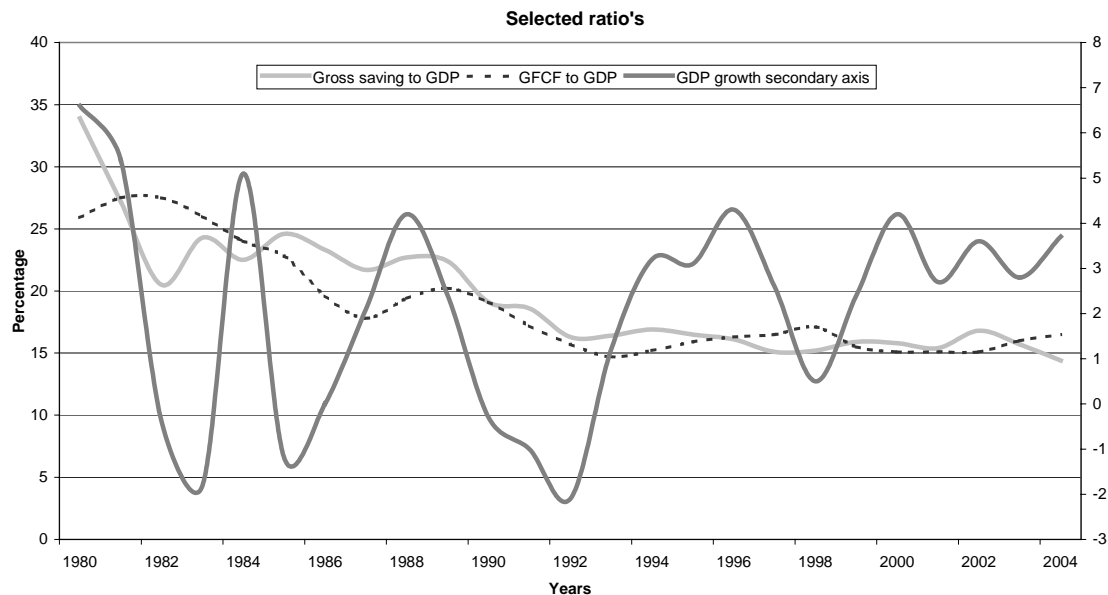
#### **Raising investments as a proportion of GDP**

Government remains firmly committed to increasing the ratio of investment to GDP. In line with this policy objective, capital expenditure by general government accelerated from 3 to 3.5 percent of GDP, with further capital spending planned over the MTEF. Real gross fixed capital formation expanded by 8,6 per cent in the first half of 2005 relative to the same period in 2004, reflecting sustained high levels of business confidence and the expectation of favourable economic conditions in the years ahead.

Government's commitment to increasing the productive capacity of the economy has also been supported by a number of successful public-private partnerships. Growth in gross fixed capital formation by public corporations

has also increased significantly from 2.7 to 15.6 percent, reflecting a substantial improvement and expansion of infrastructure.

Private investment has also remained robust, increasing by 8.9 percent in the first half of 2005 from 12.7 percent in the second half of 2004.



## Address the risk of capital flight

Over the past few years, South Africa has equipped itself to be able to deal with a reversal of capital flows by substantially improving the levels of international reserves (see earlier comments on reserves). Furthermore, financial markets continue to deepen, ratings agency has upgraded South Africa's risk profile, the country is characterised by responsible state spending, and low foreign debt levels. Policies to manage the cyclical capital flows include amongst others the sterilizing of capital flows through reserve accumulation, the use of debt management instruments to promote financial stability, and maintaining confidence in the inflation-targeting framework.

Over the past ten years, South Africa also managed the risk of capital flight during economic transition by following a gradual approach to the lifting of exchange controls on capital outflows.

Key challenges remain: increasing the (domestic) saving to GDP ratio, increasing the gross fixed capital formation ratio to GDP ratio and ensuring the continued expansion of access to financial services. However, as levels of economic activity rise, largely due to strong infrastructure spending, income levels should rise, thereby creating the means for higher domestic saving.

### **Question 5: Extent is your country vulnerable to internal and external shocks**

The South African currency is generally considered to be relatively volatile, as is the case with other commodity exporting countries (including developed countries such as Australia and Canada). Given the negative impact volatility has on growth via uncertainty, Government policy will continue to focus on reducing currency volatility. These include emphasis on reserve accumulation, inflation targeting and reducing growth volatility. It is important to note that the South African Reserve bank (SARB) does not intervene in currency markets to manage the exchange rate, but has bought foreign exchange at times of rand strength to improve its international reserves position. Gross international reserves increased from the equivalent of 70 percent of short-term external debt at end-2003 to an estimated 178 percent as of end-June 2005.

Efforts to reduce external vulnerability through strengthening and reducing the volatility of current account flows have focused on export promotion and diversification. Measures to impact on export competitiveness have focused on skills development, infrastructure investment (particularly in the transport sector) and lowering the costs of doing business especially for SMMEs.

In ensuring internal stability, South Africa will continue on the path of prudent monetary and fiscal policies (as discussed under objective 1, question 1). These policies may need to be augmented by increased GDP growth to ensure continued social stability. As such South Africa seeks more rapid growth not as an end in itself, but as a means of broadening social and economic participation, overcoming poverty, reducing inequality and raising standards of living. The Government's growth strategy focuses both on physical investment and on people. It should foster a climate for robust and sustained investment in productive capacity, and promote investment in people's skills and well-being.

OBJECTIVE II: *Implement sound, transparent and predictable government economic policies*

**Question 1: Efforts your country has taken to make the fiscal authorities work effectively and in a transparent manner**

The South African public expenditure management system has undergone substantial reform since the mid-1990s. The previous system required an overhaul as the new democratic government inherited a system which provided inadequate tools with which to stabilise fiscal imbalances and manage required policy shifts. The system was highly fragmented, not only in terms of a de-linking of policy, budgeting and implementation, but also institutionally, increasing budgeting uncertainty, lack of clarity and the scope for ad hoc changes. It planned and controlled for inputs and cash, with limited opportunity for allocations directly to policy. It was not transparent, with poor underlying information systems, hidden spending and inadequate mechanisms to extract good information for the use in the budget process and for accountability purposes. The budget process itself was largely incremental, offering insufficient opportunity for the new government to identify ongoing non-priority activities and create fiscal room for higher priorities.

Special attention has been given to improve efficient resource allocation and effective service delivery. The highlights of the reform programme have been:

- The roll-out of a new intergovernmental fiscal relation system that requires all levels of government to formulate and approve their own budgets;
- The introduction of 3-year rolling spending plans for all national and provincial departments under the Medium Term Expenditure Framework (MTEF);
- New formats for budget documentation that include a strong focus on spending analysis and service delivery information; and
- The enactment of new financial legislation such as the Public Financial Management Act (PFMA) and the Municipal Financial Management Act (MFMA).

These reforms sought directly to enhance the capacity of the national budget framework to coordinate, integrate and discipline policy and budget processes for the country at national, provincial and local level, and to improve the efficiency of allocations and use of funds, both internally and externally, to improve public policy and funding choices and to enable accountability.

### **Transparency and Predictability**

To improve transparency and predictability, the reforms have focused on increasing the quality of information for decision-making to ensure commitment to decisions taken and to enable accountability. Most of this

information forms part of the budget documentation, which is a key component in external accountability and transparency.

The first public document in the budget process is the Medium Term Budget Policy Statement (MTBPS) which is tabled approximately 4 months before Budget Day. This public document serves to conclude the broad prioritisation phase of the budget process and consolidate the main budgeting ceilings. It signals government's fiscal and budget policy intentions, providing information on the macroeconomic assumptions and policy priorities driving the budget, the fiscal policy framework, the vertical and horizontal division of revenue and the expected functional and economic spending allocations.

The main budget documentation includes the Budget Review, the Estimates of National Expenditure (ENE), the Estimates of Revenue and the Division of Revenue Bill and imparts a comprehensive and transparent review of government's current and planned future fiscal and budget directions, and the consequences of past decisions. Each February, the National Treasury publishes no less than 2000 pages of in-depth statistics, policy information and analysis on the national budget.

The Budget Review provides information on national policy priorities and how they are to be realized through the budget. The Review offers a comprehensive picture of all revenue, including off-budget revenue and expenditure of general government and the main fiscal balances, framed within information on the macroeconomic outlook and key macroeconomic assumptions. Information on the broader public finances is provided with a discussion on its implications for fiscal policy. The Review also discusses revenue issues in detail and the management of public assets and liabilities, including an assessment of contingent liabilities. On the expenditure side, the Budget Review provides aggregate information on the distribution of expenditure in the MTEF framework, between spheres and functions of government and between economic purposes of expenditures.

Detailed financial and non-financial revenue and expenditure information is provided by vote in the Estimates of National Expenditure. The ENE provides 7 years of financial and performance information together, by national vote, and is aimed at providing parliamentary committees and other stakeholders with comprehensive information on departmental performance and plans. An important reform in 2002 has been the introduction of measurable objectives for each spending programme. Departments are required to set out what their main objectives are and what strategies they will be deploying to achieve them, and how they intend to finance these strategies within their budget allocations. They also review their past performance, both financially and in terms of achieving objectives. The ENE effectively serves as a coordinating document for coherent planning and information for departments, since they are called to account in Parliament for their chapters.

The Division of Revenue Bill details the respective shares of the three spheres of government in nationally raised revenue and, together with the Intergovernmental Fiscal Review, is the key public document in the intergovernmental system. It sets out how the provincial and municipal shares are to be divided horizontally, details conditional grants to the sub-national spheres and provides for various procedural matters regarding the management of intergovernmental finances, the responsibilities of Treasuries, accounting officers and the Auditor General. It also legislates a number of rules of cooperative governance, including what must happen if actual revenue falls short of anticipated revenue and how funds may be reallocated from one horizontal unit of government to another. The annexures to the bill include a framework analysis of each conditional grant, detailing its conditions, rationale, criteria for allocation, monitoring mechanisms, past performance, allocations, projected life and payment schedule. This framework is published to provide clarity and certainty on the complex system of conditional grants to stakeholders, and for budget implementation and monitoring purposes. Departments are expected to report against the Division of Revenue Bill and its schedules, covering both financial and non-financial performance. The Auditor General audits compliance with the bill, in both the transferring national departments and the receiving provincial departments and municipalities.

## **Accountability and Public Financial Management**

The PFMA put in place a legal framework for modern public financial management and has been at the centre of government's efforts to enhance public financial management and accountability.

It shifted the onus of managing the use of resources from central control to the managers of spending departments and agencies. This mirrors the shift in budget preparation practices from central decision-making to discretion resting with spending departments for programme choices within spending ceilings. The PFMA does not prescribe specifics, for example what payment approval procedures should be. Instead, the Act specifies who is responsible for putting in place such procedures, what the procedures should achieve, what the information and reporting requirements are and how these are to be overseen, monitored and compliance assured.

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

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

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

In addition to regulating accounting officers and executive authorities, the PFMA provides a legal framework for the role of the national and provincial Treasuries in the budget process, including coordinating the national and provincial budget processes, managing budget implementation and enforcing revenue, assets and liabilities management. It provides the legal framework for the National Treasury to develop the macroeconomic and fiscal framework, coordinate intergovernmental relations and determine the banking and cash management framework.

### **External and internal assessments and oversight**

The Treasury Regulations require all departments to appoint chief financial officers. All departments must set up internal audit committees and formulate 3-year rolling internal audit plans that assess and address key areas of risk, as well as fraud-prevention plans.

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

### **Experiences and challenges**

The South African experience shows that better financial management and improved service delivery do not occur through the passing of legislation and

regulations and the provision of guidelines. Implementation of performance oriented reforms has required appropriate training of managers and recruitment of additional management skills in the public sector, supported by an overhaul of information system and information processing. Furthermore, it involved the building of capacities and an understanding of new concepts and systems, and called for a different style of management across the public sector.

Successful implementation will take time. Nevertheless, much effort is put towards developing practical guidelines, close liaison with departments, better linkages with public service management frameworks, i.e. Public Service Regulations, to address capacity shortfalls.

Reforming the budgeting and public expenditure management system is never the full answer to economic governance challenges; however, when backed by robust political support and decision making systems and sound human resources management, it plays a significant part in improving public sector management.

## **Question 2: What measures have been taken to make economic policies more predictable?**

(As they relate to the National Treasury)

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

National Cabinet makes all the final decisions on medium-term policy priorities and spending; this includes the macro and fiscal framework, the division of revenue and changes to the medium-term allocations to national votes and provincial governments. An important event in supporting this decision making process is Cabinet's periodic strategic planning 'lekgotla' at which budget policy and planning uses are discussed. At the provincial level, discussion on provincial policy priorities and the finalization of allocations to provincial departments takes place in the provincial executive councils. An important principle in structuring the process is the use of inter- and intra-governmental political/technical forums where competing interests are represented on an equal footing, thereby maximizing the possibility of political peer pressure, discipline and sanction.

### **Awareness of national economic policies, their implementation and progress made.**

(As they relate to the National Treasury)

The national budget is widely communicated to people of all spheres of the South African society, through an annual budget speech, extensive coverage in all major newspapers, radio stations and on TV. Documentation on the budget is available on the website of the National Treasury (in a timely fashion), and several NGOs provide extensive analysis of the national budget on their websites.

On Budget Day each year, the National Treasury publishes the People's Budget, which provides an easy accessible summary of achievements and progress, policy priorities and spending plans for the medium term. The extensive budget documentation further provides comprehensive information

for stakeholders to assess government's policies, its progress and implementation.

### OBJECTIVE III: *Promote sound public finance management*

#### **Question 1: What measures have been taken to develop an effective system of fiscal decentralisation?**

(As they relate to the National Treasury)

South Africa is a unitary state with three interdependent but distinctive spheres of government: national, provincial (9) and local (284 municipalities). The Constitution assigns to each of the three spheres of government certain functions, which may be concurrent (shared responsibility between spheres) or exclusive (sole responsibility of the unit of government). The national government's main role is policy making, regulation and oversight. It also administers exclusive functions (justice, defence and foreign affairs). Provinces are mainly responsible for social delivery, either concurrently with national government (primary and secondary education, health, social services and housing) or exclusively (provincial culture matters, provincial sport, recreation and amenities), while municipalities have localised functions (storm water management and fire-fighting) and deliver basic services (water, sanitation, electricity and refuse removal).

The division of revenue between the three spheres of government (national, provincial, local) follows the principle that funds should follow function, and is informed by the responsibilities of each sphere and its capacity to generate revenue to meet its obligations. The share of available revenue for each sphere is determined finally by Cabinet, after a process of consultation and discussions in intergovernmental forums, which is underpinned by technical work undertaken jointly by national and provincial Treasury task teams.

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

In addition to the equitable share, which is a block grant, provinces and municipalities also receive specific-purposes grants and other transfers that are intended to fulfill national policy imperatives in sub-national spheres. Only after the share of each sphere has been determined is the horizontal division of revenue between the provinces determined by transparent formulae that take into account national priorities, relative demand for services between provinces and particular provincial circumstances.

The practice is to phase in any drastic shifts in allocations on account of changes in formula structure or key determinant data so as not to upset the stability of provincial budgets. Similarly, the redistribution of resources from previously disadvantaged to disadvantaged provinces, which resulted from the formula structure and weighting, were phased in over the first few years of the formula.

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

The expenditure mandates of provinces and municipalities are not matched by their assigned revenue-raising abilities, although this is less so for local government which has access to property taxes and user charges. Provinces (and to a lesser extent municipalities) therefore depend on transfers from national government to fulfill expenditure responsibilities. The Constitution states that provinces and municipalities are entitled to a equitable share of nationally collected revenue and that they may borrow under specific circumstances.

The capacity of subnational authorities to generate and manage fiscal resources is largely dependent on their revenue raising capability which is determined by the number of tax payers (individual and business) in their geographical area. Provinces collect relatively little revenue (on average only about 4%? of their total budget), while a number of municipalities are able to generate substantial resources.

While the intergovernmental fiscal relations system is stable and supports affordable and effective spending, there is still room for improving coordination of spending towards policy priorities and for improving the functioning of the intergovernmental forums and other coordination structures.

Effective implementation is also hampered by a lack of management capacity in many municipalities.

#### OBJECTIVE 4: *Fight corruption and money laundering*

### **Question 3: What is the prevalence of money laundering in your country?**

South Africa's legislative framework to combat money laundering consists of the Prevention of Organised Crime Act, Act No. 121 of 1998 ("the POC Act"), the Financial Intelligence Centre Act, Act No. 38 of 2001 ("the FIC Act") and Protection of Constitutional Democracy Against Terrorist and Related Activities Act, Act No. 33 of 2004 ("the POCDATARA Act").

The Financial Intelligence Centre (FIC) Act was enacted to counter money laundering and impose certain obligations on institutions that are vulnerable to be used for money laundering. These obligations entail, amongst other things, the identification of customers; including occasional customers; record-keeping; reporting certain information; and implementing internal rules and training to ensure compliance with these obligations. These obligations apply to a wide range of financial and non-financial institutions referred to in the FIC Act as "accountable institutions".

The FIC's main functions are to collect and analyse information reported to it under the FIC Act and to disseminate information extracted from such reports to the relevant law enforcement agencies for investigation, and is not mandated to investigate the reported information itself. The MLAC advises the Minister of Finance on issues relating to policies and best practices to identify the proceeds of unlawful activities and to combat money laundering. The FIC started functioning in February 2003 and has since then referred a number of matters for investigation by law enforcement agencies. Investigations into these matters are still pending and may lead to charges of money laundering. However, no information on these investigations is currently available.

The main challenges facing the South African anti-money laundering framework revolve around skills and experience. This applies to all areas of the AML/CFT environment, from a shortage of skills and experience to investigate and prosecute money-laundering offences, to a shortage of skills and experience to implement various parts of the legislation within the accountable institutions. An additional challenge concerning the implementation of the legislation is that the current measures for its enforcement by supervisory bodies are inadequate.

## SECTION 4:

### SOCIAL ECONOMIC DEVELOPMENT

OBJECTIVE I: *Promote self-reliance in development and build capacity for self-sustaining development*

#### Question 2: How is the national development programme funded?

Table 1(a) below represents total receipts for the consolidated general government account, which consists of National, Provincial and Local Government and all extra budgetary agencies related to these different spheres. The data is only available up to 2003/04, as the National Treasury is currently in the process of compiling an update of these numbers that will be published in the 2006 Budget Review.

It is clear from these numbers that there is a very low dependency on donor funding for the various expenditure programmes of government. The small amount of donor funds is targeted at very specific expenditure outcomes, for example combating the HIV and AIDS pandemic, specialized interventions where international experts are used to improve financial management skills, etc. and is not used to finance expenditure of a general nature.

**Table 1(a): Total receipts consolidated general government**

	2001/02	2002/03	2003/04
<b>R million</b>			
Own account receipts	292 200	355 081	396 714
Donor funds received	1 423	1 743	1 688
<b>Total receipts</b>	<b>293 623</b>	<b>356 824</b>	<b>398 402</b>
Percentage of total receipts			
<i>Own account receipts</i>	<i>99,5%</i>	<i>99,5%</i>	<i>99,6%</i>
<i>Donor funds received</i>	<i>0,5%</i>	<i>0,5%</i>	<i>0,4%</i>

Legally all donor funds are channeled through the National RDP Fund and are recorded outside of the National Revenue Fund. There is a clear decline in the share of donor receipts, if compared to national government receipts. This is mainly due to a projected leveling out of donor contributions as donor countries focus more of their aid programmes on other developing countries.

## **ANNEX B:**

### **Compliance with Standards and Codes**

**QUESTION 1: To what extent has your country signed, ratified and complied with the following codes and standards?**

South Africa has subjected itself to external reviews under the following standards and codes of relevance to the National Treasury:

1. Code on Good Practice on Fiscal Transparency
2. Guidelines for Public Debt Management
3. International Standards in Auditing
4. International Accounting Standards
5. Principles for Payment Systems
6. Core principles for Security and Insurance Supervision and regulations
7. Core principles for Security and Insurance Supervision and regulations
8. Special Data Dissemination Standard

There is also evidence that relevant Standards and Codes have been used as guidelines in the formulation of national policy frameworks and are consistently and continuously informing further improvements to the South African legislative environment and efforts to enhance the efficiency of policy implementation.

With few exceptions, South Africa is compliant with most of the core principles established by these codes and standards, and has in some cases, as for Public Debt Management, been adopted by the standard setting agencies as a case study.