CHAPTER FOUR

4. ECONOMIC GOVERNANCE AND MANAGEMENT

4.1 Overview

277. Following the transition to majority rule in April 1994, the new South African government inherited an economy that was well-developed, yet characterised by economic stagnation and sharp socio-economic inequalities. The economy was largely in disarray as a result of several years of economic sanctions, internal unrest, lack of investors' confidence, low productivity, and wide asset and income inequalities. Indeed, the apartheid system of government systematically excluded black South Africans from meaningful participation in the economy. Access to skills, self-employment and productive resources was racially restricted through deliberate government policies, beginning in the 1800s with the dispossession of land and continuing through the 20th century under apartheid.

278. The economic legacies of the past are: a long period of economic stagnation, unsustainable levels of inflation and budget deficits, a dualistic political economy, massive structural unemployment, endemic poverty, and a hostile global environment. In fact, when the new government took over in 1994, the economy was characterised by the following:
   - There had been three years of negative growth – the economy and wealth of the nation were shrinking.
   - South Africa had experienced more than a decade of declining growth in per capita terms – the average income of South Africans had been falling since the 1980s.
   - From 1985 to mid-1994, total net capital outflows from South Africa amounted to almost R50 billion.
   - During the fiscal year 1993/94, the government had run up a budget deficit equal to 9.5 per cent of the gross domestic product (GDP), including the debt of the so-called independent homelands.
   - The net open forward position of the South African Reserve Bank (SARB) was US$25 billion in deficit, whereas public sector debt equalled 64 per cent of GDP.

279. The key challenges to the new regime were: to reorientate the economy to meet the needs and aspirations of a new democratic dispensation; to undo the economic injustice of the apartheid era by addressing issues of asset and income inequality; and, in parallel, to create the economic stability and policy credibility needed to stimulate private sector investment and reintegrate the country into the global economy. During the past 12 years South Africa has made measurable progress in addressing these challenges. The macroeconomic situation in the country has changed considerably:

- Inflation has been reduced to 4 per cent if one uses the Consumer Price Index excluding interest rates on mortgage bonds (CPIX), or less than 1 per cent if one uses the Consumer Price Index (CPI).
- The country has experienced the longest period of continuous growth since the GDP was properly recorded in the 1940s.
- The net open forward position of the SARB rose to US$4.7 billion in surplus by the end of 2003 (currently net reserves are over US$20 billion).
- Public sector debt has now dropped to less than 50 per cent of GDP.

280. The government has placed the need to address poverty and inequality firmly at the epicentre of its development agenda. This is reflected in the various development policy documents and strategies that have been initiated. In a broad sweep of events, the government adopted three main development strategies. The first of these was the Reconstruction and Development Programme (RDP) in 1994, which could be viewed as the cornerstone of the government's development policy during 1994-1996. The RDP sought to attain socio-economic growth and delivery of basic services, while at the same time addressing the legacy of apartheid through racial-targeted investments in healthcare, education and social security. It placed emphasis on people-centred, integrated and sustainable development that is democratic and participatory.

281. However, as a development policy document, the RDP had a number of shortcomings: it had some overambitious targets; it made no attempt to set priorities or assign responsibility for the implementation of each programme component; and it lacked mechanisms for ensuring interdepartmental coordination. Moreover, local government, which has been assigned constitutional responsibility for promoting socio-economic development, did not have adequate planning and implementation capacity. Despite these shortcomings, the RDP played a critical role in fostering a democratic culture and establishing the legitimacy of the African National Congress (ANC).

282. Although the government appeared to have been content with the RDP's broadly humanitarian thrusts, problems began to surface from 1995. The economy, in particular, was not growing at the envisaged rates. The sluggish economic performance in turn impacted negatively on the RDP, with achievements falling behind expectations. The welfare orientations of the programme also came under critical scrutiny as investors and international financial institutions began demanding greater clarity on national economic policy.

283. In response, the government introduced the Growth, Employment and Redistribution (GEAR) Strategy in 1996, which reflected the beginning of a significant shift in economic management. GEAR did not completely depart from earlier government policy but committed the government to accelerating aspects of existing policy through macroeconomic stabilisation.

284. However, many of the gains expected to result from the adoption of the measures did not materialise, as GEAR failed to attain many of its goals in an effective manner. Although

changes in corporate tax levels, foreign exchange controls and interest rates have yielded some degree of increased investment, many of the strategy's long-term targets were not met. The anticipated 6 per cent growth rates in GDP have not been achieved, as the intrepid deficit reduction, through its associated demand compression, fostered a lower growth rate.

285. During the period under GEAR the economy grew by only 3.3 per cent and, by 1998, it was actually contracting at 0.3 per cent per annum, partly due to contagion from a global downturn in international financial markets. Similarly, exceptionally poor performance was recorded in the job market. Instead of achieving the creation of 200 000 jobs in the first 18 months of GEAR's existence, 80 000 jobs were in fact lost. By 1999, it was estimated that the economy had actually shed off some 500 000 jobs since 1994 and 350 000 since the inauguration of GEAR in 1996. Throughout this period, formal employment dropped. Similarly, investment rates were low and foreign direct investment (FDI) inflows disappointing. Thus, although GEAR helped ensure macroeconomic stability and thereby enhanced the government's international status, yielded tangible macro-stabilisation achievements and enhanced policy legitimacy, it did little to redress the sharp social economic inequalities in South Africa.

286. Notwithstanding these initiatives, rapid growth and job creation remained elusive. In response, the government initiated the Accelerated and Shared Growth Initiative for South Africa (AsgiSA) in 2005 to accelerate economic growth, job creation and skills development largely through prioritised expenditure on economic infrastructure, health and education. (AsgiSA is discussed in greater detail in Chapter Six.)

287. Undeniably, the government has restored and maintained macroeconomic stability after decades of isolation and economic sanctions. Inflationary pressures have generally been contained while budget deficits have been reduced through robust measures for revenue mobilisation. However, experience has shown that unqualified reliance on market forces and macroeconomic management does not necessarily ameliorate the poverty and unemployment situation. (These issues are explored in greater detail in Chapter Six.)

288. Heightened fiscal discipline has been integral to the stabilisation effort. The government has sought to maintain a competitive tax regime, increase social spending at a measured and sustainable pace, and introduce greater transparency and accountability into the budget process at all levels of government. By the 2002/03 fiscal year the public sector borrowing requirement had been lowered to around 1 per cent of GDP, from a peak of around 9 per cent in 1993/94. This effort involved major improvements in the efficiency of tax collection, facilitated by the creation of an independent revenue authority, the South African Revenue Service (SARS).

289. Undoubtedly, the success SARS has had in broadening the tax base through improvements in efficiency has made it possible to exceed its revenue targets. This strong performance has facilitated cuts in both personal and company income tax rates. The fiscal strategy has

also rested on such initiatives as the Public Finance Management Act (PFMA) of 1999 and the Municipal Finance Management Act (MFMA) of 2003. These were designed to monitor and control spending better and to provide safeguards against waste in the government. In the process, important changes took place in the composition of government spending. A lower debt service burden and large cuts in defence spending freed resources that were reallocated to enhance the delivery of social services and upgrade the country's economic infrastructure.

290. South Africa's monetary indicators have also been favourable. Inflation is down to 4 per cent (based on the CPIX measure) and is comfortably within an inflation target range of 3 to 6 per cent, whereas net foreign reserves exceed US$18 billion. The key challenge, however, is to translate macroeconomic stability into rapid growth and development that also benefits a broad section of the South African society.

291. Improved macroeconomic conditions have contributed to a more positive sovereign rating of South Africa. Several credit-rating agencies upgraded the country's ratings in 2005 and, in the process, reduced sovereign risk spreads to historic lows by decreasing the cost of capital to South African borrowers. In August 2005, Standard & Poor's upgraded South Africa's long-term sovereign borrowing in foreign currency from BBB to BBB+, which is equal to that of Poland and Thailand and a notch above Mexico's. In the rating for borrowing in local currency South Africa was upgraded from A to A+, citing the country's improved economic stability, reduced vulnerability to external shocks, moderate debt burden, and strong and stable political institutions. A rival international ratings agency, Fitch, had South Africa on a positive ratings watch at the time. Moody's, the third major ratings agency, upgraded South Africa's credit rating in January 2005, reflecting a strong track record of macroeconomic management and improved prospects of sustainable higher GDP growth rates. South Africa was also rated the most competitive economy in sub-Saharan Africa and the most attractive country in Africa to invest in by the World Economic Forum's 2004 Annual Global Competitiveness Index.

292. However, while real economic growth in South Africa has been consistently positive, it has remained well below the targeted 6 per cent real GDP growth rate which it is believed would extricate the bulk of the historically disadvantaged from the shackles of poverty. In 2005, South Africa experienced a GDP real growth rate of 4.9 per cent, its highest since the end of apartheid. In fact, by the third quarter of 2005, South Africa had experienced six years of uninterrupted economic growth. The relatively high growth was driven by strong domestic demand, with private consumption and investment spending supported by low interest rates and improved sentiment. Household consumption was also boosted by rising incomes and wealth effects from buoyant housing and stock prices. However, economic growth remained robust in the first two quarters of 2006, but showed some moderation compared with 2005. An annualised growth rate of 4.2 per cent was recorded in the first quarter of 2006.

293. The distribution effects of growth have, however, been unsatisfactory. Unemployment has remained high and poses a significant challenge to social and economic policy. In 2004, the official rate of unemployment stood at 26 per cent of the labour force, excluding discouraged workers (i.e. job seekers who were pessimistic about finding a job and indicated they were not looking for a job during the four-week period preceding the employment survey). This is roughly the same level as in 1994. The unemployment rate was 40 per cent of the working age population, including discouraged job seekers. 2006 figures from Statistics South Africa (StatsSA) show a marginal drop in unemployment of about 0.9 per cent, which is encouraging. However, more needs to be done to reduce the levels substantially. Unemployment is particularly concentrated among historically disadvantaged groups and is higher among rural and female populations, the uneducated and the youth. Although higher employment growth has accompanied the increase in economic growth since 1994, it has not kept pace with growth in the potential labour force. During 1995-2003, employment increased by around 1.25 per cent annually, while the labour force grew by 4 per cent.

294. South Africa continues to be characterised by sharp economic dualism. A sophisticated industrial economy has developed alongside an underdeveloped "informal" economy. While much of the white population and emergent black middle class of about 13 per cent of the population benefit from a developed economy with an established infrastructure and an economic base that possesses great potential for further growth and development, large segments of the population that constitute the "second economy" continue to live in abject poverty. The large informal economy presents both untapped potential and a development challenge for South Africa.

295. Achieving the national objective of broad-based growth and development will invariably require policy measures for addressing pervasive distortions in all factor markets: for labour (as is evident in the scale and persistence of unemployment and inadequate investment in human capital); for capital (seen in the relatively low savings and investment rates and the limited and capital-intensive nature of FDI); and for land (due to the failure of land reform and rural development efforts to reverse policies that over decades have virtually eliminated the small farming sector). The unfinished agenda of structural reforms leaves South Africa at a disadvantage in an increasingly competitive global environment. Indeed, failure to deconstruct the institutional framework on which apartheid was based has perpetuated extreme income inequality and constrained poverty reduction.

296. In recognition of these challenges, the authorities have unveiled the ambitious AsgiSA, which elaborates a broad framework of further steps to be taken to accelerate growth and development and ensure that its benefits spill over to a broad section of society. The main focus of AsgiSA is to deal with a set of binding constraints (Box 4.1) that inhibit faster growth and development.

Box 4.1: The Accelerated and Shared Growth Initiative for South Africa

Although AsgiSA is still a work in progress, it has identified six key constraints to growth and is formulating proposals to address some of them:

1. **Level and volatility of the exchange rate.** The volatility of the South African rand is thought to be deterring investment in tradable goods and services that are not commodity based. The rand has also been perceived in some official circles as overvalued, in the sense that economic resources have been diverted into narrow areas of investment.

2. **Inadequate infrastructure and logistics.** The government plans to invest the equivalent of about 20 per cent of 2005 GDP over the next three years in transport, communications and power provision by public enterprises; housing and social institutions; and provincial projects in agriculture, mining and other areas.

3. **Skills shortages.** Measures in this area include the Joint Initiative on Priority Skills Acquisition (JIPSA), which is a new committee with representatives from the government, business, labour and education, tasked with identifying and addressing urgent skills shortages. The immediate focus will be on the skills needed for infrastructure development, public service delivery, and sectors identified under AsgiSA as priorities (e.g. tourism).

4. **Barriers to entry and competition.** Competition policy is being reviewed to find ways to reduce input costs and promote "downstream" sectors like metal fabrication, machinery and plastics. Discriminatory pricing practices that favour exports over domestic markets (the so-called import parity pricing) have been targeted. Duties on certain steel products, for example, have been removed to facilitate greater import competition.

5. **Regulatory environment.** A current review includes plans to introduce one-stop shops for starting businesses, a system for analysing regulatory impact, and improved planning at provincial and local levels. The environmental impact assessment (EIA) system will also be reformed.

6. **Capacity limitations within the government.** Project Consolidate aims to improve provincial and local administration, including through the deployment of skilled professionals where they are most needed. Development finance institutions (DFIs) will also be reviewed.

Other initiatives being considered under the AsgiSA framework include:

- Sectoral investment and industrial strategies. A number of sectors have been earmarked for special support, starting with outsourcing and tourism (together expected to create 500 000 jobs). Investment in research and development will also be supported.
- "Second economy" interventions, including support for SMEs and black economic empowerment (BEE) through, for example, preferential procurement, improved access to small-scale credit, and the provision of employment through the Expanded Public Works Programme (EPWP). The impact of labour laws on SMEs is also being reviewed.

Source: www.info.gov.za/asgisa.

297. The constraints identified are: threats to macro-stability, including currency volatility; inefficiencies in the national logistics system; shortage of skilled labour; disjointed spatial settlement patterns and high levels of inequality; barriers to entry and competition in key sectors of the economy; the burden of the regulatory environment and the impact this has on small and medium enterprises (SMEs); and deficiencies in the organisation of capacity and strategic organisational leadership.

298. The proposals included in the initiative are:
- Increasing infrastructure spending by over R370 billion over the medium term expenditure period;
- Encouraging firms worldwide to outsource labour-intensive activities to South Africa to take advantage of lower labour costs;
- Articulating short and medium-term strategies for expediting skills development for the implementation of AsgiSA projects; and
- Reducing the size of the "second economy" by utilising targeted public expenditures to promote small business development; designing sector strategies informed by the development needs of the second economy; and reducing the regulatory burden, particularly on small enterprises.

299. Indeed, the turbulence (damaged confidence, slow recovery and threat to macroeconomic stability) that rocked international financial markets over the last few years has affected South Africa as well. Furthermore, the rapid spread of the HIV and AIDS pandemic in South Africa threatens the hard-won health and social service delivery gains of recent years, and poses an even more fundamental challenge to long-term poverty reduction.

300. In sum, 12 years into the post-apartheid era, the transition is far from over. What lies ahead is the daunting task of ensuring that South Africa's rich natural and human resources are employed for the benefit of all, promoting sustainable livelihoods, improving social conditions and alleviating poverty. However, the progress made so far in macroeconomic governance has qualified South Africa to be classified as an emerging market economy. Egypt and South Africa are the only two African countries that have qualified to be listed in the exclusive league table of developing countries that are striving to move up the economic ladder.

4.2 STANDARDS AND CODES

i. Summary of the CSAR

301. The CSAR does not address in detail South Africa's compliance with the standards and codes as requested in the APRM Questionnaire. Rather, there is a broad listing of all the adopted standards and codes in this thematic area in an appendix to the CSAR.

ii. Findings of the CRM

302. Discussions with the Department of Foreign Affairs indicated that South Africa has indeed acceded to and ratified all relevant standards and codes as listed in the APRM Questionnaire. These are the:

- NEPAD Framework Document of 2001 (a signature or ratification is not required as South Africa was one of the five initiating states of the New Partnership for Africa's Development);
- Constitutive Act of the African Union (2000; ratified on 23 April 2001);
- Code of Good Practices on Fiscal Transparency;
- Guidelines for Public Debt Management;
- Code of Good Practices on Transparency in Monetary and Financial Affairs;
- Principles for Payment Systems;
- African Union Conventions on Preventing and Combating Corruption (signed on 16 March 2004 and ratified on 11 November 2005);
- Abuja Treaty establishing the African Economic Community in 1991 (acceded to on 25 June 2001);
- Best Practices for Budget Transparency; and
- Relevant Treaties, Conventions and Protocols of Regional Economic Communities.

The codes below are also discussed more elaborately in Chapter Five:

- International Standards in Auditing;
- International Accounting Standards (IAS);
- Core Principles for Security and Insurance Supervision and Regulations;
- Core Principles for Effective Banking Supervision; and
- Principles of Corporate Governance (both national and international).

303. The CRM could not ascertain the extent of compliance with these standards and codes. The 2005 Article IV consultation with the International Monetary Fund (IMF), however, indicates that South Africa has completed reviews of the full range of standards and codes. By the end of April 2005, South Africa was one of only two IMF members to have completed Reports on the Observance of Standards and Codes (ROSCs) in each area endorsed by

the IMF and World Bank as being important for their work. Five of these ROSCs have been published, covering data on transparency; anti-money laundering and combating the financing of terrorism; corporate governance; accountancy; and auditing.

General Data Dissemination Standards

304. South Africa subscribes to the General Data Dissemination Standards (GDDS) of the IMF and the United Nations' Fundamentals of Official Statistics. In its assessment of South Africa's national accounts statistics in the context of the ROSCs, the IMF indicated that the country subscribes to the GDDS and publishes all data on the reserves template.

305. Economic data for South Africa are generally of good quality and are provided to the public in a timely manner. The key challenges are to improve the quality of labour market and real sector data, and to narrow the scope of unidentified transactions in balance of payments statistics. This would facilitate economic analysis and support policy design and implementation. Although the authorities have indicated that they plan to address weaknesses in labour market statistics, they also need to overcome capacity constraints.

iii. Recommendations

306. The APR Panel recommends that South Africa:

- Address weaknesses in labour market statistics and also overcome capacity constraints. [StatsSA]

- Take measures to narrow the scope of unidentified transactions in the balance of payments statistics. [SARB]

4.3 Assessment of the Performance on APRM Objectives

Objective 1: Promote Macroeconomic Policies to Support Sustainable Development

i. Summary of the CSAR

307. The CSAR notes that South Africa has achieved macroeconomic stability without necessarily constraining government spending. It highlights the success of the South African government in achieving macroeconomic stability and reversing the negative growth trend inherited prior to the end of the apartheid regime in 1994. Indeed, South Africa has succeeded in reducing the budget deficit to GDP ratio, while at the same time increasing social spending and reducing the tax burden for a broad section of the society. The government's success in this area can be attributed to improved revenue collections, which have ensured increased social spending and, in parallel, provided tax relief for companies and individuals. Indeed, the CSAR praises SARS for consistently exceeding its revenue targets, although sceptics attribute this success to poor or deliberately conservative revenue forecasting.

308. Inflationary pressures have been contained. The SARB has also been largely successful in moderating inflationary pressures and reducing the volatility of the South African rand through its inflation targeting policy. However, concerns have been raised about the volatility of the rand over time. Businesses note that the strengthening of the rand is undermining export competitiveness in manufacturing and job growth.

309. South Africa's economic growth has not, however, been associated with significant job growth. Notwithstanding improvements in the macroeconomic indicators, economic growth has been modest and hence unable to absorb many new entrants to the labour market. It is hoped that the country's new development paradigm, AsgiSA, will succeed in raising growth to at least 6 per cent per annum and ensure that its benefits are broad based and accrue to the majority of the citizenry through job creation for millions of unemployed.

310. Efforts are in place to increase investment and boost long-term economic growth and employment through robust mobilisation of domestic resources. Submissions acknowledged the efforts of the government to boost domestic savings, stimulate capital formation and control capital flight. These include changes in banking regulations, development of low-cost banking accounts, pension reforms and increased government capital expenditure. Appropriately channelled additional resources accruing from increased savings could promote investment and accelerate growth and employment.

311. South Africa is still confronted by sharp asset and income inequalities typified by the dualistic nature of its economy. The CSAR notes that South Africa has two economies: the first is developed, prosperous and male dominated; while the second is underdeveloped, survivalist and virtually de-linked from the growth opportunities generated by the first economy. The government's efforts to bridge the gap between the first and second economies through BEE initiatives have been faced with challenges ranging from poor skills to a general lack of access to credit within the second economy. These constraints constitute significant barriers to employment and entrepreneurship.

312. The broad-based BEE initiative aims to reduce race-based inequalities by integrating emerging "black" businesses into the value chain through: preferential procurement; financing; regulations using a balanced scorecard to measure progress in achieving BEE objectives; legislation for issuing guidelines and codes of good practice on BEE; the establishment of a Business Advisory Council to advise the President on the implementation of BEE; and partnerships with the private sector. However, the benefits of this programme have largely been concentrated among a few black people. While the CSAR acknowledges the existence of several initiatives to improve access to credit (e.g. Industrial Development Corporation, National Empowerment Fund, Khula Enterprise Finance Limited, Apex Fund etc.), small, medium and micro-enterprises (SMMEs) continue to experience credit constraints.

313. Capacity constraints and the legal and regulatory environment are of particular concern to businesses regardless of their size. Businesses cite skills shortages and overregulation, including the labour market, as constraints to competitiveness and employment growth.

Consequently, they recommend the introduction of regulatory impact assessments to build an empirical case for policy change in this area. Trade unions, however, are not convinced that current labour laws are overly stringent and inflexible. Both business and labour acknowledge the need to nurture and retain skills in the private and public sectors through capacity-building initiatives. Skills shortages tend to be most severe at the sub-national levels (provinces and municipalities) despite targeted interventions such as Project Consolidate.

314. The perceived effectiveness of the government's HIV and AIDS policies is mixed. The CSAR generally acknowledges that the potential economic impact of HIV and AIDS on South Africa's economic growth is significant. While some perceive that the actual impact will be mitigated by prevailing measures to address the pandemic, others are of the opinion that the government's interventions have failed to achieve the desired outcomes. The increase in the number of AIDS orphans is, however, of concern to most respondents.

315. Data on poverty are unsatisfactory. The CSAR raises concerns about: the availability of poverty-related data; the appropriateness of adopting a definition of unemployment that excludes discouraged workers; and the independence of StatsSA.

II. FINDINGS OF THE CRM

Macroeconomic Record

316. The CRM observed that economic policy has been conducted in an exemplary manner since 1994, with South Africa turning itself into one of the emerging markets with the lowest risk spreads.

317. By early 2006, the economy was experiencing an economic boom unprecedented in South Africa's history. The 2006 second quarter Economic Prospects of the Bureau for Economic Research (BER) pointed out some of the outstanding facts:

- Real GDP growth had averaged 4.9 per cent in 2005, the fastest growth rate since the (short-lived) spurt of 1984.
- The current business cycle upswing was running for a record 19 months.
- Real household consumption expenditure grew by 6.9 per cent, the fastest annual growth rate since 1981.
- 2004 and 2005 showed the lowest inflation rates recorded in 37 years.
- Long-term interest rates registered a 35-year low of 7.3 per cent early in 2005.
- The household debt ratio accelerated to a record high of 65.6 per cent at the end of 2005, while the household debt to service ratio remained close to a 25-year low at 7 per cent.
- The budget deficit was estimated at 0.5 per cent of GDP for the fiscal year 2005/06, i.e. the lowest in 25 years.
- The gold price reached a 25-year high early in 2006.
- The financial account of the balance of payments recorded an inflow of R98.4 billion, the largest ever – though, of course, this net capital inflow financed a large current account

deficit of R64.4 billion, or 4.2 per cent of GDP. In the first quarter of 2006, the deficit hit 6.4 per cent of GDP, the highest since 1982.

318. To be added to this impressive list is the volume of international reserves that South Africa has accumulated in recent years. Between the end of 1996 and the end of 2005, gross international reserves (GIR) increased from US$2.2 billion to US$20.6 billion. By the end of May 2006, the GIR exceeded US$24 billion. Figure 4.1 shows developments in some macroeconomic aggregates.

319. The CRM noted that the democratic elections in 1994 and the lifting of international economic sanctions against South Africa paved the way for broad liberalising reforms. An underlying principle for virtually all government policy is to bring the previously excluded black community into the mainstream economy through job creation and entrepreneurship. The overall results of reforms to date have been positive, with a stronger and stable macroeconomy, better integration into the global trading system, and some progress in redressing past injustices.

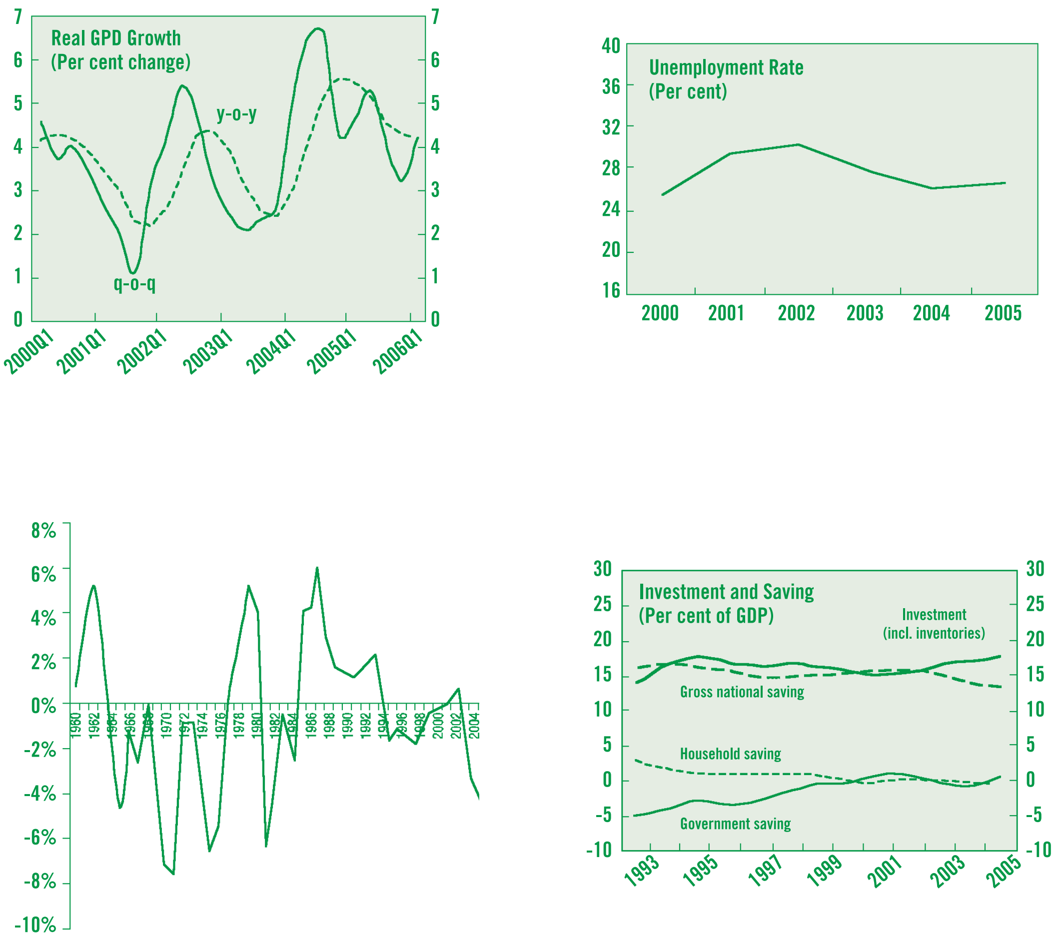
320. Despite these macroeconomic successes, several challenges remain in the area of macroeconomic management. While growth increased substantially over the past decade, it has not been sufficient to reduce unemployment and poverty significantly. Investment and production growth are still below the levels needed to boost jobs and reduce inequality. The distribution of income and wealth in South Africa is highly unequal.

321. Perhaps the major challenge confronting policy-makers in South Africa is the unemployment rate, which has grown inexorably and poses a significant social and economic policy challenge. Another serious challenge is the high level of crime, especially crime of a violent nature. The adverse effects of HIV and AIDS result in lower labour productivity, loss of labour, and higher production costs (including health costs). In recent surveys, a majority of firms in the mining, manufacturing and transport and storage sectors have reported such problems.

322. As mentioned earlier, the authorities have, in recognition of these constraints, launched AsgiSA, which aims to raise the rate of GDP growth to 4.5 per cent through 2009 and 6 per cent during 2010-2014, and to halve the rates of unemployment and poverty by 2014. This initiative seeks to achieve higher sustained economic growth; markedly reduce unemployment and poverty; and address other urgent social needs. The strategy is to remove the most binding constraints on growth while preserving macroeconomic and financial stability.

323. The authorities have begun to identify binding constraints on growth and design policy measures, as indicated in Figure 4.1. The government has consulted with a range of stakeholders, including a panel of international experts, which will be providing backstopping advice over the next two years.

Figure 4.1: Main Macroeconomic Aggregates



Source: South African Treasury Department.

324. The APR Panel believes that the AsgiSA growth targets appear achievable at a general level, judging from the history of growth accelerations worldwide.

325. However, the Panel wishes to reiterate that despite the many strengths of the South African economy, there are several real, emerging and potential imbalances in the economy that constrain efforts at reducing poverty. Apart from the major disparity between rich and poor, there are also:

- A chronic shortage of savings in the country. Gross domestic savings amount to only 14 per cent of GDP, whereas investment in the expansion of production capacity requires more than 20 per cent of GDP;

- A relatively high predisposition to consume (resulting in low savings and low investment ratios);

- High propensity to import consumer goods in response to expansion in domestic demand, putting pressure on the balance of payments; and

- A chronic shortage of skilled and professional workers, which places continuous excessive pressure on wages and salaries.

326. Macroeconomic policies such as fiscal and monetary measures at all time must take account of these imbalances to ensure sustainable development in the long run.

Monetary Policy Effectiveness

327. The mandate of the SARB, as the central bank of South Africa, is defined in the Constitution as the protection of the value of the currency in the interests of balanced and sustainable economic growth in the Republic. Deriving from this constitutional mandate, the Bank regards its primary goal in the South African economic system as "the achievement and maintenance of price stability".[18] This is currently interpreted as CPIX inflation (i.e. headline inflation less mortgage interest costs) being 3 to 6 per cent.

328. An interesting development in central banking in the past 20+ years has been the increasingly widespread adoption of the monetary policy framework known as inflation targeting. Over the past decade, variants of inflation targeting have proliferated, with newly industrialised and emerging market economies (e.g. Brazil, Chile, Israel, Korea, Mexico, South Africa, the Philippines and Thailand) being among the most enthusiastic initiates.[19]

329. A formal inflation targeting regime was announced in South Africa with the presentation of 2000/01 budget. A target range of 3 to 6 per cent was established for the annual average rate of CPIX inflation, starting in 2002. The choice of the target would be a prerogative of the National Treasury. An escape clause was introduced in the 2001 Medium-Term Budget Policy Statement, which allowed the SARB to define publicly the target as temporarily non-binding under special circumstances, such as supply shocks. A Monetary Policy Committee (MPC) would meet at the SARB every six weeks to assess monetary conditions and decide on the appropriate level of the repurchase interest rate (key policy rate). Several changes to the framework were subsequently made. The annual average target was replaced with a continuous year-on-year rolling target, still at 3 to 6 per cent. The escape clause was replaced with an explanation clause – the SARB would explain the reasons for deviations from the target and indicate by when the inflation rate was expected to return within

[18] See www.reservebank.co.za.

[19] Most recently, this policy framework was also adopted by several transition economies, notably the Czech Republic, Hungary and Poland. Central banks that have switched to inflation targeting have generally been pleased with the results obtained. The strongest evidence is that, thus far at least, none of the several dozen adopters of inflation targeting has abandoned the approach.

the target range. The frequency of the MPC meetings was reduced to four a year and subsequently increased to six a year.

330. Indeed, the most significant accomplishment of the SARB has been the containment of inflation at a relatively low level since 1994 and within the target range since September 2003. This does not imply that other functions are neglected. On the contrary, these remain crucial in the operations of the SARB. Despite some initial setbacks in late 2001 and during 2002, when inflation increased rapidly in reaction to the significant depreciation of the currency, the inflation targeting framework has served South Africa well. Having averaged 7.9 per cent between 2000 to 2002, inflation has been contained within the target range since September 2003. For the past two years inflation has averaged 4.0 per cent. Without getting into its merits and demerits, the inflation targeting framework has served as a good anchor for monetary policy in South Africa. It has led to better coordination of monetary policy and other economic policies than was the case in the past. The political commitment, as evident in the pursuance of prudent fiscal policies, has been crucial to the containment of inflation within the target band.

331. The CRM noted that despite positive developments in the inflation outcomes during the past years, the rate of increase in domestic demand was a cause for concern. In the last two years, household consumption expenditure has grown at annual real rates of almost 7 per cent. Retail sales continued to grow strongly and consumer confidence reached an all-time high by the end of 2005. This was fuelled by high rates of credit extension by the banking sector, which averaged over 20 per cent in 2005 and resulted in household debt rising to 66 per cent of disposable income in the first quarter of 2006. The strong growth in expenditure had little immediate impact on domestic inflation, although adverse price effects would be inevitable if these trends continued unabated.

332. Increases in domestic consumption expenditure, however, contributed to the progressive widening of the deficit on the current account of the balance of payments from 4.2 per cent of GDP in 2005 to 6.4 per cent in the first quarter of 2006. This development poses a potential threat to inflation through its possible impact on the exchange rate, should the deficit be regarded as unsustainable. Nevertheless, these deficits have so far been adequately financed by capital inflows. However, in response to these heightened risks and the deteriorating inflation outlook, the MPC took some pre-emptive actions. These saw the repurchasing rate increasing by 50 basis points to 7.5 per cent in June 2006, a further 50 basis points in August 2006 and by 50 basic points in October 2006.

333. The SARB published its new strategic framework and strategy for the National Payment System (NPS), known as Vision 2010, in April 2006. Vision 2010 provides strategic direction for the payment system and its bank and non-bank participants up to 2010. It identifies five major challenges for the payment system: accessibility; transparency; security; support for payments; clearing and settlement initiatives of the Southern African Development Community (SADC); and keeping abreast of international developments.

334. The monthly value of settlement in the South African Multiple Option Settlement (SAMOS) system amounted to R4.6 trillion in June 2006, or approximately R200 billion per day. This includes the settlement of transactions stemming from the equity and bond markets, as well as the rand leg of domestic foreign exchange transactions. Approximately 90 per cent of settlement through the SAMOS system is affected on a real-time basis during the day, while the remaining 10 per cent emanating from the retail batch environment is settled in the evening. An upgrade of the SAMOS system providing for the handling of dematerialised money market instruments was successfully implemented in June 2006.

335. The SARB has continued to facilitate a low-cost payment solution for the different role-players in the low-income collection environment.

336. The CRM sought to determine the extent to which the SARB's inflation targeting policy is aligned with the government's vision of achieving real growth rates of 6 to 8 per cent. It was unclear from the discussions whether the inflation target is consciously aligned with the policy priorities of the government as espoused in AsgiSA. What emerged was that the overriding concern of the SARB appears to be price stability as a precondition for growth. Currently, the fiscal and monetary policies do not appear to be working at cross-purposes, since considerable fiscal space has been created through a conservative fiscal policy stance and improved revenue collection.

337. Furthermore, the limited capacity of the public sector to absorb the revenue build-up has resulted in an accumulation of unspent funds and redirected attention to improving absorptive capacity at the national and sub-national levels as opposed to generating additional resources. For instance, in the fiscal year 2005/06, the non-financial public sector recorded a cash surplus for the first time in history, amounting to 0.7 per cent of GDP. In addition, the deficit declined to 1 per cent of GDP, well below the projected deficit of 3.1 per cent of GDP.

338. However, this favourable situation may change as inflationary pressures exert upward pressure on interest rates, as government spending on infrastructure and social services rises in response to the demands of AsgiSA, and as the capacity to absorb revenues improves. Indeed, there are indications of rising inflationary pressures fuelled in part by a depreciating rand and continued high levels of consumer expenditure. In response, the MPC increased the repurchase rate from 7.0 to 7.5 per cent per annum on 8 June 2006. This followed a period of 14 months during which the repurchase rate had been kept unchanged. This is the first increase in the benchmark rate since September 2002.

339. Since its establishment, the SARB has always been privately owned. It has over 630 shareholders and its shares are traded on an Over-the-Counter Share Transfer Facility Market coordinated within the Bank. However, the South African Reserve Bank Act of 1989 states that no individual shareholder may hold more than 10 000 shares of the total number of 2 000 000 issued shares. After allowing for payment of company tax on profits, transfers to reserves and dividend payments of not more than 10 cents per share

to shareholders, the surplus of the SARB's earnings is paid to the government. Presumably these provisions ensure that the Bank's operations are not driven by a profit motive, but serve the best interests of all the people.

Budget Formulation and Fiscal Policy Effectiveness

340. The CRM noted with interest the budget formulation process in South Africa, which is very insightful. Within the context of budgetary discipline, budget prioritisation has progressively become more inclusive. Two key episodes in the role of the Cabinet in the annual budgetary process are the lekgotlas[20] held in January and July each year. All Cabinet Ministers, Deputy Ministers, Director-Generals and some Presidential Staff – a total of 80 to 90 people – attend these two or three-day retreats. The annual process starts with a request, early in the calendar year, by the Minister of Finance for the contributions of all Ministers to the budgetary priorities paper for the July lekgotla. This paper goes first to the Ministerial Committee on the Budget (MCB), chaired by the Minister of Finance. The other seven senior Cabinet Members making up this group, as well as heads of some of the big-spending departments (e.g. the Department of Education), are selected to represent the Cabinet and make decisions in the overall national rather than sectional or departmental interest. The President, who has his or her own economic adviser as well as a Policy Coordination and Advisory Services Unit, has input at all stages, especially during the drafting of the budgetary priorities paper.

341. The budgetary priorities paper is, in practice, an expression of priorities for the following MTEF round. It is finalised at a Cabinet meeting in June and discussed at the July lekgotla. Departments thereafter submit their detailed bids for the upcoming budget, plus their spending plans for the next two years. These plans are discussed first in the Medium-Term Expenditure Committee (MTEC). The MTEC's recommendations are reviewed by the MCB over the next few months and individual Ministers are called in to discuss issues arising from their bids. The MCB also reviews the macroeconomic framework and fiscal policy, including the division of revenue between the three spheres of government (national, provincial and local). Recommendations on this last issue are made by the independent Financial and Fiscal Commission (FFC). In late September, the MCB's proposals are considered by an "extended" Cabinet meeting (the normal Cabinet plus the nine provincial premiers) and, in October, by the Cabinet proper.

342. When the Minister of Finance submits the detailed budget to the Cabinet in November, he does so with the MCB's backing. Ministers who are dissatisfied with their allocations may raise objections at this late stage, but these rarely lead to significant changes. The budget is approved at the January lekgotla. A few last-minute changes can still be made before it is presented to the parliament in February. The Minister of Finance briefs the President two days before the budget is presented and also before the President's State of the Nation Address is finalised. The Cabinet receives the printed budget review a week before it is presented.

[20] These are meetings on budget preparation aimed at obtaining cooperation and consensus as outcomes.

343. The January lekgotla also begins the process of planning priorities for the next MTEF round and the following year's budget. Clusters comprising Ministers from several departments aim to provide the first statements of medium-term priorities for the departments concerned. From the discussion at the lekgotla the President's staff writes up a government-wide statement of priorities. After reference to the clusters for approval, this statement informs the President's State of the Nation speech, given in February.

Best Practice 6: The Budget Formulation Process
South Africa has one of the model Medium-Term Expenditure Framework (MTEF) processes, with heavy involvement throughout by the Cabinet and other key stakeholders. As a result the budget, and therefore policy, is highly predictable and the government has consistently maintained strong budgetary discipline. The two annual lekgotlas set the tone. The Cabinet in its various forms (regular, extended, and lekgotla) has at least eight meetings a year on budgetary matters. The MCB meets four or five times a year and is explicitly intended to serve as a substitute for the Cabinet, acting in collegial mode. Frequent meetings of Ministers further encourage collegiality, or at least collectivity, for other purposes. There are six Cabinet subcommittees that meet every two weeks, and the Cabinet itself meets in the intervening weeks. The President or his or her staff, or both, has the chance to be involved during all stages of the process. Working relationships between the President and the Minister of Finance are said to be close. The MTEF, which has reduced the significance of the annual budgeting process by putting it into a three-year context, has encouraged both longer-term thinking and planning, and some propensity to prioritise. Source: www.pmg.org.za, www.gcis.gov.za, APRM CRM compilation, July 2006.

344. Normally, one adjustment budget is produced each year, seven or eight months into the fiscal year. This budget allows for supplementary appropriations (although only for unforeseen and/or unavoidable contingencies), for supplementary appropriations, and for the allocation of windfalls.

345. The CRM found that revenue collection improved due to increased efficiency in collection (due to investments in electronic filing modalities and increased personal visits) which, as noted above, increased the fiscal space for higher expenditure on social services without compromising total government expenditure. Improvements in revenue collection have effectively widened the tax base and made it possible for the government to: reduce taxes for low-income earners and corporations; increase social service expenditure; and reduce fiscal deficits. However, the CRM also found that the government has not been able to utilise or absorb fully the additional resource flows resulting from improved revenue collection due to a lack of capacity in all three spheres of government.

346. The CRM noted that the success of revenue agencies in exceeding their targets can be attributed to challenges in forecasting. Specifically, revenue agencies have had trouble anticipating higher-than-expected GDP growth and accurately reflecting efficiency

gains from tax collection in their forecasting models. Moreover, variations in absorptive capacity across government agencies create a situation where some agencies' budgets are considerably underspent while others run out of funds before the end of the financial year. The government proposes to implement an information system for capital expenditure management to address this problem. These efforts must be complemented by parallel initiatives to improve the absorptive capacity of government agencies.

Capacity Development and Retention

347. The government has developed several initiatives and institutions for addressing the capacity constraints confronting the country. These include JIPSA, the Sector Education and Training Authority (SETA), further education and training (FET) colleges, vocational training, adult basic education and training (ABET) and learnership programmes. The CRM, however, observed that such programmes are not directly linked to employment opportunities, which results in frustration among beneficiaries. Furthermore, some contractors charged with implementing learnership programmes abandon the programmes midway, thus leaving participants short of the requisite skills required for employment or sustaining a small business. Moreover, the skills imparted tend to be so narrowly based that beneficiaries are vulnerable to changes in the economic climate.

Broad-Based Black Economic Empowerment

348. The CRM noted that the benefits of the Broad-Based Black Economic Empowerment (B-BBEE) programmes are mainly concentrated among a minority of the historically disadvantaged. Implementation is hampered by: a general lack of information about the programmes; ineffectiveness of existing monitoring mechanisms in alerting officials to implementation bottlenecks, such as delays in payments to beneficiaries; and nepotism and favouritism when awarding contracts. The CRM was also alerted to conflict of interest that minimises the benefits of B-BBEE. Stakeholders are of the view that government officials are often given major ownership stakes in firms they previously had a responsibility to regulate, thus bringing in issues of corruption and conflict of interests.

349. It has been estimated that the thriving black middle class emerging from black economic empowerment (BEE), and particularly those who earn at least R154 000 a year, grew by 368 per cent between 1998 and 2004. Although the numbers benefiting from the BEE programme are still relatively small and "production" still lags behind demand, BEE is nevertheless impacting favourably on the growth rate of the economy.

350. Some stakeholders informed the CRM of an emerging trend in which some government officials, immediately upon retirement or resignation, take up appointment with entities that benefited directly from their oversight role. This behaviour is tantamount to the abuse of official position. Further, in view of the apparently limited impact of B-BBEE on black economic empowerment, some have suggested that the programme is depriving the economy of much-needed funds for investment.

351. In the government's response to concerns about BEE, it was indicated that prior to the release and adoption of the first phase of the Codes of Good Practice on B-BBEE by the Cabinet, BEE benefited the elites without being broad based. In fact, 70 per cent of BEE transaction deals concluded before the release of the draft codes in 2004 solely involved the top six BEE consortia and only 10 per cent involved broad-based groups. While the phenomenon of having fewer individuals benefiting from BEE deals is still prevalent in the South African economy, the trend is towards a drastic decline in such BEE transaction practices. The majority of BEE deals now involve broad-based schemes, black women, young people and new entrants, thus ensuring that the broader community is involved in BEE, particularly in the ownership component. The participation of black women as significant partners in BEE deals has increased steadily after the release of the draft codes, standing at 60 per cent of the deals concluded. There has been a marked increase in the participation of broad-based groups, especially employees (70 per cent), in BEE deals during 2005/06.

352. The Broad-Based Black Economic Empowerment Act of 2003 provides for the establishment of a national advisory council on BEE. The Black Economic Empowerment Advisory Council was established as a mechanism for providing guidance and overall monitoring on the state of BEE in the entire economy. It will make policy recommendations to deal with bottlenecks and address those areas that may contribute to unintended outcomes.

353. The Council's functions, as set out in section 5 of the Act, include the power to: conduct research; request information from organs of state or private bodies; publish reports on BEE; establish subcommittees to deal with specific matters as and when required; co-opt experts to serve on or advise subcommittees and oversee the functions of the different sector Charter Councils. (These Councils are established through the sector transformation charters whose mandate it is to monitor and advise the government on BEE performance at sectoral level.) The BEE Advisory Council is to be established immediately once the codes of good practice are gazetted and adopted by the Cabinet, and it is anticipated to provide effective monitoring on BEE performance.

Quality and Coverage of Statistical Data

354. Interactions with StatsSA and stakeholders revealed that the quality of statistical data on core economic and social indicators such as real GDP growth, inflation, unemployment and interest rates is generally higher than for other indicators. This is consistent with the findings of the CSAR. Submissions by StatsSA reveal that data on the prevalence rates of HIV and AIDS are particularly difficult to compile, since medical officials do not always attribute the immediate cause of death to HIV and AIDS. This is because the proximate cause of an HIV-related death is invariably an opportunistic disease resulting from a compromised immune system. Data quality is also constrained by a general lack of skills in StatsSA.

355. Representatives from StatsSA unequivocally stated that there is no political interference in the production and dissemination of statistical data. They pointed out that while the Minister of Finance determines what data StatsSA can collect, it is the prerogative of StatsSA to determine how to collect such data and when to terminate collection of such data if it so chooses. The CRM had no evidence to contradict this assurance that StatsSA's independence, as guaranteed by the Constitution, has not been compromised.

iii. Recommendations

356. The APR Panel recommends that South Africa:

Monetary Policy Effectiveness

- Ensure consistency between the inflation target and AsgiSA's growth target. [SARB]
- Continue to r eform the payments systems. [SARB]

Broad-Based Black Economic Empowerment

- Link skills development programmes to job creation. [Government]
- Strengthen monitoring and evaluation systems to assess the effectiveness of government programmes. [Government]
- Consider imposing restrictions on the professional activities of officials, public or private, after their resignation or retirement, especially where such activities or employment relate directly to entities over which they have had an oversight role in the past. [Government]

Quality and Coverage of Statistical Data

- Devote more resources to improving the quality of data on poverty, HIV and AIDS and labour statistics. [StatsSA]

Objective 2: Implement Sound Transparent and Predictable Government Economic Policies

i. Summary of the CSAR

357. The CSAR indicates that since 1994, the National Treasury has successfully implemented much-needed reforms to the fiscal system. The major features of these reforms were: the creation of a new intergovernmental fiscal relations system; multi-year budgeting through the MTEF; new budgeting formats focusing on spending analysis and service delivery information; and the introduction of the PFMA and MFMA. As a result of the above reforms, the quality of annual financial statements improved with implementation

of the PFMA and the transition from a cash basis for accounting to the modified accrual basis. The majority of national and provincial departments now comply with the deadlines for submitting financial statements and tabling in the relevant legislature. Many local governments, however, still have problems complying with the deadlines. Implementation of the MFMA is intended to address the situation. The CSAR further notes that the Public Service Commission (PSC) has observed that the number of qualified audit reports in the public service is a matter of concern, which is indicative of the challenge for departments to comply with the PFMA.

358. The consultative process needs to be strengthened. The CSAR is critical of the quality and frequency of engagement by the citizenry, particularly at provincial and municipal levels. There is a concern that, in its current form, the consultative process does not allow for substantive input from a wide range of stakeholders.

359. The oversight role of the parliament needs to be strengthened. Several submissions in the CSAR urged the parliament to enact the necessary legislation to allow it to change line items in the budget[21]. Currently, the parliament is limited in its oversight role because it is only allowed to vote yes or no to the entire budget without being able to modify line items or programmes. The CSAR also notes that national and provincial legislators fail to monitor and evaluate adequately public expenditure at the sub-national level or hold departments accountable for poor-quality activity reports. The CSAR observes that the implementation of policies at sub-national level is hampered by poor intergovernmental communication. It suggests that efficiency in the delivery of services to the community could be enhanced through improved coordination, oversight and intergovernmental communication.

ii. Findings of the CRM

Financial Reporting

360. Submissions by the Auditor-General corroborate findings in the CSAR that a significant number of provincial and local governments do not meet the deadlines for filing required disclosures, financial statements and performance reports. The CRM observed that weaknesses in financial and audit reporting are attributable to capacity constraints, particularly at provincial and municipal levels. Meanwhile, the majority of social and infrastructure spending is undertaken at the sub-national levels. For instance, the Department of Health transfers 92 per cent of its programme budget to the provinces.

361. The CRM identified other related factors contributing to the relatively high number of qualified audit reports. Most departments are unable to keep pace with the rapidly changing guidelines that frame the reports. The problem is compounded by the limited capacity of these institutions.

362. Information provided by the government regarding the tabling of provincial annual reports shows that there was significant improvement in 2005/06, as reflected in Table 4.1.

[21] See section 3.2.10 of the CSAR.

Table 4.1: Tabling of Provincial Annual Reports, 2005/06

Tabling information	EC	FS	Gau	KZN	Lim	Mpu	NC	NW	WC	Total
Number of departments	13	12	13	16	13	12	13	12	13	117
Tabled timeously	13	12	12	16	10	10	12	10	13	108
Tabled late	n/a	n/a	1	n/a	3	2	1	n/a	n/a	6
Outstanding	n/a	n/a	n/a	n/a	n/a	n/a	n/a	2	n/a	3

Source: Department of Public Service and Administration, January 2007.

Stakeholder Consultations

363. The CRM identified gaps in stakeholder consultations, particularly at provincial and municipal levels. The mechanism for information dissemination tends to favour organised stakeholders and the elite. Several stakeholders indicated they were uninformed about dates and venues for scheduled public consultations. The CRM also notes a sense of apathy among stakeholders stemming from a feeling of exclusion from the benefits of social programmes. There is considerable room for improvement in stakeholder participation in the formulation of provincial and municipal development plans. Stakeholders expressed the concern that although they participate in the consultative process, they tend to be disconnected from the outputs of such processes. For example, copies of provincial and municipal development plans are not widely disseminated in local languages. This constrains absorption of information among stakeholders about sub-national development strategies and, in turn, compromises effective stakeholder participation in the monitoring and evaluation of sub-national development plans and programmes.

Parliamentary Oversight

364. The CRM corroborated the CSAR's findings that parliamentary oversight has been weak. In the meeting with the national parliament and based on interactions with stakeholders, the CRM found that the ability of the parliament to examine the budget critically and offer an alternative framework is limited. The PFMA, enacted in 1999, provides a legislative framework for the performance of oversight in the area of budgeting. Although it increased the importance of committees as oversight bodies and thus created an enabling environment for more effective oversight, the capacity of the parliament and the provincial legislatures was not at a level that could take advantage of these changes. Additionally, while the PFMA outlined specific roles for the legislatures, these functions are not being effectively carried out due to limited staff and capacity. The CRM also noted that lack of resources was another constraint hindering the ability of the parliament to carry out its oversight function.

365. The CRM noted that although the Constitution empowers the parliament to amend money Bills (i.e. a Bill that appropriates money or imposes taxes, levies or duties), legislation stipulating how this should be done has not been enacted. Section 77 states that the parliament can amend money Bills, but only by way of a process provided for in national legislation: "An Act of parliament must provide for a procedure to amend money Bills before parliament." No such legislation has been enacted thus far and, as a result, the parliament cannot amend line items in a money Bill. It can either accept or reject it in its entirety. The inability of the parliament to amend money Bills, including the budget, considerably weakens the measure of parliamentary oversight.

366. The CRM was, however, impressed with oversight in KwaZulu-Natal. In deliberations with the provincial legislature, the team was informed that oversight is conducted against a set of performance criteria. Departments are expected to produce a strategic plan with measurable output/outcome indicators that are incorporated into the budgetary process. There are 14 portfolio committees whose main function is to monitor departments. These committees meet with every department once a month to scrutinise the budget and to establish whether they are meeting the expectations of the public. Moreover, the Standing Committee on Public Accounts (SCOPA) also scrutinises the report of the Auditor-General and the departments.

iii. Recommendations

367. The APR Panel recommends that South Africa:

Financial Reporting

- Stringently enforce penalties for late filing of financial statements. [Government]
- Step up efforts to strengthen the monitoring and evaluation capacities of local governments in order to facilitate effective use of public resources. [National, Provincial and Local Governments]

Stakeholder Consultations

- Broaden outlets for disseminating information about stakeholder meetings at all spheres of government. [National, Provincial and Local Governments]
- Make an effort to translate provincial and municipal development plans into local languages. [Provincial and Local Governments]

Parliamentary Oversight

- Expedite the enactment of legislation empowering it to amend line items of the money Bill. [Parliament; Government]

- Strengthen the parliament to interrogate line items in the budget. [Legislature; Government]
- Empower the parliament and the provincial legislature to effectively carry out their oversight function. [Government]

Objective 3: Enhance Sound Public-Finance Management

i. Summary of the CSAR

368. According to the CSAR, the government has implemented several structures and legislative frameworks since 1994 to improve and ensure the maintenance of sound public finance management. These are anchored by the PFMA and the MFMA. These two Acts regulate how government revenues and expenditures are to be managed at all levels of government. In addition, the Public Service Management Framework requires all provincial departments to formulate strategic plans 12 months prior to the beginning of the fiscal year. These plans must explicitly identify measurable outputs as well as the resources needed to deliver them. These initiatives have resulted in significant improvements in public finance management since 1994.

369. The economy, however, is continuously being plagued by an acute lack of capacity, especially financial expertise for managing social programme spending and facilitating the delivery of services at the provincial, municipal and local (district) levels. The emigration of trained and experienced staff from the public service to the private sector and foreign destinations during the past 12 years has exacerbated the impact of skills shortages and made capacity building at all levels of government an imperative.

370. The government has developed a customer-service scheme known as Batho Pele (People First). The principle of this scheme requires that citizens should be consulted about the level and quality of the public services they receive, and told what level and quality of public services they will receive, so as to be aware of what to expect. People should be given full and accurate information concerning the public services they are entitled to receive. This vision is driven by the Government Communication and Information System (GCIS).

371. The CSAR noted that the government has instituted several initiatives to improve local government capacity, including Project Consolidate. As mentioned, this initiative seeks to enhance social service delivery at local government level by fielding in the required personnel wherever needed. However to date, it has not yielded the expected results because of the depth and pervasiveness of the problem of skills deficiency and the limitations of hands-on and top-down approaches to local government by the national government. (These were discussed extensively in the overview of Chapter Three.) Consequently, partly due to the failure of the approaches, it is now openly admitted that easing skills shortages may entail recruitment of foreign experts, bringing retirees back into public service and bringing South Africa in the diaspora back even for a short period while efforts continue to build local capacity.

372. On fiscal decentralisation, the much-needed legislation and regulation for improving the quality of financial management at local and provincial governments are in place. According to the CSAR, the various submissions widely agreed that the nation's biggest problem in fiscal management involves poor control, transparency and accountability at sub-national levels. Furthermore, the submissions made it clear that fiscal control, staff capacity and managerial performance issues are all intertwined.

ii. Findings of the CRM

373. Issues concerning public finance management across the three spheres of government (national, provincial and local) and the fiscal relations among them were a major preoccupation of stakeholders during the CRM's provincial visits. The key issues discussed were:

- The process of preparing and implementing a predictable national budget within the MTEF;
- The effectiveness of SARS in generating projected revenue and expenditure targeting, monitoring, reporting and auditing, and oversight functions of the legislature in fiscal operations;
- Promotion of sound and effective public finance management; and
- The allocation of resources between national, provincial and local governments.

374. There is consensus among all stakeholders that the government has put in place a sound framework for public finance management, and that management of public finances has improved since 1994. An efficient agency for domestic revenue collection is in place. In the past four years, SARS has consistently exceeded its forecasted target due to greater efficiency in revenue collection. However, capacity and skills deficits have resulted in under-spending of the budget, especially in the lower spheres of government. There are problems with respect to financial/expenditure control, tracking and monitoring, particularly at municipal level.

Best Practice 7: South African Revenue Service

Despite the challenges in revenue projection noted in this chapter, SARS has been effective in consistently exceeding its revenue target. SARS was established by the South African Revenue Service Act of 1997. Unlike many revenue agencies worldwide, SARS is an administratively autonomous organ of the state; it is outside the public service but within the public administration. Thus, although South Africa's tax regime is set by the National Treasury, it is autonomously managed by SARS. The main functions of SARS are to: collect and administer all national taxes, duties and levies; collect revenue that may be imposed under any other legislation; provide protection against the illegal importation and exportation of goods; facilitate trade; and advise the Minister of Finance on all revenue matters. Due to efficiency gains in tax administration, SARS over time has been able to implement fundamental tax policy reforms that have improved the culture of tax compliance and contributed to SARS's success in consistently exceeding its revenue target. Consequently, the South African economy has an impressive tax revenue to GDP ratio of over 26 per cent.

Source: www.sars.gov.za, APRM CRM compilation, July 2006.

375. Stakeholders in both the public and private sectors feel proud and very satisfied that their government is in a position to finance its expenditure programmes from domestic resources without resorting to external borrowing. There is general consensus that South Africa has no serious constraint in funding a sustainable social and economic development agenda. The challenge is that of putting in place a development strategy that will squarely address issues of structural unemployment, underdevelopment, inequality, social service delivery and poverty. The CRM concurred with this view. Nevertheless, very low levels of domestic savings and investments, coupled with the high propensity to import consumer goods, weak inflows of FDI and low levels of fixed capital formation could probably and partially explain the slow growth in job creation in the economy.

376. The CRM lauds the South African government for initiating public service principles in government service, but is of the view that more needs to be done to improve compliance with these principles. For instance, stakeholder consultations revealed a lack of compliance with Batho Pele principles despite the establishment of the Quality Assurance Unit of the PSC and the multi-purpose community centres (MPCCs). Stakeholders raised concerns about the nonchalant attitude of civil servants and poor compliance with the principle that citizens have to be given reasons when they are adversely affected by the government's decisions. A 2004 PSC study found that only 57 of the 115 provincial and national departments had service standards[22] as required by Batho Pele. There is a need to evaluate and augment existing monitoring mechanisms for improving compliance. To this end, the introduction, particularly at sub-national level, of citizens' satisfaction surveys that rank institutional compliance with Batho Pele in a transparent way, should be seriously considered.

[22] The service standard refers to the principle that citizens should be told what level and quality of public services they will receive so that they are aware of what to expect.

377. The CRM noted with satisfaction the shift by the national government to devolve greater autonomy to sub-national governments. One manifestation of this trend is fiscal decentralisation, operationalised through conditional and unconditional transfers from the centre to sub-national governments. The CSAR observes that there is a need to step up fiscal control, as well as transparency and accountability in the administration of funds at the sub-national levels. In addition to these issues, the CRM observed that the provinces are very dependent on the national government for their resources. Indeed, 97 per cent of provincial expenditure is financed by transfers from national government and almost 90 per cent is received by way of unconditional grants disbursed on the basis of the Provincial Equitable Share (PES) formula. Provinces raise roughly 1.3 per cent of their revenue from internal sources but account for 44 per cent of total government expenditure at all levels. The disproportionate dependence of the provinces on transfers implies that the volume of expenditure incurred by each province depends on the volume of transfers.

378. It implies that the national government has a significant influence on equity considerations in spending through the current structure of the PES formula. Moreover, the absence of a fixed formula for determining vertical resource flows from the centre to the sub-national governments potentially compromises the fiscal autonomy of these entities, since it leaves such decisions to the discretion of an external agent, the FFC. Section 220 of the Constitution mandates the FFC to make recommendations on the vertical division of nationally raised revenue among the three spheres of government and the horizontal allocation across sub-national governments. However, while the PES formula has been developed to guide horizontal allocations, no corresponding formula exists for vertical allocations. The FFC should consider the possibility of establishing a formula for the vertical allocation of resources. One possibility is to allocate a fixed percentage of revenues to the sub-national governments to strengthen the fiscal autonomy and predictability of sub-national resource inflows.

379. The formula for sectoral allocations of resources needs closer examination. The CRM noted the concerns raised by the FFC about the extent to which the weights applied to the seven components[23] of the formula appropriately reflects the changing priorities and composition of sub-national expenditure and input cost variations across provinces, municipalities and local governments. It is also worth noting that there is no correspondence between the criteria for resource allocation to the provinces and the uses to which such resources are put. For instance, even though education constitutes 41 per cent of the total unconditional provincial transfer, apparently due to its perceived priority, provinces are not required to spend 41 per cent of their resources on education, since the transfer is unconditional and thus fully fungible. The criteria for revenue allocation need to be more closely aligned with spending patterns and applied on a needs basis.

380. The CRM was pleased to learn that Chapter 13 of the Constitution addresses revenue sharing. Provincial and local governments are said to be protected from abuse under vertical revenue sharing by a list of ten criteria in section 214 of the Constitution as well as the Bill of Rights.

[23] The components are: education (41%); health (19%); welfare (18%); basic services (7%); economic activity (7%); institutional factors (5%) and infrastructure backlog (3%).

381. There are portfolio and standing committees at the national parliament and provincial legislatures with oversight functions to ensure accountability and proper use of government resources by the executive. There are physical oversight exercises by the legislature through visits to projects in order to verify project implementation by the executive. Departmental accounts are audited annually. By law:

- Departments submit financial statements within two months;
- The Auditor-General must audit within two months (by end July); and
- Departments must submit annual reports, including financial statements and audit reports, to the parliament before six months after the year end (municipalities do so within seven months).

iii. Recommendations

382. The APR Panel recommends that South Africa:

Capacity and Decentralisation

- Continue to improve capacity and skills development in the area of public finance management, particularly at the provincial and municipal levels. [National, Provincial and Local Governments]
- Periodically undertake a national capacity and skills audit to determine the nature of the capacity constraint and types of skills shortage. [DPSA]
- Establish an effective supervisory framework for monitoring and evaluating service delivery, infrastructure and administrative capacity at the local and municipal levels of government. [National, Provincial and Local Governments]

Oversight Role of the Parliament

- Enable members of parliament (MPs) and the provincial legislature to participate regularly in workshops, seminars, etc. relevant to their oversight function in order to enhance their capacity as watchdogs in all aspects of fiscal management. [Parliament; Provincial Legislature]

Fiscal Decentralisation

- Align provincial and local government resource allocations with sub-national and national development priorities. [Government]
- Orient monitoring and evaluation mechanisms for verifying alignment and include a component for alignment in the formula for horizontal resource allocation. [Government]

- Establish appropriate incentives for provincial and local governments to raise more of their own revenue and direct expenditure towards sustainable economic growth and development. [Government]

Objective 4: Fight Corruption and Money Laundering

i. Summary of the CSAR

383. The national government has introduced and promoted several pieces of legislation for preventing and combating corrupt practices. It has also adopted various international audit standards, signed protocols against corruption, and ratified various international conventions on preventing and combating corruption. Although there is some concern about the level of corruption and its debilitating effects on service delivery and the fight against poverty, South Africa has a relatively lower level of corruption compared with many other African countries. This, however, is no reason for complacency.

384. Some relevant pieces of legislation that were introduced and promoted include the Protected Disclosures Act of 2000; Promotion of Access to Information Act of 2000; Financial Intelligence Centre Act (FICA) of 2001; Promotion of Administrative Justice Act of 2000; and the Prevention and Combating of Corrupt Activities Act of 2004. The last Act is based on actual experiences of corruption and seeks to address the systemic lapses that make it possible.

385. South Africa has created institutional framework at national and provincial levels to complement the work of the South African Police Service (SAPS). These include: the Public Protector; National Prosecuting Authority (NPA); Special Investigating Unit; PSC; Financial Intelligence Centre; and the Auditor-General. Specialised commercial courts have been established to prosecute and try corrupt offenders. In addition, an Asset Register has been created for accounting officers to disclose their financial assets and interests.

386. South Africa's integrated approach to fighting corruption is anchored by the Public Service Anticorruption Strategy under the auspices of the Department of Public Service and Administration (DPSA). The government has made the fight against corruption a key priority of its governance and administration cluster.

387. South Africa is also a party to the SADC's Protocol Against Corruption (2001), a signatory to the African Union (AU) Convention on Preventing and Combating Corruption, the UN Convention Against Corruption (2003) and a member of the Financial Action Task Force (FATF). [24]

388. Of the reported cases of corruption, civil society is responsible for uncovering 18 per cent of the cases in state structures; official process was responsible for 60 per cent; and the media uncovered 9 per cent that would have not been known because of the sensitivity of the cases.

[24] South Africa formally acceded to the OECD Convention on Combating Bribery of Foreign Public Officials in International Transactions in April 2007.

389. A framework for combating money laundering is in place. The FICA of 2001, the Prevention of Organised Crime Act (POCA) of 1998, and the Protection of Constitutional Democracy Against Terrorism and Related Activities Act of 2004 constitute the main pillars on which the efforts of the government to combat money laundering rest.

390. South Africa has a comprehensive legal structure to combat money laundering. This was observed by the 2004 ROSC for the FATF; the 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations for Combating the Financing of Terrorism prepared by the representatives of member jurisdictions of the FATF and the Eastern and Southern African Anti-Money Laundering Group (ESAAMLG); and members of the FATF and ESAAMLG Secretariats.

391. Currently, the main statutes are the POCA and the FICA. The Financial Intelligence Centre and other supervisory and investigative bodies appear to be genuinely committed, although there are capacity issues to be dealt with to implement the new system efficiently. However, many of these measures are new and have not been fully put into effect yet. All sectors need to continue to increase their focus on and training in anti-money laundering issues.

392. The CSAR indicates that the real challenge confronting the South African anti-money laundering framework is the shortage of skilled and experienced manpower needed to investigate and prosecute offenders and execute various aspects of the legislation in accounting institutions.

ii. Findings of the CRM

393. During its discussions with stakeholders at national and provincial level, the CRM focused on stakeholders' perceptions of corruption within the economy and whether the government had put in place any framework to fight corruption and combat money laundering. Stakeholders were more interested in discussing corruption than money laundering because most of them were not aware of the existence of the latter.

394. There is misunderstanding about the difference between corruption and misallocation of funds at the provincial and municipal levels of government. As part of the effort to combat corruption, an anticorruption hotline has been established in the offices of all Premiers in all the provinces and there is some indication that offenders are being prosecuted and punished. The main challenge, however, is lack of adequate capacity to handle reported cases expeditiously at all levels of government.

395. It is gratifying to note that the executive fully understands the need for firm enforcement and implementation of laws and rules for the proper control of corruption, as well as the strengthening of existing institutions established to perform related tasks.

iii. Recommendations

396. The APR Panel recommends that South Africa:

Corruption

- In collaboration with civil society organisations (CSOs), undertake measures for strengthening the human capacity needed to investigate and prosecute cases of reported corruption. In the absence of domestic capacity, this could be achieved by specifically recruiting such personnel from outside South Africa in the short run while internal training programmes are being put in place to train locals. [Government in collaboration with CSOs]

- Take proper steps to enforce compliance with the code of conduct for National Assembly and permanent Council members, and the public service regulations that require Ministers, members of the Executive Council (MECs) and upper-level managers to declare their assets and financial interests. [Government]

- Publicise all cases of officials found guilty of corruption to serve as a deterrent to potential offenders. [Government; Media]

Anti-Money Laundering

- Take proactive action to address the acute shortage of skilled and experienced personnel capable of investigating and prosecuting money-laundering offences, and rigorously implement and enforce the relevant laws. [Government in collaboration with CSOs]
- Strengthen the capacity of institutions responsible for reporting money-laundering activities to ensure that they are complying with their obligations as stipulated in the FICA. [Government]

Objective 5: Accelerate Regional Integration by Participating in the Harmonisation of Monetary, Trade and Investment Policy

i. Summary of the CSAR

397. The CSAR states that the Southern African Customs Union (SACU) and the SADC are of great importance for South Africa's relations with Africa. Apart from these two sub-regional institutions, South Africa has preferential trade agreements with the European Union (EU), the European Free Trade Association, and Mercosur. South Africa also belongs to the Indian Ocean Rim Association for Inter-Regional Cooperation.

398. South Africa has signed and ratified the SADC Trade Protocol, which aims to attain sustainable economic growth through industrialisation. The SADC's goals are to become a

free trade area by 2008, a Customs Union by 2010 and a Common Market by 2015. As noted in the CSAR, significant political, economic and bureaucratic challenges confront the SADC in its attempt to reach these objectives.

399. Trade balances within the SADC have continued to remain in favour of South Africa, accounting for 50 per cent of intra-SADC exports and 10 per cent of its imports. To address the trade imbalance, South Africa extended tariff preferences to SADC countries since January 2006 so that all imports from these countries will have duty-free status. Concerns were raised about rules of origin of products within the SADC Trade Protocol that continue to help protect South African producers from competitors in other SADC countries.

ii. Findings of the CRM

400. Regional integration constituted a major aspect of deliberations during the CRM, both in the capital and the provinces. Stakeholders indicated that South Africa has been actively involved in regional integration initiatives within the region in the context of globalisation. Being the largest and most sophisticated economy in Africa, the country has quite naturally taken a leading role in these initiatives. There is a relatively high degree of convergence among the economies of South Africa, Swaziland, Lesotho, Namibia and Botswana due to initiatives like SACU,[25] being the oldest customs union (formed in 1910), and the Common Monetary Area (CMA) agreement along with Lesotho, Swaziland and Namibia. The CRM noted in general that the CMA and SACU have encouraged stable macroeconomic conditions in member countries as well as enhanced welfare.

401. At a regional level, South Africa is also a member of the SADC, along with Angola, Botswana, the Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Swaziland, Tanzania, Zambia and Zimbabwe. Among other things the SADC seeks to deepen trade and economic and financial integration within the region, and the CRM acknowledges the progress made so far on several fronts, albeit at a slow pace. Through these groupings, South Africa has managed to maintain important trade and investment links in Africa. Over the last ten years, South Africa has been the single largest foreign direct investor on the continent.

402. South Africa has also been fully involved in the restructuring of the SADC to ensure that it delivers tangible benefits within the region and plays a useful role on the continent. Of particular importance is the 15-year Regional Indicative Strategic Development Plan (RISDP), which is aimed at operationalising the restructured SADC to address pressing development needs. The RISDP has been developed in line with NEPAD and is the regional expression of NEPAD's priorities and objectives, which will ensure that the SADC's development agenda works in tandem with that of the AU. One measure of the strong political and economic cooperation between South Africa and its SADC neighbours is that by 1999, South Africa had established residential missions in all SADC capitals.

[25] Currently, other member countries are Botswana, Lesotho, Namibia and Swaziland.

403. South Africa, together with other SADC countries, is working towards the creation of a customs union that would ultimately lead to the establishment of the SADC Common Market by 2015. Towards this end, the region has established the following important targets: the formation of a free trade area by 2008; completion of negotiations of the SADC Customs Union by 2010; and completion of negotiations of the SADC Common Market by 2015.

404. Some stakeholders were concerned about the free trade agreement South Africa entered into with the EU in 2000. This development presents both opportunities and challenges for the southern Africa region, more especially SACU member countries. The Trade Development and Cooperation Agreement (TDCA) will open up the 25 EU economies to 95 per cent of South African goods over a ten-year period, while allowing up to 86 per cent of EU goods into South Africa's market over a 12-year period. South Africa on its part agreed to reduce import duties on EU goods from 10 to 4.3 per cent, while the EU lowered import duties on South African goods from 2.7 to 1.5 per cent. A general expectation of the TDCA was that fiscal revenue would decrease initially due to cuts in import duties. SACU countries, however, have seen an increase revenue-sharing formula, as well as the growth in the South African economy.

405. Macroeconomic convergence is key to the acceleration of regional integration within SADC countries. Substantial progress has been made towards this objective which, among other things, calls for attainment of deeper monetary policy cooperation in order to maintain economic stability within member countries, which is a necessary step for growth and faster integration. It is hoped that by 2008, member countries would have attained single-digit inflation rates; decreased budget deficits to less than 5 per cent of GDP; and achieved gradual interconnection of payments and clearing systems, among other things. To this end, South Africa has been actively involved in the SADC's Committee of Central Bank Governors (CCBG), a body established by the SADC Ministers of Finance in 1995 to achieve closer financial/monetary cooperation and integration within the SADC region. The body meets twice a year and is chaired by the SARB Governor. Through these meetings, SADC member countries have thus far managed to bring about closer cooperation in the areas of monetary policy and instruments which, inter alia, span the areas of bank supervision; money and capital markets; international financial relations; national payment systems; clearing and settlement systems; human resource development; and money laundering.

406. Greater regional integration calls for further reduction or removal of exchange controls. If left unchanged, exchange controls could deter investors and be a stumbling block in the way to smooth, effective cooperation among members. The CRM noted that although South Africa has made considerable progress in easing exchange controls, the process has stalled since 2004, the target year for the abolishment of all intra-regional exchange controls. To date, exchange controls are still being implemented to a large degree. This has resulted in low levels of FDI to the country, while direct investment by South African companies in the SADC region has been on the rise, tipping the scale in favour of South African investors.

407. Some stakeholders were, however, of the view that South Africa is still faced with the challenge of clarifying its position from that of a regional hegemony to one of partnering

with all member states in achieving the region's common agenda. In order for regional integration to become a reality in southern Africa, South Africa needs to strike a good balance in this respect.

408. The challenge for South Africa in the coming years is that of ensuring effective implementation of the RISDP and further strengthening of the reorganised SADC. The country needs to find a more equitable trade structure to address the current imbalances of trade that are in its favour.

409. Stakeholders indicated that South Africa, together with other pivotal African states, has played a leading role in reconstituting the Organisation of African Unity into the AU. Since hosting the inaugural summit of the AU in July 2002, South Africa, in collaboration with other member countries, has been fully engaged in operationalising AU organs and structures. To this end, the country has hosted the Pan-African Parliament since September 2004, while at the same time playing a pivotal role in the implementation of NEPAD and the APRM, as indicated in Box 4.2.

Box 4.2: The Role of South Africa in NEPAD and the APRM

South Africa has played a prominent, leading role in developing NEPAD and supporting its structures and processes. The President, as one of the five initiators of NEPAD, has actively participated in almost all the meetings of NEPAD's Heads of State and Government Implementation Committee (HSGIC). As Chairperson of the AU in 2002/03, the President was responsible for the overall roll-out of NEPAD as the socio-economic development programme of the AU and, as such, promoted it in all international forums, from the UN and the World Summit on Sustainable Development (WSSD) to the Association of Southeast Asian Nations (ASEAN).

South Africa has also been instrumental in the development of several generic NEPAD action plans and projects. Each government department has established a focal or coordinating point for NEPAD to ensure the synchronisation of their activities with the objectives of NEPAD.

The country has hosted the NEPAD Secretariat since its inception and has been the largest financial contributor to its budget to date. In addition, it seconded the Economic Advisor of the President to head the Secretariat for the first four years of its existence. It has also seconded a number of officials on a full-time basis to the Secretariat over time while still carrying the costs of these posts.

South Africa also hosts the APR Secretariat in Midrand and continues to play a leading role in the development and operationalisation of the APRM. However, clarity is needed on the legal status of these secretariats.

Source: www.nepad.org, APR Secretariat and CRM compilation, July 2006.

iii. Recommendations

410. The APR Panel recommends that South Africa:

- In collaboration with other SADC member countries, ensure effective implementation of the RISDP through support for monitoring and evaluation. [Government in Collaboration with Other SADC Countries]

- In collaboration with SACU and SADC members, develop a framework for a more equitable trade structure to address the current imbalances of trade in favour of South Africa. [Government; SACU and SADC Member countries]

- Expedite action on the removal of exchange controls in order to remove barriers to trade and economic integration. [Treasury; SARB]