

FINANCIAL & FISCAL COMMISSION

***FRAMEWORK DOCUMENT FOR
INTERGOVERNMENTAL FISCAL RELATIONS IN SOUTH
AFRICA***

(First draft for discussion - 19 June 1995)

**All comments and submissions concerning this document should be sent to
the following address, by no later than 31 July 1995:**

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EXECUTIVE SUMMARY

1. Introduction

Section 198 of the Interim Constitution (Act 200 of 1993), establishes the Financial and Fiscal Commission (FFC). The FFC has a mandate to play a leading role regarding the development and maintenance of inter-governmental financial and fiscal relations in South Africa. This mandate is interpreted and given substance in *The Framework Document for Intergovernmental Fiscal Relations*. The framework document explores how the FFC's role and responsibilities are envisaged in the Interim Constitution and how these may be realised in practice. The framework document is presented for discussion and comment by affected, relevant and interested parties. The document is divided into six parts.

2. Part A: *The Constitutional context*

The Interim Constitution establishes a unitary state comprising three levels of government. The FFC is given the task of making recommendations to the legislative authorities regarding financial and fiscal policies; equitable allocations to the national, provincial and local governments from revenue collected nationally; the intention of provincial governments to levy taxes and surcharges; the raising of loans by lower-tier governments; and the criteria to be used for these purposes.

3. Part B: *Norms applicable to a system of intergovernmental fiscal relations*

Because resources are scarce, they should be used effectively. This occurs best when communities make their own decisions as far as possible with respect to the allocation of resources and those responsible for the decisions are accountable to the electorate for what they have done. People generally are only prepared to monitor government if their own interests are affected. The fiscal system should be designed to encourage such participation by linking communities' expenditures to their own revenues, meaning that each level of government should raise as much as possible of the revenue that it spends. Such systems are characterised by relatively high levels of fiscal autonomy.

Fiscal autonomy must be balanced against the important norm of nation building. Not only can some functions be fulfilled better at the national level, for example the achievement of macro-economic objectives, but even where this may not necessarily be the case, by placing various functions at a national level, a sense of nationhood and national cohesion is enhanced.

Accountability only has practical meaning if governments' activities are transparent. This requires common and easily intelligible reporting, accounting and auditing procedures. These systems must be in place before lower-tier governments assume fiscal independence. Furthermore fiscal

autonomy is only possible if the lower-tier governments are financially sustainable through having adequate sources of own revenue and dependable shares of national revenue.

The system of intergovernmental fiscal relations must be equitable. Vertical disparities between the three levels of government and horizontal disparities between jurisdictions at the same level should be compensated for by grants from the national government; thereafter, granting lower-tier governments freedom to make own allocative choices should enhance efficiency. Equity is closely related to development, which is the multi-dimensional process that improves the quality of life for all.

The ease and efficiency with which the fiscal system can be administered is a crucial norm, particularly as some possibilities entail sufficient administrative disadvantages to render them not feasible.

These norms may be either conflicting or mutually re-enforcing - where conflicting, a mechanism is required to resolve competing norms. For example, the requirement of administrative efficiency can be reconciled with that of provinces raising sufficient own revenue, by having the national commission for Inland Revenue handling provincial taxes on an agency basis.

4. Part C: *Fiscal allocations to national, provincial and local governments*

Provinces are entitled to an equitable share of revenue collected nationally, consisting of three parts:

- * percentages of certain national taxes (personal income tax, VAT, and the fuel levy);
- * transfer duties on property situated in the province concerned; and
- * other conditional or unconditional allocations. (Sections 155 and 199 of the Interim Constitution).

Local governments are entitled to an equitable allocation of funds by the provincial governments. (Sections 178 and 199)

The first point (*) above is referred to as revenue sharing and will remain of major importance until the provinces have developed their capacities to raise other revenues. Revenue sharing will also be the most important mechanism for achieving an equitable distribution of resources, particularly on account of the existing disparities.

Once the procedures envisaged in the Interim constitution have been introduced, provinces may pass legislation to allocate the funds at their disposal according to their own preferences as far as

the functions that are subject to their authority are concerned. This implies changes to the present budgetary process.

Revenue-sharing funds will be allocated according to a formula incorporating minimum standards and objective variables such as population numbers. It will only be possible to phase in the formula as suitable statistical data become available. This is also necessary to avoid disrupting the current provision of public services.

5. Part D: *Provincial and local government revenue sources*

As stated in Part B, lower-tier governments should ideally raise as much as possible of the revenue that they spend. Part D is devoted to an analysis of existing taxes to ascertain which would be suitable for this purpose.

Total tax independence would allow provinces to choose their taxes, the tax bases and rates, and to administer their own systems. This would, however, lead to administrative confusion and duplication of effort. In addition, for a variety of reasons the major taxes cannot be devolved suitably to lower-tier governments.

A workable compromise is possible through allowing lower-tier governments to implement flat-rate surcharges upon national taxes. This implies that the national tax bases must be used unaltered, but that provinces and (in some cases) local governments, may add a few percentage points to the national tax rate according to their own discretion. At the provincial level, the most suitable tax for this purpose is the personal income tax. The problems which remain (e.g. the allocation of taxable income to the different provinces) can be overcome in a pragmatic way.

Many local governments have in the past been able to rely on property rates and implicit excises on certain services (e.g. electricity). It may be possible to supplement these revenues by placing surcharges on certain national taxes (e.g. the fuel levy and transfer duties).

6. Part E: *Provincial and local government borrowing powers*

Borrowing is conceptually appropriate to finance capital expenditure because it results in the costs and benefits of long term assets being related to each other. The converse is also true: future generations should not be required to pay for the consumption of the present generation. Borrowing is therefore inappropriate to finance recurrent expenditure.

The allocation of loans is best left to the capital markets and credit-rating institutions. Government interference in these markets is likely to lead to the incorrect allocation of one of the country's scarcest resources. Borrowing is therefore not an appropriate mechanism for alleviating poverty, which should be addressed directly through the revenue-sharing procedure discussed in Part C. Loans should be reserved for commercially viable projects.

Lower-tier government debts which have been guaranteed by national government, effectively become part of the country's national debt and could affect South Africa's national credit ratings. Guarantees should therefore only be given for projects that are considered essential.

Owing to the limited size of the South African capital market, it would be beneficial to co-ordinate public sector borrowing.

7. Part F: *The way forward*

To avoid *ad hoc* developments it is important for all role-players to be included in the development of the system of intergovernmental financial flows. Also, it is these role-players and stake-holders who must determine the overall strategic and developmental objectives, and the goals towards which the system should aspire. In addition, the manner in which the FFC interfaces with the budget process requires clarity. Three stages are conceived; the first is the determination of the total revenue budget, possibly by the Intergovernmental Forum (which should include local government representatives). The pool of resources, minimum standards and priorities should be set and be communicated to Parliament via the Joint Standing Committee on Finance. The second stage involves the division of the pool of resources. The third and final stage comprises approval by Parliament.

The immediate way forward envisages a consultative process which will include relevant role-players, through comments and submissions regarding the framework document. These inputs will be incorporated into the presentation of a synthesised document and will include the first revenue sharing formula for the present budget cycle. Finally, since both the recommendations and the process through which they are arrived at are important, the Commission commits itself to a process which both allows the broadest possible involvements of relevant role-players and is also transparent.

Part A

CONSTITUTIONAL CONTEXT

1. Introduction

1.1 The Financial and Fiscal Commission (FFC) owes its existence to section 198 of the Constitution of the Republic of South Africa, 1993 (Act 200 of 1993). Chapter 5 of this Act provides for the adoption of a new Constitution which shall comply with the constitutional principles contained in Schedule 4 of the Act. Although Act 200 of 1993 is currently the foundation (or framework) for establishing a system of intergovernmental fiscal relations, it will be replaced in time by the new Constitution. For this reason the following terms are used in this document: "Interim Constitution" refers to Act 200 of 1993, whereas "new Constitution" refers to the Act which will replace it in the future.

1.2 The Interim Constitution establishes a unitary state (section 1) with three levels of government, national, provincial and local. Each of these tiers of government is assigned certain powers, functions and financial resources, exclusive, concurrent and shared. In addition, the Interim Constitution creates a framework for intergovernmental relationships, including fiscal relationships. It is not only these governments which are part of the intergovernmental fiscal relationship, the FFC is intended to be a central component thereof too.

1.3 The FFC is given a special role within the intergovernmental fiscal framework. This role is to be an independent and impartial statutory institution, accountable to the legislatures, with the objective of contributing towards the creation and maintenance of an effective, equitable and sustainable system of intergovernmental fiscal relations, rendering advice to legislatures regarding any financial and fiscal matter which has a bearing on intergovernmental fiscal relations. It is in this context that the Interim Constitution's framework provisions relating to intergovernmental fiscal relations and the responsibilities of the FFC are dealt with in this document.

1.4 The FFC is given the following overall tasks in the Interim Constitution.

1.4.1 It must render advice and make recommendations to the legislative authorities regarding financial and fiscal policies and the equitable financial and fiscal requirements of all three tiers of government, as defined in section 199 of the Interim Constitution.

1.4.2 It should make recommendations to the national and provincial governments on equitable fiscal and financial allocations from revenue collected nationally; the intention of provincial governments to impose certain taxes, levies, imposts and surcharges; the raising of loans by provincial and local governments; and the criteria used for determining the allocation of fiscal resources.

1.5 In performing its functions the Commission is to take into account the provincial fiscal capacities, provincial fiscal performance and their efficiency of revenue utilisation, provincial needs (including developmental needs) and economic disparities, provincial administrative responsibilities, other legitimate provincial interests, and other objective criteria identified by the FFC. In addition,

factors such as the national interest, the redemption of national debt and the legitimate needs and interests of the national government must be taken into account (section 155).

1.6 The set of constitutional principles referred to above, which is the basis for the new Constitution, also provides for a three tiered governmental structure and a financial and fiscal commission. Because the new Constitution must comply with the constitutional principles, an attempt is made in this document to establish practices which are compatible with both of them. It is, however, clear that current law is embodied in the Interim Constitution. Furthermore, once the new Constitution is adopted, all institutions will have to be re-evaluated in the light of its provisions.

2. The constitutional framework

2.1 Provincial governments

2.1.1 Following from this, the Interim Constitution provides for provincial government revenues in sections 155 and 156 in that each province is *entitled to an equitable share of revenue collected nationally* in order to enable it to provide services and to exercise and perform its powers and functions. This equitable share comprises three elements, namely:

- * percentages of nationally collected individual income taxes, value added tax or other sales tax, and the fuel levy;
- * transfer duties on property situated within a province; and
- * other conditional or unconditional allocations out of national revenue.

2.1.2 In all cases, with the exception of transfer duties, to determine the percentages and amounts an Act of Parliament is required, which must take into account the national interest and the recommendations of the FFC. In the case of "other" allocations, the criteria as set out in paragraph 1.5 above also need to be taken into account

2.1.3 The expression "revenue collected nationally" is interpreted in this document to mean revenue collected at the national level, rather than revenue collected in the nation as a whole. Revenues collected by the national tax administration on behalf of a lower-tier government are not considered to be included.

2.1.4 Provincial taxation powers are provided for in section 156, which gives provincial legislatures the *competence to raise taxes, levies and duties* - with three exceptions, namely income tax, value-added tax and sales tax. In addition, they are given the competence to *impose surcharges on taxes*. In all cases, the following provisos apply: the province must receive authorisation by an Act of Parliament passed after Parliament has considered the FFC's recommendations on the Act's draft text; and there must be no discrimination against non-residents of a province who are South African citizens.

2.1.5 Section 156 also provides that provincial legislatures shall be competent to enact legislation authorising the *imposition of user charges*, subject to the following provisos: the legislation may only be enacted after the provincial legislature has considered the recommendations of the FFC on the criteria according to which such charges should be determined; and there must be no discrimination against non-residents of a province who are South African citizens.

2.1.6 Besides access to revenues, lower-tier governments *require access to loans*. The generally accepted principle that borrowing should only be to finance capital expenditure finds expression in section 157 of the Interim Constitution, which grants provinces this competency but expressly prohibits the raising of loans for current expenditure. The only exception to this is bridging finance, provided that such loans are redeemed within twelve months.

2.1.7 All borrowing must be done within a framework of norms and conditions prescribed by an Act of Parliament, passed after Parliament has considered recommendations of the FFC on the draft text of the Act.

2.1.8 Section 157 of the Interim Constitution also provides that provinces may not guarantee loans (presumably loans by local governments within their geographical areas, or loans by agencies or corporations of the provincial government) unless the FFC has verified the need for a guarantee and recommended that it be given.

2.1.9 Similarly, section 188 of the Interim Constitution provides that the national government may not guarantee any provincial or local government loan unless the guarantee complies with the norms and conditions for such a guarantee as set out in an Act of Parliament and the FFC has made a recommendation concerning compliance of the guarantee concerned with such norms and conditions.

2.2 Local governments

2.2.1 In addition, the Interim Constitution provides for local government revenues in section 178, which requires that such governments should render efficient services to persons within their jurisdictions. In this context, the section provides the following:

2.2.2 Local governments shall be *competent to levy and recover such property rates, levies, fees, taxes and tariffs* as may be necessary to exercise their powers and perform their functions. These competencies are subject to such conditions as may be prescribed by law after taking into account recommendations of the FFC. Furthermore, within each local government's area of jurisdiction, such rates, levies, fees, taxes and tariffs must be based on a uniform structure.

2.2.3 Local governments shall be *entitled to an equitable allocation of funds* by the provincial government. The FFC is charged with making recommendations regarding criteria for such allocations, taking into account the three categories of local government identified in section 174(2) of the Interim Constitution namely, metropolitan, urban and rural local government.

2.2.4 The Interim Constitution contains no direct reference to the *borrowing powers* of local governments, other than that mentioned in paragraph 2.1.9. This reference and the indirect reference referred to in paragraph 2.1.8, imply that local governments are entitled to borrow. It is logical to assume that it was intended that the restrictions on provincial government borrowing discussed above should apply equally to local governments, with appropriate adjustments.

3. The constitutional concept of equity

3.1 The subsequent points concerning functions, powers, financial resources and norms are intended to be consistent with both the Interim Constitution and the constitutional principles. With reference to the latter, the following principles apply: XVI, XVIII, XIX, XX, XXI, XXII, XXIII, XXIV, XXV, XXVI and XXVII.

3.2 The concept of equity in revenue sharing referred to in paragraph 2.1.1 and 2.2.3 above can only be understood in terms of the requirement that provinces and local governments provide and execute the services and functions assigned to them.

3.3 This requirement is affected by two principal variables, namely: the extent to which the relevant powers and functions are devolved to the lower tiers of government; and the level of government at which the services are to be provided and the functions executed.

3.4 The first variable is governed directly by the constitutional framework referred to above in paragraph 2. To reiterate, government is structured at national, provincial and local levels. Each of these levels should have appropriate and adequate legislative and executive powers and functions, and the financial wherewithal to enable them to function effectively. This provision requires the allocation of powers among the levels of government to be made on a basis conducive both to financial viability at each of these levels, and to effective service provision and public administration, while recognising the need for and promoting national unity and legitimate provincial fiscal autonomy and acknowledging cultural diversity.

3.5 The second variable refers to equality of opportunity for access to government services, and local governments being enabled financially to provide basic services.

3.6 The Interim Constitution refers in section 126 to provincial legislation taking precedence over Acts of Parliament in relation to concurrent provincial legislative competencies except where the Act of Parliament: deals with a function that, to be performed effectively, requires to be regulated or co-ordinated by uniform norms or standards that apply generally throughout the Republic of South Africa; it is necessary to set minimum standards across the nation for the rendering of public services; or it is necessary for the maintenance of economic unity, the protection of the environment, the promotion of inter-provincial commerce, the protection of the common market in respect of the mobility of goods, services, capital and labour, or the maintenance of public security.

3.7 Clearly, to the extent that powers and functions are devolved to lower tiers of government, and to the extent that the national government imposes related expenditure requirements on lower tiers of government by means of national legislation, these lower tiers have a right to an equitable share of national revenues in order to enable them to exercise these powers and fulfil these functions.

3.8 Although the FFC is only required to take the criteria referred to in paragraph 1.5 into account when making what the Interim Constitution in section 155 refers to as "other" conditional or unconditional allocations, similar criteria, which must be clearly defined, continually measured, recorded and re-evaluated, must be developed for all the FFC's recommendations, as required by section 199(2). These must comply with generally accepted norms applicable to systems of intergovernmental fiscal relations.

4. Application of the framework

4.1 The discussion of generally accepted norms applicable to systems of intergovernmental fiscal relations is contained in Part B of this document. The analysis includes a discussion of the necessity to define, measure, record and re-evaluate the constitutional criteria.

4.2 Part C then deals with the application of revenue sharing, embracing both the percentage sharing of certain nationally collected taxes, levies and duties; as well as allocations from national revenues.

4.3 Part D deals with the competence of provincial and local governments to raise revenues from various sources, and discusses possible options.

4.4 Part E deals with the competence of provincial and local governments to raise loans to fund expenditures.

4.5 Finally, Part F looks at the way ahead, and deals with the future of intergovernmental fiscal relations in the short, medium and long term.

Part B

NORMS APPLICABLE TO A SYSTEM OF INTERGOVERNMENTAL FISCAL RELATIONS

1. Introduction

1.1 In democratic societies a government's role is to serve its citizens by providing the socio-economic environment and the public goods and services desired by them. The ways in which this can be achieved are countless: policy makers have the choice of a great number of instruments, and the combinations chosen give rise to different fiscal systems. It is therefore important to have acceptable norms with which to evaluate the instruments chosen in any particular case.

1.2 This does not imply that, once chosen, such norms are easy to apply: instruments may be effective in terms of one norm yet inefficient in terms of another. The goals of public policies are often conflicting, which means that trade-offs of one against another are normally necessary.

1.3 Therein lies the importance of clearly stated norms. As the combination of instruments and concomitant results inevitably becomes complicated, judging the suitability of a given set of instruments is difficult without weighing up each element separately.

1.4 Furthermore, socio-economic policy decisions are always subject to resource and other constraints. As is the case with all constrained optimisation, the feasible options are determined by the nature of the constraints. Therefore the presence of additional constraints will usually lead to a different solution. This is particularly relevant when adapting an existing system as opposed to designing a new one: in the former case existing structures impose constraints that do not exist when one is given a *tabula rasa* and asked to design a system afresh. Consequently, the results will differ, even though each system may be optimal in its own right.

1.5 Bearing these general points in mind, one can turn to the norms usually applied to systems of intergovernmental relations.

2. Effective resource use

2.1 Economic resources are scarce; therefore to acquire maximum benefit for a community they must be allocated in the best possible way. In the case of public goods and services that are used communally, direct purchases do not occur and members of the public are therefore not obliged to reveal their preferences for goods and services. This makes it difficult to judge whether a consumer of a public good is deriving benefits greater than the cost of producing the commodity. Yet, if this is not the case, the resources are being allocated incorrectly. The problem

arises because no ready mechanism exists to identify what citizens want in the form of public goods. Consequently, such decisions must be taken on the basis of citizens' votes.

2.2 Furthermore, those responsible for implementing these decisions should be subject to public scrutiny, i.e. the authorities should be accountable for implementing the majority view. It is equally important that citizens should provide checks and balances by participating in the process to ensure that resources are put to best use. Finally, all tiers of government must be equipped with sufficient budgetary and financial expertise to ensure that decisions are taken and implemented effectively.

2.3 A tacit assumption upon which the logic of the previous paragraphs rests, is that wealth is spread evenly, making comparison between personal requirements of citizens feasible. In practice this assumption does not hold and adjustments must therefore be made in the interests of equity. This concept is developed more fully below.

3. Accountability

3.1 Accountability, as enshrined in the Interim Constitution, e.g. in sections 92 and 153, and in constitutional principle VI, is the obligation on a government to the constituency which has endowed it with specific responsibilities. Accountability requires that a government should explain and justify its decisions to the electorate and implies that, if the electorate is dissatisfied with its decisions, the government may be removed from office in a free election. Accountability also applies to the fiscal decisions of a government: those in authority are required to justify their expenditures and to explain why the revenue necessary to sustain expenditure is raised in the way it is.

3.2 The advantage of having systems by which governments are accountable is that, when decisions are subject to public scrutiny, those in power are more likely to consider their consequences, act with restraint and use resources effectively in implementing the will of the people.

3.3 The fiscal system should be designed to encourage accountability. Because people generally are only prepared to monitor government and to object to irregularities and inefficiencies if their own interests are affected, the system should ensure that this occurs by encouraging beneficiary participation. One way of achieving this is by linking expenditure and revenue and, subject to equity considerations, by raising the required revenue directly from the beneficiaries of the service provided. Another is to subject all public accounts to rigorous annual auditing.

4. Nation building and fiscal autonomy

4.1 The Interim Constitution has heralded the advent of a new chapter in South African history, one in which a fragmented land and divided people are brought together to form one nation. The diversity of South Africans' backgrounds enriches this process of forging a nation out of different elements. The Interim Constitution's provision for government at national, provincial and local levels should be seen in the context of national unity.

4.2 Constitutional principles XVI - XXV, reflecting the essence of the Interim Constitution, state that the level of government at which decisions should be taken should be determined by considering at which level this can be done most effectively, taking into account national unity, provincial autonomy and cultural diversity. It is a generally accepted principle that matters such as the maintenance of national security, economic policy and essential national standards should fall under the jurisdiction of the national government, whereas matters concerning provincial planning and development, the rendering of services and, in particular, the specific socio-economic

and cultural needs of the inhabitants of a province, should be entrusted to the province. Schedule 6 of the Interim Constitution lists the areas falling within the concurrent legislative competence of the provinces. Section 175 includes a similar list for local governments.

4.3 From this it is clear that both the Interim Constitution and the constitutional principles strive to maintain a balance between those functions which are allocated to the national government, and those which are vested in the provincial and local governments. Some functions can be performed more effectively by a national than by a subnational government. Even where this may not necessarily be the case, by placing various functions at a national level a sense of nationhood and national cohesion is enhanced.

4.4 Within this context provincial and local governments are granted a large degree of fiscal autonomy. Section 174(3) of the Interim Constitution states specifically that local government should be autonomous. Fiscal autonomy refers to the degree to which lower-tier governments can take their own decisions and determine their own priorities consistent with the expenditure, taxation and borrowing powers assigned to them. Furthermore, it refers to the freedom inherent in self-government. This does not only mean that lower-tier governments should be administratively responsible for the delivery of goods and services at the local level, but also that the decision-making powers, fiscal responsibilities and obligations to raise as much of the required revenue as possible should all be situated at the corresponding level.

4.5 Fiscal autonomy fosters responsible government in so far as each level of government is answerable for its own decisions and it cannot shift the blame for incorrect decisions onto higher governmental tiers. An essential element of this is, however, a high degree of fiscal independence, otherwise the level of government providing funds will be in a position to influence decisions by manipulating the revenue flows to the lower governments. As pointed out in section 6 below, fiscal independence is best achieved by assigning revenue sources to each level of government, although this alone is seldom sufficient. Usually, these revenues need to be supplemented by the sharing of the revenue from other national taxes, or allowing lower-tier governments to add surcharges to national taxes.

4.6 These revenue options reflect varying degrees of fiscal autonomy and have administrative consequences which are discussed below. Nevertheless, the right to choose the rates applicable to surcharges and a legally enforceable right to a non-arbitrary share of the nationally collected revenue, are usually considered sufficient for a lower-tier government to be referred to as being fiscally autonomous.

4.7 Fiscal autonomy at lower levels allows regional differentiation to be established, in theory giving citizens the opportunity of choosing a locality where the particular set of public goods provided by the local government in relation to its tax price (or tax level necessary to support the expenditures) is to their liking. Alternatively, because the ability of households to move to the areas of their choice may in reality be far less than that assumed in the theoretical models, fiscal autonomy enables lower-tier governments to choose different levels of public services, in accordance with the preferences of their residents. This process enables local communities to develop a measure of homogeneity in their demand for and supply of (semi-) public goods.

4.8 Despite these potential positive aspects, high levels of fiscal autonomy may have certain disadvantages. The first is that disparities in terms of wealth and poverty between communities may be exacerbated. Allowing provinces to impose certain taxes or surcharges on individual income taxes may provide substantial fiscal autonomy to the richest provinces, but would leave

the poorest ones with few fiscal resources. In addition, if the combined national tax burden cannot be increased, provincial surcharges would only be feasible if the national tax rate were reduced, which would imply a smaller pool collected nationally for sharing amongst the provinces. To counteract this potential for increasing disparities it is necessary for the national government to retain the powers of prescribing minimum standards, which the lower-tier governments are obliged to apply. This would be particularly necessary on sensitive social terrains, such as health and education. Of course, the imposition of minimum requirements must be accompanied by transfers from the national government or alternative revenue sources so as to enable poor provinces to meet those requirements. More is said about this below under the heading "equity" in section 7.

5. Transparency

5.1 The method for calculating subnational revenue sharing should be transparent and understandable so as to promote credibility and stability. In order to achieve this, uniform information and regulatory systems should be developed and applied to all budgetary and financial accounts. The first step in this process is to create uniform definitions of the key concepts and establish common reporting procedures. These must include accounting standards in line with an internationally accepted public sector system of accounting. This will enable like to be compared to like and a consistent revenue-sharing formula to be developed and applied objectively.

5.2 Of equal importance are regular monitoring and auditing to confirm that all expenditure has been authorised correctly. Unless this occurs, confidence in the system will not develop. The importance of this aspect can scarcely be overemphasised: in fact, accounting and auditing structures must be finalised before functions are transferred to lower-tier governments. The Interim Constitution in section 155(4)(b) also requires the FFC to take the "efficiency of utilisation of revenue" into account when making allocations. It will therefore be necessary to institute a system of performance auditing to fulfil this important requirement.

6. Certainty of revenue

6.1 Provincial and local governments cannot be fiscally autonomous unless they are financially sustainable, as already implied above. This means that these levels of government must receive adequate revenue sources to finance the services they are expected to provide. In this respect, finance must follow functions. It is essential that this revenue be certain and not subject to arbitrary decisions even though, of course, the amounts depend on the economic circumstances and cannot be guaranteed in advance.

6.2 However, the devolution of tax bases is not devoid of problems. Vertical disparities exist between levels of governments, whilst horizontal disparities exist among provinces and localities. These would make it less desirable to devolve taxes even where it is technically possible to do so, as this could limit the possibility to provide corrective transfers. Furthermore, spillovers of benefits from services to other jurisdictions occur, (e.g from primary education), which reduce the incentive of provincial and local governments to finance those services. Such services are therefore best financed nationally, even if this is done through transfers to lower-tier governments. Spillovers may also be negative. The spillover of lower-tier taxes, or tax exporting to neighbouring regions, may necessitate these taxes being restricted to the national level.

6.3 Despite these limitations, it is possible to assign certain taxes to lower governmental tiers, depending upon the mobility and complexity of the tax base and the role of the specific tax in

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stabilisation or distribution policy. Using the consistency of revenue means and expenditure needs, and cost efficiency as criteria, the following set of guidelines may be offered.

6.3.1 Highly progressive taxes for redistributive purposes, should be centralised, because of the incentives they would create for migration between provinces. Income taxes with strongly progressive rate structures should be reserved for the national government and provincial governments should be restricted to imposing flat-rate surcharges on the national income tax base, (i.e. not on the tax itself, which would increase progressivity.)

6.3.2 Taxes suitable for macro-economic policy purposes should be national; lower-level taxes should be cyclically stable.

6.3.3 Taxes on highly mobile tax bases should be avoided by local government, since these taxes could distort the locational pattern of economic activity. Taxes on completely immobile factors such as land and other fixed assets are best suited for the local level.

6.3.4 The national government should in general exercise primary taxing authority over those tax bases that are distributed in a highly unequal fashion among provinces. Profit-based taxes on deposits of natural resources should be national, both to avoid geographical inequities and to prevent allocative distortions that could result from the local taxation of such resources.

6.3.5 User charges and benefit taxes do not in principle create distorting incentives for movements between provinces, and are workable at the most decentralised level of government, but can be used at all levels of government. These taxes should promote efficient decisions by mobile consumers, and efficient functioning of lower level governments, since they adhere to the benefit principle. Their application in situations where personal incomes differ widely should, however, always be tempered with the norm of equity.

6.4 Although a range of revenue sources is potentially available, it is important that the taxes levied by different jurisdictions should avoid distorting economic activity. Section 156(2) of the Interim Constitution states specifically that national economic policies, inter-provincial commerce, and the national mobility of goods, services, capital and labour should not be affected detrimentally by taxes raised by the provinces.

6.5 In devolving taxes, the duplication of administrative effort must be avoided. This can be achieved by having the national Commission for Inland Revenue collecting provincial taxes on an agency basis, at least those using national tax bases.

6.6 Even if lower-tier governments are given suitable powers to tax, the limited size of the tax bases will in most cases make it imperative that a portion of the revenue raised nationally be channelled to provincial and local governments. In order to achieve this an objective revenue-sharing or financing formula should be devised as described below in Part C.

6.7 The requirement of certainty has two sides. On the one hand, a province or local government must be able to rely on the predictability of its revenue flows in order to plan its activities, especially its multi-year infrastructural projects. On the other hand, the national government must obtain certainty regarding its liabilities towards subnational governments. The national government should not allow additional debt of lower-tier governments to be shifted onto it. If this were to happen, attitudes towards debt and risk taking could be affected adversely and moral hazard introduced.

6.8 "Moral hazard" refers to incentives that encourage an insured person or institution to cause the events against which they are insured. In this case, the event would be defaulting on the debt, because the national government is seen as insurer and, therefore, the province is shielded from adverse effects. Once such attitudes take hold, they tend to increase accumulatively and ultimately they undermine the stability of both the currency and the financial system. The sustainability of the system could be placed in jeopardy as a result.

7. Equity

7.1 The Interim Constitution stipulates (in section 155) that a province is entitled to an equitable share of revenue collected nationally, and that allocations should be determined with due regard to the national interest, the different fiscal capacities, fiscal performances, efficiency of utilisation of revenue, needs and economic disparities within and among provinces, as well as the developmental needs of the provinces. The purpose of these stipulations is to ensure fiscal fairness or equity in the provision of public services.

7.2 Equity is characterised by the spirit of fairness, justice and impartiality. It further serves as a moral virtue which qualifies, moderates and reforms the hardness of economic forces and acts as a yardstick for redressing an existing maldistribution of income or welfare in a country. Equity has many dimensions: it refers to income distribution, economic development, equal opportunities and many more. Through the ages philosophers and, more recently social scientists have devoted much thought to the concept of equity. On the fiscal terrain several dimensions are normally distinguished.

7.3 Firstly, tax equity requires that the burden of maintaining public expenditure should be borne by the taxable entities of a country in proportion to their ability to pay. This concept distinguishes between vertical and horizontal equity. The former relates to the relationship between tax incidence and the differences in income levels, whereas the latter refers to the equal treatment of individuals in equal positions by the fiscal system.

7.4 The same concepts are also met in reference to subnational governments, where intergovernmental fiscal fairness is an important element of general economic equity. The aim is to ensure fiscal fairness in the provision of public services to all households, in so far as each should have equal access to publicly provided services such as education, health care, sanitation, water, etc. Nevertheless, a second element of intergovernmental fairness requires that, beyond the equal provision of basic human services, households should receive equal or similar public services for equivalent contributions of tax or fiscal effort, i.e. a poor community making comparable fiscal effort should not be disadvantaged.

7.5 The terms generally used to judge the relative positions of subnational governments in this respect are fiscal capacity, fiscal effort, fiscal need and fiscal performance. *Fiscal capacity* is a measure of the amount of revenue a subnational government would raise if a nationally uniform set of tax rates were applied to commonly defined tax bases, and gives an indication of the level of economic resources in any jurisdiction (i.e. fiscal resources that are potentially available). Alternatively, fiscal capacity can be viewed as the relationship between the potential ability of a jurisdiction to raise revenue from its own sources and the cost of its service responsibilities. Indicators of fiscal capacity are designed to reflect the relative relationships amongst jurisdictions. These relationships are generally expressed in per capita terms to facilitate comparisons amongst

jurisdictions. High-income areas will be able to finance their own services more easily than lower-income areas and the magnitude of transfers should be inversely related to fiscal capacities.

7.6 On the other hand, *fiscal effort* is a measure of the extent to which a government's taxable capacity is actually used. It measures actual tax revenue in relation to tax capacity. Fiscal effort is normally defined as the ratio of tax collections to tax capacity. The idea is that communities that try hard to raise taxes but still cannot finance an acceptable level of public services are worthy of receiving a grant. Furthermore, a province or local government applying a tax rate above the national average could be rewarded, while one following the opposite strategy should not rely upon assistance from the national level. This factor is often added to formulae to ensure efficient tax collection by subnational governments. *Fiscal need* refers to the outlay in a subnational jurisdiction necessary to secure a standard level of performance or service; and *fiscal performance* is the ratio of actual outlay, obtained by applying the jurisdiction's outlay rate to that required to meet the standard level at some common rate.

7.7 A final factor to be taken into consideration is that of cost differences, which are determined by factors such as the province's demographic make-up, i.e. age distribution, population density, population growth, issues related to gender, etc. These factors serve to change the per capita cost of services within a province and must therefore be considered when defining the revenue-sharing formulae referred to in Part C below.

7.8 In the interest of equity it may be necessary as mentioned in paragraph 4.8 to target specific services for which national standards have been specified, by giving conditional grants to lower-tier governments. In the case of education and health care, which have a direct impact on human capital development, this may be necessary for another reason. Subnational governments may spend less on these services than optimal from a national perspective. Because people are highly mobile, the local jurisdictions are in danger of not reaping the benefits of their expenditures.

7.9 Grants can assume many guises. It may, for example, be desirable to introduce unconditional capacity equalization grants, and to reward governments with matching revenue for additional local tax effort, separately from the revenue-sharing formula.

8. Development

8.1 Equity is closely related to a second set of issues which can collectively be termed development. Development refers to the multi-dimensional process that improves the quality of life for all. This may be reflected in, for example, improvements in the levels of nutrition, morbidity, housing, education, the use of electricity, the availability of water and refuse removal services, and many more. Economic growth is correlated to development. However, development entails much more than economic growth. Of late the narrow concept of "economic development" has been subsumed under that of "human development". Statistical indices such as human development indices (HDIs) are used in attempting to measure this broader approach to the improvement in quality of life. Another facet is that of "community development" which was often prejudiced in the past, for example by the system of migrant labour. Community development should once more receive general encouragement.

8.2 It is important that development should be reasonably spread within a country so as to enable citizens living in different parts of the country to have broadly comparable opportunities. While acknowledging that equal facilities could never be replicated in every region, this means that

attempts must be made to eliminate backlogs in the provision of essential infrastructure and to provide sufficient economic opportunities within the provinces.

8.3 While not seeking to prevent or reverse the tendency of economic activities to agglomerate in metropolitan areas, fiscal transfers may be required to encourage regional development and employment to their maximum potential. As in other cases, the benefits of improving equity by providing services in rural areas must be weighed up against the benefits of doing so in urban areas.

9. Administration

9.1 Whichever fiscal system is chosen, it needs to be administered. The ease and efficiency with which this can be done therefore become crucial norms for evaluating the system, particularly as some possibilities entail sufficient administrative disadvantages to render them not feasible. For example, the devolution of all taxes to subnational levels would clearly enhance the fiscal autonomy of the regions, but would lead to large-scale administrative confusion. It would also lead to the duplication of tax-collecting mechanisms and thus be costly. On the other hand, if all taxes were to be centralised, the administrative burden would be minimised, but some independence of the subnational governments would be lost. A variation is possible by placing surcharges on nationally administered taxes, by which the rate applicable in a certain jurisdiction could vary from that applicable elsewhere.

9.2 Administrative efficiency would be enhanced if provincial taxes were to be handled by the national Commission for Inland Revenue on an agency basis as already indicated in paragraph 6.5 above.

10. Macro economic management

10.1 As pointed out in section 4 above, certain goals have macro-economic dimensions which make them impossible to decentralise. Examples are the stimulation of economic activity and the sound management of the economy. These functions must therefore be performed centrally by national institutions.

10.2 Furthermore, macro-economic demand management would be jeopardised if provincial governments were to disregard their budgetary constraints. This would be aggravated if the national government were to establish a precedent by coming to the aid of such provinces. The effect would be to erode the fiscal discipline necessary for stable economic growth, ultimately to the detriment of all citizens.

11. Loan financing

11.1 The system of intergovernmental grants should not impede provinces' reasonable access to other sources of finance. For instance, a province may wish to acquire additional funds from the capital market to implement long-term infrastructural projects. In principle, loan financing for such projects makes it possible for costs to be spread over a similar period to that during which the benefits arise, thus ensuring intergenerational equity. (This argument implies that each

generation should pay for its own current expenditures and that these should consequently not be financed with loans).

11.2 Often collateral security must be provided for loans. If a given project will deliver an income stream over its lifespan, this could be pledged as security. However, many public services do not generate income, making it necessary to pledge alternatives, such as the income from grants or revenue sharing. This can only be done if the provinces are certain about their future income and the capital markets have confidence in the stability of the income. If this can be achieved, the income from the national government could be used to leverage private sector resources.

11.3 This does not imply that subnational borrowing should not be coordinated, particularly as many capital-intensive functions have been devolved to the provinces, (e.g. roads, housing, education and health care). The total demand for capital, if uncoordinated and uncontrolled, could prove to be excessive.

12. Transition

12.1 Stability in the delivery of essential services must be maintained during the transition from the old order to the new. In addition, the developing system of intergovernmental grants should support the speedy restoration of delivery systems in the interests of socio-political stability. In this sense, the financial responsibilities of the FFC, namely that of facilitating adequate cash flows to finance essential services to all, are as important as the fiscal ones.

13. Resolving competing norms

13.1 As pointed out in the introduction, the norms described above may be in competition with one another. For example, the norm of fiscal autonomy may require the devolution of authority, whereas that of equity may require nationally determined minimum standards. Likewise, the criterion that revenue should be raised by the government responsible for providing the service, may conflict with the requirement of administrative efficiency. Consequently, some balance in which society's objectives are maximised must be sought.

13.2 Again, though the norms of accountability and fiscal autonomy require the devolution of taxes, the most important taxes, such as income tax on individuals and companies and consumption taxes, are usually centralised for administrative reasons in most countries.

13.3 As already mentioned there are procedures which help to balance conflicting norms, and which avoid some of the disadvantages of centralising taxes while retaining other advantages. The first is that of adding a specific rate to a levy collected by the national government on behalf of a province. This is known as the "piggy-back option" and is administratively simple in a number of cases (e.g. personal income tax, but not value-added tax (VAT)) as the surcharge allows several levels of government to tax the same base, with only one level actually administering it. The second is revenue sharing, which provides a relatively simple and inexpensive way of reallocating resources back to lower levels of government. Where provincial disparities are prevalent, the division of the revenue according to formulae that take the disparities into account, enhances equity. The combined use of surcharges and revenue sharing may provide a reasonable way of balancing provincial autonomy with equity.

13.4 The final way of financing subnational governments, if efficiency of tax administration has resulted in a relatively centralised system, is through intergovernmental grants. Depending on

how they are structured, grants may satisfy a number of the norms listed above. For example, conditional grants, are often used to ensure a minimum standard of essential services, thus promoting equity, even though they may limit the fiscal autonomy of the subnational unit.

13.5 Conditional grants may be matching or non-matching. A matching grant is one in which the national government matches the amount of money spent by the recipient government on a particular service, primarily to offset spillovers generated by the service. In this way a higher degree of recipient fiscal autonomy is maintained in that the decision on how much of the service to provide is still taken by the lower-tier government, despite its having been positively influenced to provide more than it would previously have done. Matching grants may, furthermore, be either open-ended or closed-ended. A closed-ended grant means that a ceiling exists for the amount that the donor will contribute, thus making possible sounder fiscal control of expenditures.

13.6 Unconditional grants address the fiscal issue of a general lack of finance at subnational level. Unconditional grants are usually provided on equity grounds; they also interfere less with provincial preferences than do conditional grants. The fiscal autonomy of the recipient government is therefore largely maintained. One form, the equalising grant, allows more generous sums to go to poorer provinces.

13.7 In summary: Although the redistribution of revenue represents a trade-off between some of the norms discussed above, a carefully designed system of revenue sharing can achieve a balance in which the positive aspects of the different norms predominate. The next section is devoted to outlining how this can be done.

Part C
**FISCAL ALLOCATIONS TO NATIONAL, PROVINCIAL AND
LOCAL GOVERNMENTS**

1. Introduction

1.1 As outlined in Section A above, section 199 of the Interim Constitution states that, amongst other things, the Financial and Fiscal Commission (FFC) must make recommendations on equitable allocations to the national, provincial and local governments from revenue collected at national level. In section 155 it is stated that an equitable share of these revenues for provinces shall consist of percentages of income tax on individuals, value-added tax (VAT) and the national levy on the sale of fuel, as well as the transfer duties on property situated in the province.

1.2 In addition, other conditional and unconditional allocations out of national revenue shall be made to provinces. The latter allocations should be made with due regard to the national interest and payments in respect of the national debt. They must take into account the different fiscal capacities, fiscal performances, efficiency of utilisation of revenue, needs and economic disparities within and between provinces. Furthermore, the developmental needs, administrative responsibilities and other legitimate interests of the provinces and the national government, must also be considered. Finally, the Financial and Fiscal Commission may identify additional objective criteria which could be used in determining equitable financial allocations.

1.3 With respect to the provinces, the "equitable share of revenue collected nationally", therefore, comprises three parts. The first consists of percentages of certain national taxes. The FFC must recommend criteria and percentages for the division of these revenues, a process which will be referred to as "revenue sharing". The second is a share of the transfer duties collected nationally, which must be determined on the basis of the origin of the revenue. These revenues will be termed "shared transfer duties". The third consists of other (conditional and unconditional) allocations, which must be made according to the criteria listed in section 155(4) of the Interim Constitution. Grants made in this category will be referred to as "allocations".

1.4 Section 178 of the Interim Constitution states that a local government is entitled to an equitable allocation of funds by the provincial government. The FFC should make recommendations regarding the criteria for these allocations, taking into account the distinctions between metropolitan, urban and rural local government categories.

1.5 Clearly, the need for funds at the different levels of government depends upon the division of functions among them as determined by the Interim Constitution. This was outlined in the previous sections.

2. The annual budget

2.1 Two main approaches to this task can be identified: the first is centred on the short-term (annual) budgetary cycle, the second on a long-term plan. Clearly, these two are complementary

in the sense that the long-term plan should to a large extent determine the annual allocations, but that this plan should be formulated with due regard to immediate and other needs.

2.2 The Commission's *modus operandi* with respect to the first of these two, namely the budgetary cycle, will be determined in conjunction with the other major role players in this field, i.e. the national government, the provinces, organised local government and the Departments of State Expenditure and Finance. Its main purpose will be to develop a uniform and systematic procedure for evaluating public sector budgets. Essential elements in this are the adoption of a common reporting and accounting system, the use of zero-based budgeting, reduced reliance upon incremental budgeting, project appraisal from the perspective of the Reconstruction and Development Programme (RDP), and the introduction of long-term fiscal planning models and multi-year fiscal management.

2.3 In Part B.5 the introduction of uniform definitions of key concepts and the establishment of common reporting procedures, including accounting and auditing standards were considered to be essential for attaining transparency. These elements are the building blocks with which the country's future financial edifice will be constructed. The form of this edifice will not alter this requirement. Immediate attention should therefore be given to this important prerequisite. As the established provincial and local governments already have sophisticated procedures and expertise, these should be standardised and made available to the newly created authorities as quickly as possible. The Departments of State Expenditure and Finance and the Auditor-General, in conjunction with the FFC, should together ensure their introduction. Progress by provincial and local governments in this regard should be a necessary condition for annual allocations from the national government.

2.4 The Department of State Expenditure has already begun developing new budgetary procedures to enable the governmental priorities to be reflected more accurately in departmental allocations. The function committees, on which national and provincial governments, *inter alia*, are represented, are in the process of identifying key performance indicators for their particular functions (e.g. education, health care, etc.) and attributing weights to these in terms of the newly identified priorities. Budgeting in future must be freed from past expenditure patterns and planned from zero, so as to ensure that those programmes which are financed from public resources reflect priorities adequately.

2.5 To make it possible to assess the total financial impact of projects accurately, appraisal techniques such as cost-benefit analyses must be applied and a multi-year view taken. This is particularly important with capital projects where informed decisions require early information on estimated future current costs, maintenance costs and eventual replacement costs, so that provision for these can be made timeously. The Department of State Expenditure should develop an advisory function to strengthen the budgetary capacities of provincial and local governments besides their present functions with respect to national government departments. The Auditor-General has wide-ranging powers in terms of section 193 of the Interim Constitution to report on public sector financial accounts and management. These powers must be implemented rigorously at all governmental levels.

2.6 Budgeting, like governance, is an ongoing process in a large organisation such as the Public Service, which continues while changes are being introduced. Even though the Interim Constitution outlines procedures for the allocation of public resources, which imply changes in future, the existing structures must in practice continue while the new procedures are being finalised.

2.7 The existing budgetary process is centralised in the Department of State Expenditure, and the process is based upon the principle that the Budget must be implemented as approved, with only relatively marginal deviations possible in line with the authority delegated to accounting officers to make adjustments. Substantial amendments, such as transfers between votes, require parliamentary approval.

2.8 The Interim Constitution envisages a process whereby the provinces may pass legislation covering a number of important functions (as listed in Schedule 6). This implies that the provinces may allocate the funds at their disposal according to their own preferences as far as these functions are concerned. Section 199 of the Interim Constitution requires the FFC to advise the various legislatures on, amongst other things, criteria for the allocation of financial and fiscal resources, which may culminate in conditional allocations in terms of section 155(2)(e) of the Interim Constitution.

2.9 Where conditions have been set by an Act of Parliament, the funds allocated to the provinces to meet them (in so far as they cannot be met from own revenues) will have to be used in the prescribed way. Only if a province is able to comply with the conditions more cheaply than envisaged, will it have discretion over the remaining funds. Other funds allocated to the provinces and also own revenues will, however, be subject to provincial discretion, even though the calculations used to derive the totals may be based on analyses of particular provincial functions.

2.10 This does not imply that the existing structures will be superfluous in future. For example, the Department of State Expenditure's functions with respect to the national departments may remain unaltered. Secondly, function committees could continue to provide technical forums where representatives of the provinces and various national government departments can formulate proposals on minimum standards and the co-ordination of services.

2.11 The transition from the present to the future systems will need to be phased in as soon as possible. It will also be essential to establish accounting and auditing structures at provincial and local levels before the existing national controls over their spending are redefined.

3. Allocating revenue with formulae

3.1 The need for long-term fiscal planning highlights the necessity for coordination between the short-term budget and the longer-term allocation process. To avoid allocations being made in an *ad hoc* manner it is necessary to identify the programmes and activities which should be undertaken by the public sector, and to agree on the key indicators by which these activities can be measured, and also on a structure to accommodate the elements. In this way one can comply with the norm of "certainty of revenue" discussed in Part B.6.

3.2 In essence, this amounts to developing a formula, the parts of which have to be objectively agreed upon by the relevant parties. In a sense an allocation formula defines a procedure for dividing the available funds before individual issues come to the fore. In this way arbitrary allocations to the advantage of some and at the expense of others are effectively eliminated and the debate is reduced to matters of principle.

3.3 This does not imply that either the allocations or the formula itself should be static. The allocations will, of course, vary according to changes in the independent variables in the formula. For example, if the allocations for education are based upon the population figures of children of

school-going age, the allocated funds will increase as that part of the population grows. Similarly, the parameters of the formula itself should not be inflexible, but should be the subject of review to enable new circumstances to be taken into account. The important point is simply that these changes should not be the result of short-term expediency, but should be objectively justifiable.

3.4 A formula is simply a mathematical expression of certain relationships. Because of its cryptic yet precise form, a formula may conceal its aims and underlying assumptions by concentrating attention on its final outcome. It is therefore essential that these be stated specifically.

3.5 The aim of a formula for the purposes of the FFC is to be found in the constitutional provisions quoted above: i.e. it is designed to achieve an equitable allocation of public resources. In Part B an analysis of this requirement and the ways in which it could be measured were discussed. In countries having similar systems of intergovernmental relations to those embodied in the South African Interim Constitution, equity is often seen to be the requirement that comparable jurisdictions within a country should be able to provide comparable levels of public good provision at similar levels of taxation. To make this possible fiscal transfers from the national government are required to those subnational governments that are unable to provide services at the minimum levels set nationally.

3.6 An equitable allocation of public resources can be judged from both a vertical and a horizontal perspective. The vertical relationships between the national, provincial and local governments are usually such that an imbalance exists between tax bases and the obligation to deliver services, with the former normally insufficient for the latter. It is therefore necessary for revenue to be distributed to subnational governments in order for them to fulfil their functions.

3.7 The allocation of resources must furthermore be equitable from an horizontal perspective. This requirement arises because neither economic activity nor population is evenly spread geographically. Both the ability to provide services from own revenues and the need for those services vary. Despite this, it is often argued that reasonably comparable levels of basic public services should be available in all provinces within a country. Therefore, in allocating resources, whether by formula or other means, the fiscal needs and capacities of the different provinces and local governments should be taken into account. A formula is nothing more than a technique for quantifying these factors and calculating the magnitude of transfers between the levels of government.

4. Revenue sharing

4.1 Revenue sharing is the process whereby governmental incomes are pooled and subsequently divided between the national and subnational governments. This procedure is especially relevant if most taxes are raised at the national level for ease of administration and efficiency in tax collection, as is the case in South Africa where, for example, income tax and value-added tax (VAT) are levied nationally.

4.2 In principle a distinction can be made between two approaches to revenue sharing, although in practice the differences become blurred because most of the instruments to implement them can be merged. The first approach emphasises the collection of revenue at a national level and on dividing this pool equitably, taking into account the needs of the various jurisdictions, including the backlogs in facilities.

4.3 On the other hand, the second approach emphasises the equalisation of lower-tier governments' own revenues from the national pool, i.e. it is the process of supplementing the own revenues of subnational governments so as to enable them to provide nationally acceptable levels of public goods. The point of departure in this case is, therefore, the provincial (or local) income generated by the particular subnational government's tax base. (In contrast, the first approach begins with a centralised pool of income, which must be apportioned to the various jurisdictions). The process of fiscal equalisation entails calculating the fiscal capacities, i.e. the tax bases, of the subnational governments and comparing these to their standardised (i.e. nationally comparable) needs in order to determine whether a deficit exists that should be eliminated by fiscal transfers from the national government.

4.4 As already mentioned, these two procedures are essentially two views of the same problem. It must, therefore, be expected that the application of each will result in similar outcomes. For example, in designing a formula to share a pool of revenue, it is necessary to know what reasonable expenditures on essential public services should be, i.e. minimum standards must be specified. However, if the point of departure is one of fiscal equalisation, it is likewise necessary to know what level of expenditures relative to, say provincial income, is reasonable in determining the size of the provincial deficit that should be considered for equalisation. In both cases minimum standards must be set.

4.5 The most significant difference between the two approaches is that the first is based on the assumption that the major revenue sources are taxed nationally, whereas the second assumes that subnational governments should (in principle, if not in practice) have primary responsibility for raising their own revenues but, if unable to do so satisfactorily, should receive additional assistance from the national government. The pros and cons of these two approaches were outlined in the section on norms in Part B above.

4.6 The process of developing a system of intergovernmental transfers for the country will inevitably be a dynamic one of refinement as objectives change or become clearer and additional data become available. Nevertheless, in South Africa at present the immediate emphasis must fall on the first approach to revenue sharing. The reason is that in the Interim Constitution the major revenue sources have been allocated to the national government with the provision that the income must be shared with the provinces (Section 155). Provision is made in the Interim Constitution for the provinces (Section 156) and local governments (Section 178) to raise own revenues. In some cases these could be substantial. For example, as explained in Part B 4.8, in the richer provinces, surcharges on the national income tax, and in the richer local governments, property rates could generate relatively large amounts. Nevertheless, as pointed out above in Part B, paragraphs 4.7 and 6.2, the sharing of a national pool of revenue must be the point of departure in the interests of equity, because many jurisdictions will not be able to raise enough for their needs.

5. The development of minimum standards

5.1 As mentioned above, whatever point of departure is adopted, the development of minimum standards remains an essential first step in the process. The Interim Constitution provides for the setting of criteria or standards at two levels. Firstly, section 199 requires the FFC to advise the relevant legislature on criteria for the allocation of financial and fiscal resources after taking section 155 into consideration. These criteria must inevitably include the setting of standards and their financial consequences. An essential task for the FFC in this regard will be to ensure that the fiscal requirements resulting from these will be sustainable. If conditional grants are

recommended for financing the proposed standards, lower-tier governments will be obliged to adhere to them on accepting the money.

5.2 A second level at which the Interim Constitution provides for the setting of standards for the rendering of public services appears in section 126. This section makes specific provision for the setting of uniform minimum standards by the national Parliament. Although in this case no mention is made of how the standards should be financed, in practice it would be necessary to make the resources available to make them (the standards) effective.

5.3 When standards have been set, preferably in terms of outputs rather than inputs, they will form basic parameters within a revenue-sharing formula. Various methods for determining minimum standards exist: one of these may be termed "needs-assessed", another "fiscally determined". The first entails estimating requirements from a functional and technical point of view. For example, educationalists could be asked to make proposals from their particular perspectives on what minimum standards should be in schools, specified say, in terms of pupil to teacher ratios. Similar steps could be taken with regard to health, housing, and the other important expenditure categories. The existing function committees could be used to perform the task of defining minimum standards in their particular fields, consisting as they do of representatives of the national and provincial departments concerned with specific public services.

5.4 The potential difficulty with this approach is that minimum standards are likely to be set that are fiscally unobtainable. This probability is high under current South African conditions where backlogs in public services have accumulated and where expectations of speedy redress exist.

5.5 An alternative is to assume that expenditure patterns of the past reflect society's priorities, and that these are relatively stable in the short term. If this is the case, national average per capita expenditure on a specific category will indicate what the country regards to be an acceptable level of expenditure on, for example, education or health. This procedure would mean that a province providing less of such a service than the national average would receive conditional grants that it would be obliged to spend on increasing the service to the national average level. Furthermore, it has the advantages that the "norm" can be calculated without recourse to long debate and that the fiscal burden based on the norm will be affordable. In the context of a fast changing society, in which the norms of the past are likely to differ from those of the future, this procedure may not be useful.

5.6 Because of these disadvantages, it may prove necessary to develop a procedure which contains elements of both alternatives in that fundamental discussions by subject specialists on developing norms may be necessary, but that these should be constrained by what is fiscally feasible. The fiscal constraint should be viewed in a macro-sense and not as fiscal constraints on specific functions, as may be defined by spending patterns inherited from the immediate past. It is important that the new procedure is arranged to reflect changing priorities. Once the new priorities have become established, it may be possible to revert to the easier procedure of using national averages for this purpose.

5.7 Using minimum standards in a revenue-sharing formula, whether determined on the basis of national averages or through debate in function committees, will be potentially difficult during the transitional phase for a number of reasons. Firstly, detailed data on expenditure and needs are required, which are unlikely to be readily at hand. Secondly, incentives may be generated to manipulate expenditures at provincial level. If, for example, the national government is committed to providing grants to maintain minimum standards in some fields, provincial spending could be

redirected to other areas in the knowledge that the essential fields will be taken care of from the centre.

5.8 These distortions can only be eliminated if norms apply across all public expenditure fields as is for instance the case in Australia, where "standard" budgets are compiled by applying national averages to all provincial spending. However, once a piecemeal approach is adopted, with only a limited number of expenditure items included, it becomes possible to increase national transfers to a province by shifting expenditure away from the national government's highest priorities. If the national average approach to (minimum) standards is adopted and all provinces attempt to shift expenditure in this way, the national average would decline and the strategy would be self-defeating. Nevertheless, the possibility of manipulation remains one of the shortcomings of this procedure.

5.9 Despite these shortcomings, it could be argued that the existing disparities in spending on socially important service categories make it imperative to implement a minimum standards approach, even if the categories must be phased in. The detrimental effects of phasing in can be diminished by carefully selecting the sequence for doing so.

5.10 The strong disparities in South Africa also justify what could be seen as an apparent contradiction in the process of applying fiscal equalisation to decentralised jurisdictions. It could be seen as inconsistent to devolve substantial powers to subnational levels of government with the express purpose of allowing local communities greater discretion in deciding on expenditure, and simultaneously applying centralised expenditure equalisation through conditional grants. In reality of course, there is no contradiction. Problems of equity are resolved with grants from the national government, whereas lower-tier governments are assigned the task of making fiscal choices and allocating the resources.

5.11 The functions allocated to the provinces are listed in Schedule 6 of the Interim Constitution. The timing for their inclusion in the revenue-sharing formula, in the form of minimum standards, should be determined by the following factors. Firstly, those functions with maximum socio-economic significance, as viewed from the perspective of the Reconstruction and Development Programme (RDP), should be introduced as soon as possible. Secondly, those categories having maximum fiscal impact should be considered. As education, housing and health services are listed in Schedule 6, all are significant for the RDP, and together absorb a sizeable section of the total available resources, it would seem clear that they should be the first services to be included. As local government is also listed under Schedule 6, and is an essential ingredient in the government structure, it should also be incorporated into the formula immediately. It should be possible to incorporate the remaining functions, possibly even together with some of those mentioned above, as one group in the formula.

6. The independent variables of the formula

6.1 The next step in developing a revenue-sharing formula, (i.e. after identifying those expenditure categories to be subject to minimum standards), is to decide upon which factor or factors, the size of the grant should depend. In mathematical terms, the independent variables to be used in the equation must be identified. The best variables to use in each case will depend upon the circumstances, but they should be chosen so as to correlate as closely as possible with

the normal and generally acceptable expenditure obligations of the provinces in a given category without taking individual provincial priorities into account.

6.2 The variable which is likely to affect most of the expenditure categories is population; fiscal needs emanate from people and usually the greater the number of people the greater the requirements. It is, for example, clear that the demand for schools will depend on the population numbers in a given area. Not all services are, however, dependent upon population numbers in this way. Consider for instance the provision of roads in sparsely populated areas, connecting two economically important centres. Expenditure on road construction and maintenance will in such cases be related to the kilometres involved, geography and the intensity of usage rather than the total population of the province.

6.3 For some purposes it would be useful to differentiate between population groups. Many examples can be found. One is education, where the number of children of school-going age is more relevant than the total population figure, particularly if population profiles differ among provinces. Health services are also clearly a terrain where, not only the total population but also certain sections of it, are important for determining expenditures. Although the number of people using private and public health services can be expected to be highly correlated with the total population, those using public health resources may be expected to come from the poorer section of the community. Therefore, rather than using total population figures only, the numbers of patients visiting public health centres would be more appropriate. Alternatively, the total population figures must be weighted to take average per capita income levels in each region into account.

6.4 Despite the importance of using population figures for these purposes, several reservations arise. The first is because of possibly inaccurate census data due to the ineffective census procedures used in the past. Secondly, the population numbers for years between one census and another are estimates. Although in countries with relatively stable population dynamics this may be an acceptable procedure, in South Africa, where an accelerated process of urbanisation is under way, it is likely to lead to inaccuracies.

6.5 A third factor is that provincial allocations may not be able to take cross-border population flows sufficiently into account to sustain a fair system of grants. In the case of health services, for instance, patients from other provinces are attracted by or referred to hospitals in metropolitan areas. If these hospitals were to be funded on the basis of their provincial population figures, these additional patients would not be taken into account. The fact that in the past such facilities tended to be centralised, exacerbates this problem in so far as the major hospitals are now concentrated in a few metropolitan areas.

6.6 Even if allocations were to be made on the basis of estimated provincial populations, and the province providing the service were to charge fees to the province whose patients were being treated, difficulties would arise in a large number of cases. Unemployment and the lack of fixed places of abode, leading to temporary migration, would make accurate statistics on provincial populations difficult to achieve.

6.7 For this reason an alternative could be to allocate grants on the basis of the institutions providing the services, by building up data bases on patients treated, and aggregating them for the province as a whole. In this way it would be irrelevant to know from where patients originated.

6.8 In terms of revenue-sharing formulas, the difference between these two approaches depends upon the choice of independent variable. In the first case, the independent variable would be the region's population, in the second case it would be the number of users patronising an institution. The first can be regarded as emphasising needs, as reflected by the numbers of people that would make use of a facility if it were available; the second can be regarded as emphasising utilisation, as indicated by the number of people who actually make use of an institution's services.

6.9 The disadvantage of basing funding on existing utilisation patterns is, however, that the fiscal system would tend to perpetuate the current skewed position of facilities by channelling funds to those institutions already in existence rather than to areas where new facilities should be developed.

6.10 As pointed out in Part B, paragraph 1.4, there are generally more constraints in changing from one system to another than in designing new systems. The case under discussion illustrates this. Even though one may wish to take a needs approach so as to facilitate establishing future facilities where they are currently lacking, switching funds from an existing facility in order to do so could be so detrimental to the supply of services in the short run that this proves impossible to achieve. In such a situation the existing levels of service could be maintained by allowing current funds to flow to the existing facility, while directing capital funds to developing new institutions. Alternatively, there should be a phased transition from one to the other so as not to be disruptive. On the assumption that a hypothetical system is currently based totally on utilisation, which therefore has an implicit weighting of 100%, and that its future ideal should be on need, which currently has an implicit weighting of 0%, the ratio of weightings could be shifted explicitly over time from 100%-0% through 50%-50% to 0%-100%.

6.11 Allocating grants on the basis of patients would in effect amount to an expenditure-based procedure similar to that used in some other countries, for example Australia, where grants are determined on the basis of "standardised" budgets; that is, actual revenue and expenditures are corrected or standardised to determine what each state's relative share of the available resources should be.

6.12 Standardised expenditures in Australia, are what the states would need to spend on each function to provide a standard (average) service if they operated at a standard level of efficiency. Standardised revenues are what states could raise through particular taxes if they applied them at standard (average) tax rates and collected them with standard efficiency. The results of these calculations for all the states together is the so called standard budget result (which will be negative if an overall deficit arises). A particular state's requirement for general revenue assistance in any year is calculated as the difference between its standardised expenditure plus standard budget result (deficit) on the one hand, and the state's standardised revenue plus conditional grants received from the Commonwealth on the other hand. [Rye, C.R.: *The Fiscal Transfer System in Australia*, Conference on Fiscal Transfer Systems, Qingdao, China, 1994].

6.13 As indicated above, "standardising" revenue and expenditure entails various steps. On the expenditure side adjustments may be necessary to take account of cost differences between provinces which may arise, for example, from economies of scale, agglomeration economies in metropolitan areas or administrative or other (in)efficiencies. It should be taken into account that establishing administrations is likely to be equally costly for each of the provinces, irrespective of the relevant size of the provinces' populations. Decisions must also be taken on which of the potential causes may validly be taken into account. Likewise, as far as revenue is concerned,

calculations must be made to estimate the size of the provinces' tax bases in order to determine potential income or their revenue-raising capacities.

7. Local government

7.1 Local government has been assigned a prominent place in the Interim Constitution. According to Schedule 6, local government is a provincial affair with functions as described in Chapter 10 of the Interim Constitution. Section 174 states that local government should be autonomous and that the national and provincial governments should not encroach upon the fundamental status, purpose and character of local government. Section 175 states that local governments should make provision for access by all persons residing within their areas of jurisdiction "...to water, sanitation, transportation facilities, electricity, primary health services, education, housing and security within a safe and healthy environment, provided that such services and amenities can be rendered in a sustainable manner and are financially and physically practicable".

7.2 Local governments vary from large metropolitan authorities to small rural bodies, some of which are situated in traditional areas, with varying administrative systems. It is nevertheless intended that the total country should be divided into areas under local government jurisdiction, both urban and rural, by the end of 1995 when elections have been scheduled. Section 245 determines that, until elections have been held in terms of the Local Government Transition Act, 1993, local government shall not be restructured otherwise than in accordance with that Act.

7.3 In contrast to the provincial governments, local governments have long-established tax bases, even though in many areas problems are being encountered in using them effectively. Traditionally, local government income is largely generated through property rates and user charges, which often contain a tax element in that the charges exceed costs. The conversion of these existing trading surpluses into explicit excises would increase the transparency of local government finances. Furthermore, since revenues from excises would be related to consumption of utility services, they would be somewhat more predictable than trading surpluses. Regional service council (RSC) levies are an additional revenue source. Besides these own revenue sources, section 178(3) of the Interim Constitution states that local governments shall be entitled to "...an equitable allocation by the provincial government(s) of funds...". Because provincial revenues will largely depend upon the sharing of nationally collected revenues, provision must be made in the formula for those funds required by local governments.

7.4 As already mentioned, local governments are autonomous in principle and have (or could have) substantial own revenue sources. The exception to this generalisation is where the community served by a local government is too poor to support adequate tax bases and thus minimum standards of service provision. In such cases support from higher governmental levels is necessary.

7.5 The current system of intergovernmental grants to local governments is based on the system of allocations to the former black local authorities. In the past the system tended to be crisis-driven and resulted in *ad hoc* allocations, resulting in uncertainty and a lack of transparency. In addition, transfers to local governments in the former homelands were made separately on the basis of different criteria. There is an urgent need for a uniform, predictable and transparent system of transfers to local governments.

7.6 The question therefore arises as to which independent variable(s) would best be suited for this purpose. One possibility is a development index, which would indicate the levels of

infrastructural backlogs which exist in communities; a second would be a means test applied to the community, for example by taking the numbers of inhabitants of the area with annual incomes below a certain specified level. The second possibility has the advantage of approaching the problem from a current-revenue perspective which may be seen as proxy for capital backlogs as well.

8. Revenue-sharing formulae

8.1 In the light of the arguments set out in section 4 above, one can construct various illustrative revenue-sharing formulae.

8.2 The first step for the FFC is to recommend what the division of revenue between the national and subnational governments should be and, consequently, what the amount to be subject to the provincial revenue-sharing formula should be. This would depend on the functions allocated respectively to the national and provincial governments, the current transfers being made to the provinces, the constraints on the national budget, including the national debt, and the influence of the political process, for example through negotiations on the amount in the intergovernmental forum of provincial premiers. Besides determining the division between the national and other levels of government, this process would also limit the total to what was economically affordable from the perspective of the country as a whole and prevent the formula becoming open-ended. In addition, it would result in the formula being a mechanism for dividing the available amount rather than a procedure for determining it.

8.3 Secondly, appropriate independent variables must be chosen (as indicated above), depending on whether the emphasis is to be placed on needs or utilisation. The third step will be to calculate appropriate coefficients for the variables and to determine the functional form of the equations.

8.4 These are intricate processes that require intimate knowledge of the issues and problems, as well as statistical information, before they can be resolved. Many national state departments have considerable expertise on their particular terrains that should be harnessed in the initial process of developing the formula(e); there is also knowledge and experience in the Departments of Finance and State Expenditure that would greatly enhance the process. In paragraph 5.3 above it was suggested that the existing function committees should be used in the development of standards.

8.5 The FFC is required to take a wide range of factors into consideration. Incorporating the work done by the function committees would eliminate considerable duplication of effort, even though much of it will be from a sectoral perspective only. In addition to its own initiatives, the FFC must evaluate the proposals coming from the function committees sources against national priorities, supplementing them where they appear to be insufficient, influencing their methods where necessary, altering them where they appear inappropriate, and weighing up the trade-offs between the various services and departments before advising Parliament on the allocation of the revenues in the form of a formula. The process is likely to be iterative, with refined criteria being introduced as they become available.

8.6 This in no way implies that the independence and impartiality of the FFC will be forfeited. Advice on policy and the resulting allocations will always reflect the FFC's own judgement. It does, however, mean that technical research, data and information should be shared so as to curb costs. Similarly, neither the policy role of government, nor the advisory and executive roles of the Departments of Finance, State Expenditure and the provincial governments will be

diminished, even though inputs may be shared with the FFC. The proposals and actions of these institutions will, however, become the subjects of scrutiny and comment by the FFC.

8.7 The development of formulae will be dynamic; changes will be made as the understanding of the requirements improves and better statistical information becomes available; many of the parameters discussed above must still be defined and the data bases established for calculating them.

9. Phasing in the formula

9.1 The probable delay in the introduction of all the elements of the formulae should be seen in conjunction with the need to phase in the formulae as already indicated above. It is likely that, whichever formula is adopted, its introduction will necessitate shifts in the relative allocations to the provinces. Furthermore, the introduction of cost-differential and human development factors is likely to accentuate these shifts. In order not to disrupt the supply of services in those areas which may as a result be receiving relatively less in future, a phasing-in period of several years will be necessary.

9.2 The phasing-in of the formula would consequently consist of two parts. The first is the incorporation of the different elements of the formula in the revenue calculations as the statistical data necessary for doing so become available. The second part of the phasing-in process is the change-over from the existing allocation pattern to the new one calculated with the help of the formula. These two processes will run concurrently and should be mutually supportive. The delayed introduction of refinements to the formula, which will itself be phased in, should not affect the final outcome negatively, as long as the direction of the two forces is the same.

Part D

PROVINCIAL & LOCAL GOVERNMENT REVENUE SOURCES

1. Introduction

1.1 The Interim Constitution provides for provincial and local government revenue sources. These provisions are broadly compatible with constitutional principles XXV and XXVI. Part D is devoted to an analysis of taxes and surcharges on taxes which are suitable for lower-tier governments. It ends with a brief analysis of user charges.

2. Provincial government revenues and the Interim Constitution

2.1 As outlined in Part A, the Interim Constitution provides for provincial government revenues in sections 155 and 156. Section 155 specifies that each province is entitled to an equitable share of revenue collected nationally in order to enable it to provide services and to exercise and perform its powers and functions. Section 156 specifies that provinces may levy certain taxes subject to a number of conditions.

2.2 Section 156 gives provincial legislatures the competence to raise taxes, levies and duties, with three exceptions, namely income tax, value-added tax and sales tax. In addition, they are given the competence to impose surcharges on taxes. Although the terms "taxes", "levies" and "duties" have historically been applied to different forms of taxation, their economic properties are the same and the generic term "taxes" is used to cover all three. This is, for example, done in the heading of section 156 in the Interim Constitution. It is therefore assumed that provinces are competent to impose surcharges on all these forms of tax. In addition, the power to tax is interpreted to mean the competence to determine the tax base, the rate and to administer the tax.

2.3 All provincial taxes are subject to the following provisos: the province must receive authorization by an Act of Parliament passed after Parliament has considered the FFC's recommendations on the Act's draft text, and there must be no discrimination against non-residents of a province who are South African citizens.

2.4 Provincial legislatures are also given exclusive competence within their provinces to impose taxes, levies or duties (excluding individual income tax, value-added tax or sales tax) on casinos, gambling, wagering, lotteries and betting. The provisos discussed above are not applicable in these cases.

2.5 There is an overriding proviso (which applies to all of the matters discussed under this heading) that a provincial legislature is not entitled to levy taxes that detrimentally affect national economic policies, inter-provincial commerce or the national mobility of goods, services, capital and labour.

2.6 Section 156 of the Interim Constitution also provides that provincial legislatures shall be competent to enact legislation authorising the imposition of user charges, subject to the same provisos as mentioned in paragraph 2.3 above.

3. Local government revenues and the Interim Constitution

3.1 The Interim Constitution provides for local government revenues in section 178 which requires that such governments should render efficient services to persons within their jurisdictions.

3.2 In this context, the section provides that such governments be competent to levy and recover such property rates, levies, fees, taxes and tariffs as may be necessary to exercise their powers and perform their functions. These competencies are subject to such conditions as may be prescribed by law of a competent legislature after taking into account recommendations of the FFC. Furthermore, within each local government's area of jurisdiction such rates, levies, fees, taxes and tariffs must be based on a uniform structure.

3.3 This section also states that such governments are entitled to an equitable allocation of funds by the provincial government. The FFC is charged with making recommendations regarding criteria for such allocations, taking into account the metropolitan, urban and rural categories of local government.

3.4 No specific mention is made in the Interim Constitution of the raising of surcharges upon national or provincial taxes by local governments. It can, however, be logically assumed that their competence to raise taxes includes surcharges, as the latter are merely administratively simpler versions of the former. Local government surcharges on fuel levies or transfer duties could for example assist in creating viable local authorities.

3.5 In the context of the discussion above, the potential revenue sources (taxation powers) of the different levels of government are analysed below.

4. Potential revenue sources

4.1 Governments require revenues to provide public goods and services. The magnitude of the revenues, which provincial and local governments (generally referred to below as "lower-tier governments") need, depends upon the extent to which legislative and executive competencies have been given to them by the Constitution. Furthermore, the required revenue will also be influenced by the degree to which the national government sets standards that affect the level and type of services lower-tier governments are expected to provide.

4.2 In principle, as analysed in paragraph B4, lower-tier governments should largely be autonomous fiscally, which means that they should have revenue sources at their disposal, which they themselves can determine independently, at least at the margin. In this way the direct links are established between raising taxes and spending on public goods and services that are necessary to make politicians accountable for the judicious use of their societies' resources. From this it follows that lower-tier governments should be competent to raise taxes. Unfortunately, however, allowing lower-tier governments to raise whatever taxes they wish, would entail other disadvantages. Equity, macro-economic policies and administrative efficiency may for example, be severely prejudiced if lower-tier taxes were raised indiscriminately. As discussed in Part B, section 13, it often is the case that desirable norms for intergovernmental fiscal relations are in conflict with one another.

4.3 In some economies, for instance that of the USA, priority is given to the norm of fiscal autonomy, with the result that the right to determine which taxes are to be raised, to define the tax bases, to choose the relevant rates and to administer the collection of taxes are all devolved to the states. As may be expected, however, this leads to conflicting definitions of bases, leading to confusion, and considerable duplication of administrative effort.

4.4 An alternative to tax devolution that overcomes a great number of the disadvantages mentioned above, yet preserves an acceptable degree of fiscal autonomy, is the imposition of surcharges on taxes raised by a higher-tier government. Surcharges use the tax bases and administrative machinery of the higher-tier government, whilst allowing the lower-tier government to choose the tax and the rate to be added to the existing one. Because uniform tax bases are used and administrative effort is not duplicated, the use of surcharges on national taxes by subnational governments holds considerable advantages. Although the options available to the lower-tier governments are constrained by the prior decisions of the higher-tier government with respect to the type of tax and base, the decisions of whether to tax or not and, if so, at what rates, remain with the lower-tier; and it is these that are essential for attaining fiscal autonomy and accountability. Because of these advantages and the specific provision in the Interim Constitution for surcharges, an analysis of surcharges on various taxes is included in section 5 below.

4.5 As pointed out above (in section 2.1) the Interim Constitution stipulates that a province has a right to the transfer duties collected nationally on the acquisition, sale or transfer of any property situated within the province concerned. This is an example of a tax being shared between different governments. Although revenue is, of course, generated for lower-tier governments in this way and therefore vertical imbalances alleviated to some extent, tax sharing does not allow lower-tier governments any discretion in choosing either the base or the rate, or to become involved in administering the tax. (The latter is probably an advantage). Moreover, the choice of tax is specified in the Interim Constitution. Provincial discretion and the concomitant fiscal autonomy and accountability are accordingly eliminated. In addition, because the basis for sharing the tax is the origin of the revenue (i.e. the province in which the transfer has occurred), the sharing does not contribute to alleviating horizontal disparities at the provincial level.

4.6 In contrast, the sharing of a pool of revenue collected nationally does enable both vertical and horizontal disparities to be taken into account. Revenue sharing is thus an important procedure for achieving equity in the provision of public goods and services across all jurisdictions in the country. The fact that the pool of revenue to be shared between the national and provincial governments, defined in section 155 of the Interim Constitution, (and by implication also between local governments, as indicated in section 178), contains a number of the country's most important taxes, highlights the emphasis placed upon the norm of equity.

4.7 In principle it is important for revenue sharing to be applied to a pool of revenues and that this should be as inclusive as possible. If this were not the case incentives could be generated for the national government to reduce the importance of the tax revenues in the pool and to increase the importance of those over which it has exclusive control. Were this to happen, certainty of revenue, stated in Part B.6. as an essential norm, would be jeopardised. Likewise the lower-tier governments' shares of revenue should be legally enforceable and not subject to sudden changes that could disrupt the supply of services. In this regard the Interim Constitution states that an act of Parliament specifying the divisions of the revenue pool must be passed by the National Assembly and Senate sitting separately (Section 155, (2A)). The high level of consensus required

by this procedure should ensure sufficient stability in the flow of revenues to the subnational governments. Stability will allow the revenues to be regarded as quasi own revenues with the ensuing advantages that they may be used to leverage funds from the capital markets as described in Part E.

4.8 Although the Interim Constitution stipulates that provinces are entitled to percentages of the taxes forming the revenue pool and these are listed separately from one another, there is no reason why the same percentages should not be used throughout. Regarding this source of income as a revenue pool makes such an approach logical. The fact that the percentages are not specified allows for flexibility, even though (as already mentioned) this should be weighed up against the disadvantages of rapid changes.

4.9 In paragraph C4.6 it was said that revenue sharing must, in the interests of equity, be the dominant element in South Africa's intergovernmental fiscal relations, at least in the initial years, because of the great disparities in the abilities of provinces and local governments to raise other revenues.

4.10 Finally, in paragraph A2.1 it was noted that the provinces are entitled to other grants from national revenue, that these can be either conditional or unconditional and that a number of criteria as specified in the Interim Constitution must be taken into account in allocating these.

5. Discussion of specific taxes

5.1 Using the norms outlined in Part B, this section examines the technical feasibility and appropriateness of using the current South African taxes at the different levels of government, for which the Interim Constitution makes provision. It likewise considers the advantages and disadvantages of imposing surcharges on a number of important taxes.

5.2 Personal income tax

5.2.1 Personal income tax is invariably a major source of a country's tax revenues as also important for redistributive purposes. As concluded in paragraph B6.3.1, in economies where vertical and horizontal disparities are prevalent, this tax should be centralised and incorporated in the pool of revenues to be shared between different government levels. As noted above, this is done in the Interim Constitution. Internationally, personal income tax systems tend to be complex. This complexity would be compounded if lower-tier governments were given the freedom to adopt tax bases that were different from each other. In addition, personal income tax is best collected nationally to avoid the duplication of administrative effort that would ensue if each province were to collect its own tax. For these reasons it is preferable to retain the personal income tax for the national government. The constitutional prohibition on provincial income taxes is therefore appropriate.

5.2.2 On the other hand it is possible for subnational governments to impose surcharges on personal income tax. If this is done subject to certain constraints, the procedure is also not complicated. The following points need to be considered. Firstly, in order to minimise the administrative complexities, the national definitions of the base must be used by all and the tax collected nationally.

5.2.3 Secondly, unless those who complete tax returns are given the choice of having their taxes credited to their place of work, place of residence, or the family's place of residence, (where these

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differ), a uniform decision should be taken and applied by all the provinces. Despite this, those who are subject to Standard Income Tax on Employees (SITE) and do not file tax returns, and whose home addresses are therefore not known to the revenue authorities, must have their taxes credited to their place of work. Due to the high incidence of migrant labour in South Africa this could exacerbate horizontal inequalities. As this problem could be more acute if local governments were to impose surcharges on personal income taxes, this form of tax would probably have to be limited to the provinces.

5.2.4 Thirdly, the surcharge should be on the tax base and not on the resulting tax amount. As the latter is progressive, adding a surcharge to the tax amount would be administratively complex. Similarly, the surcharge itself should be levied at a flat rate.

5.2.5 Fourthly, the maximum surcharge should be limited to a few percentage points for two reasons. On the one hand, this would keep the maximum rates within acceptable limits and not dissuade persons (especially the rich) from living in particular provinces. This point would be more pertinent if the national income tax were not lowered to compensate for the surcharges. On the other hand, if the national tax were to be lowered, the horizontal disparities mentioned above would be aggravated: the richer provinces would benefit from the surcharge revenue whereas the revenue sharing pool available to the poorer provinces would be shrinking. These points suggest that provincial surcharges on national personal income tax should, initially at least, be constrained to the addition of a maximum of a few percentage points to the national rate, so as to avoid lowering the national rate.

5.2.6 These aspects must be addressed before this route is embarked upon. The avenue is specified in section 156 of the Interim Constitution, which requires particulars to be spelt out in an Act and the consensus of both the National Assembly and the Senate to pass enabling legislation on provincial taxes.

5.2.7 In conclusion, surcharges on the national personal income tax hold much potential for generating provincial own revenue in future and thus encouraging provincial accountability. Their use, however, requires the general acceptance of standardised solutions to the problems identified above. Moreover, they should not be introduced at the expense of the revenue sharing necessary to achieve horizontal equity between provinces. Nevertheless, with the future in mind when provincial disparities have been reduced, their use should be encouraged and entrenched.

5.3 Company income tax

5.3.1 The collection and administration of company income tax is complex and should preferably remain at the national level. The Interim Constitution recognises this by retaining it for the exclusive use of the national government.

5.3.2 It is furthermore inappropriate for this tax to be levied by lower-tier governments because subnational company taxes distort the location of economic activity unless they are levied at a uniform rate. And if they were to be, the reasons for their existence would disappear: they would become indistinguishable from provincial surcharges, except that the duplication of administrative effort would render them uneconomic.

5.3.3 Attempts to apportion the base, i.e taxable company income, between provinces would not succeed in the case of large companies that operate across provincial borders; therefore, as large companies are common in South Africa, difficulties would be experienced with the major section of

the tax base. Companies are able to relocate income through transfer pricing so as to declare the minimum income in areas where the tax is the highest. In addition, conceptual difficulties arise in trying to apportion company overhead costs on a regional basis. Although formulae are used in some countries for doing this, they are methodologically not beyond question. Furthermore, the skewed geographical distribution of corporate activities in South Africa would cause provincial (or local) corporate taxes to aggravate regional revenue disparities.

5.3.4 In contrast, it would be possible for the revenue from company income tax to be shared amongst the tiers of governments in a way similar to that constitutionally prescribed for the personal income tax. Such a course of action is not specifically provided for in the Interim Constitution as this tax is not included in the revenue sharing pool described in section 155 (2)(a), (b) and (c). It would nevertheless be likely (and appropriate) for it to be included amongst the revenues to be allocated in the form of other grants as stipulated under section 155 (2)(e).

5.3.5 The Interim Constitution, in allowing provincial surcharges on taxes, enables surcharges to be placed on company tax as well. Due to the limited revenue sources that can be allocated to the provinces, this may have some justification. All the difficulties outlined in the previous paragraphs, particularly those of apportioning taxable income on a regional basis and that of an inequitable interprovincial distribution of income would, however, come to the fore. It could therefore probably not be appropriate to pursue this route at this stage. If it were to be followed later, it would be necessary to have uniform definitions of both taxable income and the provincial shares of that income. For administrative reasons, the surcharges should also be collected by the national department of Inland Revenue.

5.4 Value-added tax (VAT)

5.4.1 The collection and administration of VAT is also complex. Being a tax on the value added at each stage of the production process, the tax previously paid on inputs must be subtracted. This principle is applied to international trade in a particular way, which has come to be generally accepted. When products are exported, the tax is refunded and when they are imported, the products are taxed, i.e. products are taxed at their destination and not at their origin. Expressed differently, this means that they are effectively only taxed at the point of consumption and not at the point of production.

5.4.2 If this (universally accepted) practice were to be applied on a provincial (or local) basis, it would be necessary to institute similar procedures at provincial borders. Not only would this be costly but it would require considerable administration to offset claims and refunds between provinces. Indeed, there is no reason why they should balance, especially if the national points of export and import are different. Furthermore the free flow of goods and services within the country would be detrimentally affected.

5.4.3 Introducing a provincial VAT on an origin basis to overcome these difficulties (i.e. taxing production) would have adverse effects on the location of economic activity, unless all provinces used the same rates; but doing that eliminates the reason for a provincial tax. It would be administratively easier and more cost-effective to include the VAT in the revenue sharing pool to be divided on a formula basis, as is indeed done in the Interim Constitution.

5.4.4 In conclusion therefore, VAT should not (and in practice cannot) be levied on a provincial basis. The prohibition in the Interim Constitution is therefore appropriate. Because provincial

surcharges on a national VAT would suffer from the same problems identified above in respect of a lower-tier VAT, this option should not be considered at all.

5.5 Retail sales tax

5.5.1 The retail sales tax having a different base, does not have the same problems in respect of border controls as the VAT has and could therefore, in principle, be levied by provinces, as occurs in several countries abroad. It does, however, have other difficulties; notably that tax escalation occurs if inputs are taxed (which may be difficult to avoid), and that ensuring compliance at retail outlets across the country is not easy. Although the policing costs could discourage lower-tier governments from using this tax, the problems would be less serious if a low rate were chosen.

5.5.2 Despite this, the fact that a national VAT already exists in South Africa makes it impracticable to introduce a retail sales tax at either the national or provincial levels. Because the administrative requirements of these two taxes are different, an unfair burden would be placed on business if both taxes were to be levied simultaneously. The Interim Constitution has in any event precluded this option by prohibiting sales tax as a source of lower-tier government revenue. Nevertheless, in the unlikely event of a national sales tax ever being reintroduced in South Africa, provincial sales taxes or surcharges upon the national tax would become feasible.

5.6 Excise duty

5.6.1 Although the complexity of excise duty is such that it is most efficiently administered and collected by the national government, it is technically possible for it to be treated as a lower-tier tax, based either on the full tax base, or perhaps only on defined items. It may also be administratively feasible to levy provincial surcharges on certain national excises. Doing so may be desirable for increasing revenues that are subject to the discretion of the provinces.

5.6.2 Nevertheless, if the surcharge rates levied in different regions were to vary considerably, incentives would be created to smuggle goods (which generally have a high value to weight ratio) across provincial borders, making the tax expensive to police. The system of allocating transactions to specific geographic areas will also have to be monitored carefully. One option is to rely upon distributor's records and to levy the tax at the points of distribution.

5.6.3 Besides the well known excises on alcoholic beverages and tobacco products, there are others which may prove to be convenient for lower-tier governments. Taxes on motor vehicles registered within a province are an example. Although they are normally levied in the form of annual licences, the impact is the same as that of an excise. Another product upon which an excise duty can be levied conveniently, is fuel. In South Africa this is, however, traditionally treated separately as a levy.

5.7 Fuel levy

5.7.1 This levy is relatively easily raised at a lower-tier level provided that retail outlets have pumps with sealed meters that can be monitored effectively. It is equally possible for provincial surcharges to be placed upon the national fuel levy. The obvious mobility of motor vehicles will be a check on excessive provincial surcharges. Nevertheless, this option would allow lower-tier governments greater discretion over their revenues than the present system of sharing the levy, raised at a uniform rate, on a percentage basis as stipulated in the Interim Constitution.

5.8 Transfer duties

5.8.1 Because transfer duty is levied on the transfer of properties that are geographically immobile, it has potential as a lower-tier tax as argued in paragraph B6.3.3. As property values are largely determined by neighbouring developments, which are often initiated by the relevant local authorities, transfer duties can easily be justified at the local level. As suitable taxes at this level are not abundant, their use by local governments could be advantageous. Alternatively, local authorities could, without insurmountable administrative difficulty, impose surcharges upon transfer duties.

5.8.2 The Interim Constitution stipulates that provinces are entitled to any transfer duty, collected nationally, on the acquisition, sale or transfer of any (immoveable) property situated within the province concerned (section 155 (2) (d)). In contrast to the fuel levy, transfer duties must be channelled to provinces on an origin basis and are not subject to percentage sharing.

5.9 Mining and mineral tax

5.9.1 There is an argument that minerals tax in the form of a severance tax would be levied by provinces in which the mining is undertaken, on the basis that provinces should earn some return on the depletion of the natural resources located within their boundaries in order to bolster other economic regional activities in anticipation of the ultimate closure of the mine. It is possible for subnational governments to do this; it may, however, not be appropriate for a number of reasons.

5.9.2 Unless these taxes are levied on economic rents, which is generally not the case, they tend to distort decisions regarding the extraction of minerals. Because such taxes add to the costs of the mining operation, they effectively shrink the quantum of the area's economically exploitable mineral reserves, to the ultimate detriment of the country as a whole. Secondly, prices of and therefore taxes upon natural resources, being in general subject to the forces of world markets, tend to be volatile. Fluctuations in revenue do not enable public services to be maintained in an orderly way; these taxes are therefore not suitable for subnational governments. Thirdly, natural resources are often restricted to particular areas and thus contribute to interprovincial disparities in wealth and therefore also the provision of public goods and services. This raises the issue of whether these fortuitous assets should not be viewed as belonging to and benefiting the nation as a whole rather than those who happen to be in their immediate vicinity.

5.9.3 One is accordingly drawn to the conclusion indicated in paragraph B6.3.4, namely that taxes on mineral and mining should be reserved for the national government. This does not mean that no local taxes should be paid at all. As such operations often cause environmental damage, taxes to internalise their negative spillovers have positive effects in inducing the correct usage of the area's total resources, including the environment.

5.10 Customs duty

This tax cannot easily be dealt with as a subnational tax due to the difficulty in determining the location of the ultimate usage of the imported item, where the importer's operations are geographically widespread. Allowing provinces, that fortuitously have ports of entry within their borders, access to custom duty would probably accentuate horizontal inequities. It would also probably violate section 156 (2) of the Interim Constitution, that prohibits taxes that could detrimentally effect interprovincial commerce.

5.11 Import surcharge

The current import surcharge is a temporary measure that is due to be abolished, and thus it is not dealt with here. Furthermore, provincial import surcharges would exhibit the same disadvantages as provincial custom duties.

5.12 Financial services levy

As currently constituted, the financial services levy, which is levied on certain financial enterprises instead of VAT, cannot be dealt with as a provincial tax. This is primarily due to the difficulty in apportioning the levy (which is alternately asset or interest-based) to the underlying activities of the affected financial institutions which, by their nature, are invariably geographically widespread.

5.13 Marketable securities tax and stamp duties

5.13.1 It would be impracticable to levy these taxes on a provincial basis, because they are based on the location of the ultimate client. Due to the mobility of the transactions that are sought to be taxed, differential rates between provinces would ensure almost universal migration of business to the lowest tax jurisdiction. These taxes are thus most suitably levied at the national level.

5.13.2 It should be borne in mind that it can be reasonably argued that these taxes are an impediment to financial activity and that they should be abolished, as has occurred in various other countries.

5.14 Capital transfer tax

Such taxes, in the form of estate duty and donations tax, have a location profile similar (but not identical) to personal income tax, and the discussion under that heading thus also has relevance here. The conclusion is that these are not suitable subnational taxes.

5.15 Regional Services Council and Joint Services Board levies

5.15.1 The current regional services council levies on business turnover (the establishment levy) and employee remuneration (the services levy) currently accrue to the local government level. These levies, however, contain a number of problems.

5.15.2 Turnover taxes are not economically neutral and are thus detrimental to economic activity. Because they are levied repeatedly as products move through the production - distribution process, they result in tax upon tax, thus encouraging vertical integration.

5.15.3 Payroll taxes are similar to income taxes. Provincial surcharges on the personal income tax would make it unnecessary to administer a payroll tax in addition while achieving essentially similar results.

5.16 Betting taxes

The Interim Constitution (Section 156 (1B)) gives provinces the exclusive right within their regions to impose taxes, levies and duties on casinos, gambling, wagering, lotteries and betting.

5.17 Property taxes

Property taxes, including rates on urban dwellings and commercial premises as well as land taxes, traditionally fall under the jurisdiction of the local authorities in which the properties are located. There is no reason for this to change. For practical reasons they are normally only levied on the value of immovable property. For this reason they are normally effective, although the valuations of properties under inflationary conditions tend to lag behind the real values.

5.18 Non-tax revenues: User charges

5.18.1 As a generalisation user charges can be regarded as public sector prices for the delivery of public goods and services. In principle, requiring consumers to pay for what they use ensures that only those who value the product or service highly enough, use it. This reduces waste and contributes to the effective use of resources, a norm described in Part B.2. This statement must be qualified by the norm of equity (Part B.7), because circumstances may arise where it would be inequitable and unwise to deny those who cannot pay, access to certain goods and services. Examples are water and sanitation.

5.18.2 User charges should be set to cover the costs of producing the specific goods or services in order to make them viable and to reduce the need for outside financing. Under certain (unlikely) conditions user charges should be set to equal marginal costs, that is, the costs of increasing production marginally. This would, however, probably result in insufficient revenue being raised to cover total costs in the case of even modestly capital intensive projects.

5.18.3 Where a provincial or local government owns the asset concerned, or has financed its erection or acquisition, that level of government should as a rule levy user charges, and the rates should be under its control. Such non-tax revenues can be categorised as follows:

5.18.4 Service fees - fees representing a cost reimbursement to provinces or local government for performing specific services; these include licence fees and registration fees.

5.18.5 Public prices - the revenues received by provincial or local governments from the sale of public goods and services, other than the above-mentioned service fees; these include public utility charges, lease or rental fees for the use of provincial or local government-owned assets (this includes royalties or similar charges which would be levied on mines, where a province or local authority is the owner of the related mineral rights), and admission charges to recreational facilities.

5.18.6 Specific benefits taxes - these relate to the specific benefits supposedly received by specific tax payers and tend to relate more to local government than to provincial government; these include special assessments, land value increment taxes, improvement taxes, front footage levies, supplementary property taxes related to the provision of sewers or street lighting. Usually such charges are imposed either on the assessed value of real property or some characteristic of that property, such as its area, frontage or location.

Part E

PROVINCIAL AND LOCAL GOVERNMENT BORROWING POWERS

1. Borrowing powers and the Interim Constitution

1.1 Governments, like enterprises in the private sector, often supplement their incomes by borrowing additional funds in order to increase present expenditure. Section 157 of the Interim Constitution specifically allows provinces to raise loans for capital expenditure, provided that they do so within a framework of norms and conditions prescribed by an Act of Parliament. Such an Act may only be passed after recommendations of the FFC have been submitted to and considered by Parliament.

1.2 Section 157 prohibits provinces from raising loans for current expenditure. The only exception to this is in the case of bridging finance, provided that loans to provide such finance are redeemed within twelve months, and are also subject to such further conditions as may be prescribed by the Act of Parliament already referred to.

1.3 This section provides further that provinces may not guarantee loans (presumably loans by local governments within their geographical areas or loans by agencies or corporations of the provincial governments) unless the FFC has verified the need for a guarantee and recommended that it be given.

1.4 Similarly, section 188 of the Interim Constitution provides that the national government may not guarantee any provincial or local government loan unless:

- * the guarantee complies with the norms and conditions as set out in the Act of parliament; and
- * the FFC has made a recommendation concerning compliance of the guarantee concerned with such norms and conditions.

1.5 The Interim Constitution contains no direct reference to the borrowing powers of local governments, other than that mentioned in paragraph 1.4. This reference as well as the indirect reference referred to in paragraph 1.3 implies that local governments are entitled to borrow.

1.6 It is logical to assume that it was intended that the restrictions on provincial government borrowing discussed above should apply equally to local governments, with appropriate adjustments, and the new Constitution should deal specifically with this aspect.

2. Some principles of debt financing

2.1 Borrowing can be divided into short term and long term categories. In the short term its purpose is to reconcile differences between income and expenditure flows. When the income occurs after expenditure, borrowing is required to bridge the cash flow gap. Long-term borrowing is a way of aligning the flow of benefits and costs that arise from a durable asset. If an asset is expected to benefit both present and future generations, for example, it is equitable to expect both groups to contribute to the costs. This occurs when interest and redemption payments on

the loan are spread over the expected lifespan of the asset. Furthermore, if this is not done and a durable asset expensed on purchase, economic decisions may be adversely influenced by the magnitude of the costs to the present generation.

2.2 The inverse of this analysis is that expenditure that does not benefit future generations (for example current consumption expenditure) should not be financed with loans. If this were to be done, future generations would have to pay for the consumption of their forefathers from which they derive no benefits.

2.3 In conclusion therefore, borrowing may enhance both intergenerational equity and intertemporal economic decision making, besides overcoming disjunctures in income and expenditure flows.

2.4 Despite these potentially beneficial properties the appropriateness of borrowing depends upon the circumstances. Some examples follow.

2.5 Firstly, the method of financing chosen for a particular project determines which party bears the burden of risk. In the case of borrowing the risk primarily rests upon the borrower. Failure of the project is borne by the borrower who is obliged to repay the debt even though the project may have failed to generate the income initially expected. The risk is ultimately only shifted to the lender in the case of total bankruptcy. On the other hand equity financing implies that the person making funds available carries the primary risk burden of the project's success, although (in both cases) the risk may be passed on to third parties by using tradable debt or equity instruments.

2.6 Secondly, the macroeconomic environment will influence the appropriateness of debt financing. For instance, under inflationary conditions the financing costs of debt may largely be shifted onto the present generation. Because the real value of future repayments will be reduced by the fall in the value of the currency, the effective burden is heavier in the earlier years of the project's lifespan. Projects financed through loans are therefore likely to appear to be more costly and nominal interest rates higher than would have been the case.

2.7 Thirdly, debt by definition must be repaid. Unless borrowing kindles a process of rapid income generation, borrowing is therefore not usually a suitable instrument for alleviating poverty permanently and *a fortiori* not normally appropriate for achieving the redistribution of wealth. Poor communities that must repay their loans are likely to remain poor even though this fact may have been temporarily veiled by the loan. In contrast, suitably designed grants or transfers more appropriately address such programmes directly.

2.8 It follows from this that debt financing should only be undertaken by those who can repay their loans. This normally implies that the project to be financed by the loans should be economically viable and that, if it does not generate sufficient income to service the loan, dependable alternative revenue sources must be available for this purpose. These requirements are normally reflected in the credit-worthiness of the borrower. Where doubt exists in this regard, lenders generally require collateral security to protect their interest in the event of default by the debtor. Collateral security may be in the form of either a secured asset or an irrevocably pledged income stream.

2.9 Despite the conclusion of the previous two paragraphs attempts are at times made to assist the poor by subsidising the interest rates payable on loans made to them, thereby giving them access to these financial markets while reducing the concomitant burden of debt repayments.

Although a laudable objective, the danger exists of distorting interest rate patterns if this is done on a large scale. As capital is allocated on the basis of interest rates, distortions in these markets could lead to incorrect allocations in areas unrelated to those in which the intervention was initially made. Because capital is one of South Africa's scarcest resources this possibility should be avoided.

2.10 Furthermore, subsidies of this nature tend to be capitalised in asset prices, if the supply of the assets cannot be expanded readily to accommodate the increased demand. For example, in towns where a majority of households receive housing subsidies, house prices tend to rise with the result that the intended benefits of the subsidy are largely lost.

2.11 As already emphasised in point 2.7 above the more suitable way of assisting the poor is by means of direct grants. This does not exclude direct financial contributions by the recipients of the grants, which in principle should be encouraged so as to secure their commitment to whichever project is being undertaken. A number of possibilities for doing this exist. For example, matching grants are contingent upon contributions from the beneficiaries; or grants may be combined with loans to reduce the amount of debt. However, the interest rates on the loan portion should reflect economic realities to avoid distorting the functioning of related financial markets.

2.12 A corollary to this is that, once the questions of poverty and the redistribution of wealth have been addressed, the development and functioning of normal financial markets should be encouraged, i.e those (institutions) wishing to acquire additional funds should borrow them in the customary ways. South Africa's financial systems are sufficiently developed to accommodate such needs. Moreover in this way socio-political decisions are separated from the financial with the result that the unproductive allocation of resources is likely to be minimised.

2.13 Loans denominated in foreign currencies bear the added risk of the rand's depreciation, which will greatly increase the loans' repayment costs to the borrower. In such cases borrowers must include the expected depreciation in calculating the total costs of interest and redemption payments on the loan.

3. Borrowing within the intergovernmental fiscal framework

3.1 In a completely centralised state, government borrowing must by definition be controlled centrally. Where however some form of decentralisation is envisaged, as for example in the Interim Constitution, additional considerations come to the fore. This arises because of the need to reconcile the autonomous decisions of lower-tier governments with national government policies, a need deriving mainly from the important monetary and fiscal properties of debt.

3.2 The coordination of total public sector borrowing is essential, firstly, to ensure that the public debt remains within affordable limits. The danger exists that if debt becomes excessive, interest payments will absorb a major portion of the annual budget thus limiting government's other policy objectives. This is often referred to as the debt trap, because debt appears to be an attractive option for achieving short term goals, but may in fact severely curtail long term policies.

3.3 Furthermore, ensuring that debt is affordable is a necessary condition for maintaining the fiscal discipline required to avoid increasing inflationary pressures. Because government borrowing is normally for the purposes of spending, public sector demand rises and, depending upon the available supply, may induce price increases. Ensuring that debt is affordable is also closely related to monetary policy in a number of ways. Firstly, some debt instruments enable commercial

banks to increase their credit to customers and therefore to increase the supply of money in circulation. Secondly, if repayments become excessive the Reserve Bank may be obliged to monetise the debt by creating money for repayments. In both cases these actions are likely to contribute to inflation. High inflation would in turn jeopardise the investor-confidence necessary for achieving economic growth and development.

3.4 Containing the total public sector debt within acceptable limits by coordinating the borrowing of all tiers of government is important in a country such as South Africa where the supply of capital is limited but the demand great. If this is not done, excess demand will cause interest rates to rise and make capital unaffordable to the private sector. Government activities, which tend to be less productive than private sector ones, will consequently "crowd out" private sector projects to the ultimate detriment of all.

3.5 Creating a mechanism for coordination will enable the government sector as a whole to, achieve consensus on investment priorities within the constraints discussed above. Participation by subnational governments in the process will give recognition to the autonomy of and differences between the lower tiers of government and ensure the transparency necessary to instill confidence in its fairness.

3.6 A coordinating mechanism will also have other economic as well as administrative advantages. For instance, the number, structures and timing of issues can be controlled in an orderly way in a single market to take into account the dispersion of investors, current market conditions, particularly the availability of funds in the absence of prescribed investments, and the intermittency of the maturity. In this way the marketability of the paper being sold will be increased.

4. Guarantees for lower-tier government debts

4.1 The debt of the national government must be clearly distinguished from that of the lower-tier governments even though, as pointed out in the previous section, total public sector debt should preferably be coordinated. This is because the credit-worthiness of a government (i.e. either national, provincial or local) and therefore its access to capital markets, will largely be determined by the magnitude of the debt for which it is already responsible. For the national government it is important not to be burdened with the debt of provincial governments; and it is likewise important for provincial governments not to shoulder the debt of local authorities, particularly if they are unable to control the debts.

4.2 The allocation of capital via markets depends upon a number of factors which are largely interrelated: the status and the current level of indebtedness of the borrower, the economic strength of the project(s) to be undertaken, and the nature and quality of the paper being sold. Together they describe the risk profile or credit-worthiness of the borrower. Large existing debts of a would-be borrower, that reduce the ability to service additional loans, are viewed negatively by lenders when scrutinising market opportunities. Likewise, projects or institutions that are unlikely to generate sufficient funds to service the intended new debts will not be judged favourably.

4.3 For this reason it is important that the clear distinction between national and lower-tier debt referred to above be made. For these purposes legal distinctions are insufficient: even though a lower-tier government may be legally liable for servicing its own debt, if capital markets perceive that the national government will ultimately take responsibility, its credit-worthiness will be

affected. Of course, if the lender is a parastatal body or the lower-tier debt is covered by national government guarantees, the assumption that the national government is ultimately responsible for interest on and redemption of the loans becomes almost irrefutable. These factors should and indeed are taken into consideration by credit rating organisations and clearly influence whether a country is awarded investment status or whether its paper is given junk bond ratings. The latter will detrimentally affect the country's ability to access international capital markets and could therefore impact negatively upon national economic development.

4.4 In addition, the indiscriminate guaranteeing of the loans of lower-tier governments reduces the incentives of those responsible for incurring them to economise and to ensure the success of the projects they have initiated. Moral hazard is involved because the risks of default are not brought to bear upon those taking the decisions. Equally, the providers of funds feel less obliged to subject projects to strict market scrutiny and may therefore allocate too many scarce resources to these projects. For these reasons lower-tier governments should also be prohibited from shareholding in or ownership of financial institutions that provide funds to public bodies.

4.5 It may be concluded from this that guarantees on lower-tier debt must be given cautiously and only in respect of loans to finance projects regarded as essential by the higher-tier government. Other loans should be referred to the capital market and credit rating institutions encouraged to evaluate both the borrowers and their proposed projects. This is also in accordance with the norms discussed in Part B where it is stated that each level of government should be accountable for its own decisions and that this is encouraged by requiring governments to be fiscally autonomous. Autonomy, however, also implies that the burden of debt should be borne by those who incur it.

4.6 One of the results of this approach is that the consequences of default must be considered timeously by the two contracting parties in the loan contract. To avoid litigation once default has occurred, the legal procedures for resolving differences should be explicitly stated. For example, issues of collateral security or the pledging of future revenue streams in lieu thereof should be specified at the outset of the loan.

5. Project viability

5.1 A remaining important aspect regarding market allocations of capital is the nature of the project(s) to be undertaken with the loan funds. Investors are generally anxious to know that the projects that they support, are viable, and that the projects either generate sufficient income streams or that alternative future revenue is assured to cover operational and maintenance costs as also final loan repayments.

5.2 Public sector projects can be divided into categories according to these criteria: some are able to generate sufficient income through the sale of services (eg. electricity, telecommunications, water); whereas others cannot, either because their benefits are too dispersed or their capital requirements too great. Examples from the latter category include school and university buildings, hospitals and intercity roads. In the interests of limiting the total amount of public debt whilst ensuring that the maximum infrastructural development occurs, projects that are commercially viable should be operated in ways that make use of this property. For instance, the provision of such services can be contracted out by local governments to commercial enterprises. Not only will this enable the service providers to obtain finance through the normal market channels, such as user charges, private debt and equity, but this procedure will enable competition to occur, resulting in greater efficiency with which services are provided. Even if in small localities there is

only room for one provider of a particular service, competition will occur at the time of bidding for the various contracts. In contrast services that remain in the public domain and are not subject to commercial discipline are less likely to attract the necessary funding without the backing of loan guarantees.

5.3 If the maximum use is made of private funding, the use of public debt instruments could be restricted to those projects falling in the second category. Amongst these, those of a truly local nature such as parks, recreation and local streets should be financed by municipal bonds, unguaranteed by either a provincial or the national government. On the other hand, where necessary, essential services such as education, health and major roads, could be funded with guaranteed debt. These loans, as already noted would then effectively become part of the national debt.

6. Conclusion

Borrowing is an important aspect of governments' fiscal activities. However, not being a suitable instrument for the redistribution of income and wealth (which should be achieved by other means), borrowing is best left to the normal functioning of capital markets. Consequently, the FFC should be cautious in recommending that loans be guaranteed by higher-tier governments. Benefits can nevertheless be expected from co-ordinating the borrowing requirements of the different tiers of government.

Part F

THE WAY FORWARD

1. Introduction

1.1 Over and above the critical issue of introducing the subject of a revenue-sharing formula, the framework document seeks to contribute in general to giving structure to the Financial and Fiscal Commission's (FFC) role. In the context of the evolution of a new system of intergovernmental financial and fiscal relations for South Africa, the document explores how the role of the FFC is envisaged in the Interim Constitution, and how it may be realised in practice, .

1.2 In taking the process forward, all stake-holders must be aware of potential dangers associated with a piecemeal approach to any new system. The main danger would lie in the possibility of developing a fragmented structure without any consistent rationale. To avoid this the document attempts to give an overview of how the Commission proposes approaching views its mandate. Nevertheless, rather than the FFC determining where it should fit, it should be policy agencies who reach consensus on the basis of the country's experiences and developmental needs. It is hoped that the framework document will provide a useful benchmark, particularly in the consideration of short-run options over the next two to three financial years. As shown in the foregoing chapters, eventually a full evaluation of the relative fiscal capacities of subnational governments, encompassing both revenue capacities and expenditure needs, is required for the FFC to fulfil its tasks.

1.3 While the Reconstruction and Development Programme (RDP) gives an overall national strategic perspective, the Budget and its associated process provide a short to medium-term focus around which, and in terms of which, fiscal relations are given greater definition. It is indeed along this critical path that identified priorities should be established.

2. Process

2.1. On account of the fact that the FFC's work must relate to all tiers of government, as well as their associated committees and forums, critical questions about process are raised. Answers to them would have significant political and ideological implications that the Commission feels must be dealt with in a political context. However, to the extent that we have to operate within the parameters as defined in the Interim Constitution, we have an interest in contributing to the achievement of clarity regarding the definition of process and the procedural issues involved.

3. FFC and existing governmental and quasi-governmental structures

3.1 Subject to the way in which paragraphs 1.2 and 2.1 are dealt with by the relevant policy entities, the FFC needs to know which government and state institutions it has to relate to and what the nature of such relationships should be.

3.2 While it is true to say that section 199 of the Interim Constitution outlines the broad parameters within which the relationship must take place, the method whereby this must be

achieved is not explicitly stated. Procedures that will be adopted and the process management techniques followed, once refined, should necessarily give greater depth to the evolution of the horizontal and vertical intergovernmental financial and fiscal relations.

3.3 The FFC's strategy, from a process point of view, must at all times be informed by the imperative of involving all role-players in contributing towards the development of its advice and recommendations. Thus, in taking the framework document forward, the following structures, organisations or institutions associated with intergovernmental relations are earmarked by the FFC for ongoing consultation:

3.3.1 Domestic Institutions:

- a. Intergovernmental Forum (IF);
- b. Intergovernmental Technical Committee (ITC);
- c. Commission on Provincial Government (CPG);
- d. Function committees (FC);
- e. Theme committees (Constitutional Assembly (CA));
- f. Joint standing committees on finance - national and provincial (JSCOF);
- g. RDP Office;
- h. National and provincial departments of finance;
- i. National and provincial departments of state expenditure;
- j. Commission for Inland Revenue;
- k. South African Reserve Bank (SARB);
- l. Development Bank of Southern Africa (DBSA)(or its successor);
- m. Human Sciences Research Council (HSRC);
- n. National Economic Development and Labour Council (NEDLAC); and
- o. Organised local government.

3.3.2 International Institutions (for specialised input on specific issues identified by the Commission from time to time)

- p. International Monetary Fund (IMF);
- q. World Bank (WB); and
- r. countries with systems of intergovernmental fiscal relations relevant to the South African situation.

3.4 The relationship with these institutions must be set along well coordinated lines, with proper procedures to formalise and regulate the interactions.

3.5 Apart from tasks specifically referred to in the Interim Constitution, which in fact form the basis of a broader framework, we need to consider how exactly the FFC interfaces with, impacts on or contributes to the budget process. There needs to be an identification of and agreement on the critical points in the budget process at which inputs from the FFC would be required or from which working mandates could be generated.

4. Possible structure for the process

4.1 In order to arrive at a more meaningful way of dealing with the norm of fiscal accountability alluded to earlier in this document (Part B), the process can be conceived as consisting of three stages. Firstly, the determination of the total revenue budget; secondly, the financial allocation of such revenues; and thirdly, approval by Parliament.

4.2 Determination stage

4.2.1 An appropriate intergovernmental forum (which could be the already established Intergovernmental Forum) on which all levels of government are represented could be charged with negotiating all the political issues associated with fiscal arrangements, including the determination of what the "size of the cake" is for any particular fiscal year under consideration, and also what the minimum standards should be and the applicable criteria. This approach should place the premiers of the provinces at a critical point where they are also involved in negotiating the total size of resources available for expenditure at *all* levels of government. This meeting could then be used by the FFC to establish terms of reference to be applied to the coming financial year's allocation.

4.2.2 An immediate advantage of this approach is that it will be continually focused on priorities, not only as desired, but also as agreed upon by all levels of government. It would also address the important question of the forum to which the FFC should submit its recommendations regarding financial and fiscal allocations, and enable the provinces to be consulted appropriately.

4.3 Allocation stage

4.3.1 After the first stage the FFC should concern itself with the evaluation of the key variables in its revenue formula. To be able to fulfil its requirements there must be agreement at least with the Department of State Expenditure, or with an appropriate intergovernmental forum, on the exact point in the proposed multi-year budgeting system that FFC input should be provided. Line-function responsibilities should be recognised in this process.

4.3.2. In considering the proposed new budgeting format and time-frame, two key points appear relevant for consideration: firstly, as already discussed in paragraph 4.2.1, the determination of the total amount available for spending (in June); and secondly, the Department of State Expenditure's consideration of draft estimates submitted by spending agencies (October/November). At this point the FFC could be required to implement its formula in order *to guide* the Department of State Expenditure's final allocations. In 1995 (for the 1996/97 financial year) this should be at least with regard to the key functions (education, health, housing and intergovernmental grants to local governments).

4.3.3 This procedure may not be sufficient to address all the major concerns of the provinces, in which case the following proposal regarding an appropriate intergovernmental forum procedure is made: The intergovernmental forum could become the representative forum to receive the FFC's recommendations on allocations for a particular financial year. Prior to the point at which the Department of State Expenditure considers the draft estimates submitted by spending agencies, the FFC will have to submit its recommendations (which will formally go to Parliament at a later date) to the intergovernmental forum and these will *determine* the allocations that the Department of State Expenditure will formulate.

4.4 Approval by Parliament

4.4.1 The procedure outlined above raises the further question of how the FFC should relate to Parliament. The appropriate avenue is probably the Joint Standing Committee on Finance (JSCOF).

4.4.2 With the approach noted here, the JSCOF could benefit in two ways: In the case of FFC recommendations carrying the support of an appropriate intergovernmental forum, its task in Parliament may be simpler; and in the event of the recommendations of the FFC not being supported, the JSCOF will still have the benefit of two considered and different points of view from which it can guide Parliament. At this point, the JSCOF and/or any other role-player, can still, after consideration of the differing views, place before the FFC new issues for further consideration, with clear terms of reference and time frames.

5. Taking the framework document forward

5.1 The FFC is of the view that its conclusions and recommendations should take into account the broadest possible contributions.

5.2 The framework document is envisaged as a reference point for all actors in the system of intergovernmental fiscal relations. It is therefore important for the process to allow significant input from those role-players directly involved at different points and levels of the evolving system of intergovernmental fiscal relations.

5.3 Four stages are envisaged in developing the framework document.

5.3.1 First stage

The document will be presented to:

- * the Intergovernmental Forum;
- * the provincial authorities (governments);
- * the National Department of Finance;
- * the National Department of State Expenditure;
- * the Joint Standing Committee on Finance
- * the function committees;
- * the RDP Office;
- * organised local governments; and
- * other relevant structures.

During this stage, all role-players and interested members of the public will be given a period of up to one month to consider the Framework Document and formulate their written comments. The draft will also be presented to the media. The time frame for this consideration phase is one month (mid-June to mid-July 1995).

5.3.2 Second stage

This stage will mainly comprise a series of meetings between the Commission and certain relevant role-players, who will be requested to submit or present their comments to the FFC. This process will entail:

- * meetings with role-players;
- * oral presentations ;
- * written submissions on either some or all of the issues dealt with in the draft; and
- * presentations by extra-governmental entities.

The time frame envisaged to receive all inputs is mid-July to mid-August 1995.

5.3.3 Third stage

During this stage the Commission will be synthesizing all inputs and working on the final framework document. The time frame for this phase is mid-August to mid-October 1995.

5.3.4 Final stage

The presentation of the final document, which will also include a presentation of the first revenue-sharing formula. As proposed earlier with regard to an appropriate intergovernmental forum, this presentation could be made to such a forum for consideration ahead of the Department of State Expenditure's determination of allocations in November 1995.

6. Conclusion

6.1 It is the Commission's belief that, in as much as the recommendations and advice to be made are important, the process through which it will be arriving at those recommendations will be just as important. The Commission, therefore, commits itself to processes which will allow the broadest possible inputs from all relevant role-players.

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