3. BEST PRACTICES FOR INTERGOVERNMENTAL FISCAL RELATIONS APPLICABLE TO SOUTH AFRICA

Though the Constitution sets out the broad requirements that fiscal arrangements must satisfy, there is still considerable leeway to choose the precise features of the system.

Moreover, South Africa has the essential prerequisites for launching a fiscal system of its choice, namely:

- a set of responsible national, provincial and local governments;

- far-sighted constitutional provisions that explicitly set out norms of individual equity and the obligation of the state to achieve them;

- the existence of an institution like the Financial and Fiscal Commission that can advise, from an arms-length perspective, on long-run structural matters without the constraints of day-to-day policy and budgetary concerns; and

- perhaps most importantly, a real sense of national purpose.

Sound fiscal arrangements must rest on sound principles, so it is important to set out the principles clearly. The growing literature on fiscal transfers amongst tiers or spheres of government gives some attention to these principles. There exists also considerable experience with the management of multi-level government relations in decentralised systems around the world. What follows are some observations about the lessons that have been learned that are of particular relevance to South Africa.

It is an essential feature of all multi-level government systems, federal and otherwise, that tensions exist and compromises must be made. These involve the resolution of the balance between truly decentralised provincial responsibility for fiscal decisions on the one hand, and the achievement of national equity and efficiency objectives on the other. Although decentralising basic public service provision to provincial or local levels of government can enhance efficiency, these basic public services are at the same time among the most important policy instruments for achieving national equity goals. These goals, explicitly stated or not, include the aim that citizens ought to have equal access to educational opportunities, health care and socio-economic security regardless of where they reside.

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It is the role of the grant structure, and national-provincial fiscal arrangements more generally, to facilitate the decentralisation of fiscal responsibilities in a way that leads to efficient and responsible provincial decision-making, while at the same time respecting national goals and objectives.

Nations resolve these tensions in very different ways, some more successfully than others. The experience of other decentralised states, especially the more established ones, highlights a number of general features that characterise successful multi-sphere systems and set them apart from less successful ones. By success is meant that the decentralisation of public service provision achieves two objectives. First, it gives provincial governments responsible legislative authority to meet their own constituents’ particular needs effectively. Second, it ensures that citizens are provided with comparable access to basic social services regardless of their province of residence. What follows is a summary of some of the characteristics of best practices in nations with multiple levels of government.

3.1 Fiscal autonomy of provincial governments

In the South African case, the notion of autonomy cannot be applied in absolute terms, as the Constitution defines South Africa as “one sovereign, democratic state”. However, efficient and politically accountable provision of public services by provincial governments is facilitated if provinces are allowed to exercise their responsibilities within the limits provided in the Constitution. Provinces should be better informed about the detailed needs of their residents and be best placed to micro-manage their own programmes. Moreover, the greater the responsibility they are given for legislating and implementing their own programmes, the more accountable will they be to their citizens through the political process. It might be tempting to argue that the capacity for responsible decision-making at the provincial level simply does not exist. This argument has the unfortunate consequence of perpetuating that lack of capacity rather than allowing the capacity to develop through experience.

3.2 Sharing resources for fiscal equity

Almost all decentralised states have some mechanism for the fair sharing of resources among provinces and/or municipalities. Sharing entails affording subnational governments sufficient resources, such that each can provide comparable levels of public services using similar revenue-raising effort. This is what is referred to as fiscal equity. It is an explicit objective of the FFC Consultation Document: February 2000.
Australian federal system, and is built into the Canadian constitution as a requirement of the equalisation system. The case for fiscal equity is ultimately based on the notion of horizontal equity – the idea that all persons should be treated comparably by the public sector regardless of their province of residence. It reflects the common rights of citizenship that all citizens should enjoy.

### 3.3 Formula-driven rather than discretionary grants

Grant systems whose amounts are determined by a well-specified formula have a number of advantages over those that are determined on a year-by-year discretionary basis by national government. Formula-driven grants are more transparent, reliable and predictable, and are less subject to short-term fiscal constraints and day-to-day political considerations. This aspect of grants cannot be over-emphasised, especially in decentralised systems where provincial governments have relatively limited revenue-raising power, such as South Africa. Formula-driven grants can be designed to be in place for intervals of several years. They can also be designed so that risks of unexpected changes in revenue are borne by national government, which may be especially important where provincial governments have little revenue-raising ability, and where they cannot use debt as a method of insuring themselves against revenue fluctuations.

### 3.4 Transparent processes for setting grants

The process by which grant formulae and amounts are determined should be transparent and undertaken from a longer-term perspective. Nevertheless, isolating national-provincial transfers from the budget process entirely is not feasible since money must be appropriated by the national legislature. Some countries, such as Australia and India, have found arms-length bodies to be extremely helpful as means of ensuring that longer-run considerations are taken into account in designing grants. These bodies have also proven to be effective structures for consulting with provinces.

### 3.5 Unconditionality of major grants

Major grants, especially those that play an equalising role, tend to be largely unconditional and non-matching. This ensures that the provinces are able to exercise the utmost discretion. Of course, there may be some requirement to ensure that when provinces use these grants to deliver important social programmes, they adhere to national norms and standards. As stressed above, achieving that objective is one of the most
difficult problems in systems similar to South Africa. National government and the provinces bear joint responsibility for ensuring that public services in areas like education, welfare, and health satisfy national equity criteria.

3.6 Provincial accountability

Political accountability is important for ensuring that public services are delivered in efficient ways and that they meet the needs of citizens. Therefore, explicit and unambiguous delineation of accountability relationships between the different spheres of government is critical. Nurturing responsible provincial decision-making may involve some transition, but it will pay dividends in the long run.

3.7 Avoidance of bailouts

Formula-driven, unconditional grants have one further benefit, which arises from the fact that provinces bear responsibility for the consequences of their expenditure. The grants help to avoid the potentially serious problem faced by many federations with large vertical fiscal imbalances – the problem of bailouts of irresponsible (or over-zealous) provincial governments. This is the so-called “soft budget constraint problem”. The very possibility of bailouts of other levels of government serves to encourage irresponsible decision-making.

3.8 Norms and costs as elements of grants

National-provincial grants which are intended to equalise the ability to provide comparable levels of public services are inherently difficult to design. There are two elements which can facilitate this design. One is a component that compensates for differences in the ability of provinces to raise their own revenues. This is relatively straightforward to implement, and equalisation systems in established federations tend to do so (for example, Canada and Australia). However, with the limited revenue-raising capability of provinces in South Africa, this component is not central to the discussion at present.

The other component involves differences in the resources required to achieve comparable service levels. These differences arise due to variations in demography and geography among provinces. Historical inequality in levels of development, including critical capital backlogs, is another major determinant of provincial disparities. These are typically much more difficult to measure and very few countries attempt to do so in a detailed way. An exception is Australia, where the equalisation system incorporates needs in a sophisticated way to determine the horizontal allocation of grants among states.

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There is widespread agreement that, in principle, differences in fiscal requirements ought to be included in equalisation grants. This is especially true in systems where provinces have little revenue-raising capacity of their own. Any attempts to incorporate such costs into equalisation formulas would contribute to the fiscal equity and efficiency of the multi-government system.

If norms and cost differences are to be included in the grant formula, it is important that it be done in such a way that provincial spending does not directly influence the amounts transferred. Otherwise, provinces will distort their spending priorities in order to influence the amount of grants they are to receive. Grants could be designed so that norms are able to reflect the objective features of the province that affect the amount of money needed to provide standard levels of public services.

In the South African context, the problem is made more challenging by the requirement that the norms and costs of providing basic services inform not only the horizontal division of funds across provinces, but also the vertical division of equitable shares. Although it is the prerogative of national government to determine the vertical division of national revenues, it must nonetheless be done in a way that satisfies the requirements set out in the Constitution. These involve ensuring that the provinces can provide basic services up to the national norms and standards.

3.9 Macro-economic management

National government is ultimately responsible for macro-economic management and hence the implementation of fiscal and monetary policies that will facilitate its employment, price stability and growth objectives. There are various dimensions to this. On the one hand, effective monetary management requires overseeing both the money supply and the level of public debt. The former is not an issue since it is the clear responsibility of national government. However the public debt includes not only national public debt but also any debt issued by the other spheres of government.

More generally, the idea that the three classic government functions – allocation, distribution and stabilisation – can be neatly assigned to any one of the levels of government has been discredited. In particular, virtually everything governments do has redistribution intent. The issue is how the actions of the national, provincial, and local spheres of government can be co-ordinated to achieve national redistributive objectives. The same applies to the allocation and stabilisation functions.
3.10 Provincial revenue raising

The case for decentralising expenditure functions is much stronger than for decentralising taxation functions. Nonetheless, the advantages of provincial levels of government having reasonable revenue-raising responsibilities are compelling. This need not imply a separate taxing authority. Provincial governments can have taxing responsibility without disrupting a harmonised national tax system by simply “piggy-backing” onto the national system at their own chosen rates. The ability to raise their own revenues offers provincial governments a valuable degree of freedom that allows them to implement programmes of their own choice and size. This is an important aspect of provincial autonomy.

3.11 Local government financing issues

Multi-level government systems can have significant functions decentralised to the local government level. Many of the above principles also apply to local government financing, for example the importance of decentralising local decisions and fostering independence of local decision-making, the need for oversight to ensure that local governments’ programme design satisfies national norms, and the relevance of equity and efficiency considerations in the design of grants.

One additional consideration arises in the local government context, and that concerns the relationship of local governments to national and provincial ones. In most countries, the relationship among governments is strictly hierarchical. National governments deal with the provinces, while provinces alone deal with their municipalities. The situation in South Africa is more complex, where there are three spheres of government which are required under the Constitution to govern co-operatively. Nevertheless, the local government sphere operates within the policy and funding parameters set primarily by national government.

Regardless of institutional relationships among the three spheres of government, it is clear that some of the general principles outlined above with respect to grants to the provinces also apply to local government grants. That is, these grants should be designed to achieve fiscal equity (as defined in Section 3.2 above) among municipalities, and should be transparent and predictable.