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EQUITABLE VERTICAL SHARING AND DECENTRALIZING GOVERNMENT FINANCE IN SOUTH AFRICA

Roy Bahl*

South Africa is at a crossroads in its decentralization policy. On the one hand, it has declared its intention to strengthen the fiscal powers of local governments. On the other hand, the institutional arrangements to guarantee fiscal decentralization -- revenue powers and expenditure responsibility -- have not yet been fully defined. Nor has a target been set for the vertical division of resources between the central and lower levels of government. The revenue dimension of fiscal decentralization in South Africa, particularly the question of an equitable vertical share for local governments, is the subject of this paper.

In the next section, we ask how South Africa fits the profile of countries that are “good” candidates for decentralization. We then turn to a description of vertical revenue sharing as it presently exists in South Africa. We also offer a proposal about how an equitable vertical share for South Africa should be determined. A final section summarizes the results. The policy question raised in this paper is straightforward: What percent of all tax and non-tax revenues should be assigned to the central government and what percent should be assigned to the local government? The implementation question is also straightforward: Once the assignment is decided, how do we structure each revenue instrument to guarantee the “desired” assignment of resources?

DECENTRALIZATION CRITERIA

A well-accepted economic theory of decentralization suggests the conditions under which the transfer of fiscal powers from central to local governments will increase national economic

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welfare (Oates, 1973, 1993; Bird, 1993). Though there are good reasons to question the relevance of this theory to the situation in developing and transition countries (Bahl and Linn, 1992), it remains the framework used by most analysts who study this question. There is also a body of empirical research that attempts to identify the determinants of fiscal decentralization, i.e., the characteristics of countries that choose to decentralize.¹ We begin this inquiry by asking how South Africa fits the theory and the empirically tested international norms: i.e., can we say that it is a “good” candidate for fiscal decentralization?

International Norms

South African subnational governments (province and local governments) account for about one-third of total government expenditures. This suggests a level of decentralization about equivalent to that in Norway and Austria, and about twice the average level in developing countries.

Statistical analysis can allow a more precise estimate of the “expected” level of fiscal decentralization in South Africa. Many such analyses have been carried out (see Bahl and Nath, 1986). In the traditional cross-section analyses, the dependent variable is the share of government expenditure made by subnational governments and the independent variables are the social and economic characteristics of countries. The results of these regression analyses might be summarized as showing that countries that have more decentralized fiscal structures tend to have:

- greater land areas and larger populations;
- higher levels of economic development;
- more equal regional distributions of income;

¹ For a discussion of the pitfalls, and possibilities, of comparative analysis, and for some cross-country comparisons, see Bahl and Nath (1986), Shah (1994) and Ahmad, Hewitt, and Ruggiero (1997, p. 38).

- more heterogeneous populations; and
- more stable macroeconomic and political conditions.

This general approach has been followed to test the international “fit” of South African fiscal decentralization. The following statistical test has been carried out. The subnational government expenditure share of total government expenditures (ES) is measured for 73 developing and industrialized countries for which 1993 or 1994 data were available.² Four independent variables were chosen, following *a priori* reasoning and previous research. Per Capita GDP (in \$U.S.) (Yp) measures the economic development effect and should be positively related to the sub-national expenditure share. Population (P) and land area (A) measure the size effect and should also be associated with fiscal decentralization. Finally, more homogeneous populations (more than 95 percent of the population speaking the same language) (H) should be more centralized. The results of this linear regression show

$$ES = 4.3174Yp + 0.0006 + 0.0234P + 0.0024A + 6.1199H \quad \bar{R}^2 = 0.45$$

(4.23) (2.39) (4.01) (1.31)

where t-statistics are shown in parentheses.

These findings are consistent with the null hypotheses: Countries with a higher level of per capita income, a greater population and a larger land area are significantly more decentralized. The homogeneity variable is not statistically significant at the .05 level.

We can use this equation to estimate expected levels of fiscal decentralization. In the case of South Africa, we estimate an “expected” subnational government expenditure share of 15.7 percent, well below its actual level of about 33 percent.³ We can narrow the comparison further, to those countries that are federal states. As may be seen from the comparisons in Table 1, South

² The data set has been specially constructed for this analysis. The principal source is IMF (GFS, 1998). This has been supplemented by OECD (1998), and by data from numerous case studies. Complete source citations are available from the author.

³ However, it should be pointed out that most of the expenditure decentralization observed for South Africa is at the provincial government level.

Africa's decentralization "effort" is greater than that of any other country in the sample.⁴ These findings suggest that South Africa's inclination toward expenditure decentralization is stronger than that of comparable countries in this sample, a finding that is consistent with the strong decentralization emphasis in the new constitution.

A Priori Explanations

For those who are skeptical about empirical, international comparisons, a more subjective approach might be taken. The question at hand is whether South Africa a likely candidate for fiscal decentralization? Does it fits the theoretical profile? That is, are there *a priori* reasons why we might expect South Africa to choose more or less fiscal decentralization? In fact, South Africa does have some economic and population characteristics that fit the pattern for decentralized countries. In other ways, it does not seem a prime candidate for fiscal decentralization. The question we explore here, in theoretical terms, is how far along the decentralization continuum might we expect South Africa to be.

Size. Countries with a larger population and a larger land area might be expected to have a more decentralized fiscal system. Intuitively, the "size factor" as a determinant of decentralization is appealing. Smaller countries incur large overhead costs and duplicative responsibilities if they create a layer of subnational governments with significant expenditure and financing responsibilities. There might be little opportunity for cost savings. While decentralization could also lead to duplicative costs in large countries, it could as well lead to significant cost savings. Centralized countries with a large population and land area often create rigid rules and impose excessive compliance costs on their local governments, as they attempt to control local finances. One need only reflect on China's task of dealing with one billion people, Russia's need to cope with the 11 different time zones in which its citizens live, or the challenge of governing multiple islands in Indonesia to gain a feel for the problems that emerge. The almost inevitable results in such situations are significant diseconomies of scale and increased

⁴ Expenditure decentralization effort is the ratio of actual to predicted subnational government expenditure share.

costs associated with bureaucracy. The anecdotal evidence on this is legend: excessive red tape at the central level requiring numerous steps in getting approval for action at the local level; the tendency for negotiation to replace rules that are too rigid; the requirement of physical visits with Ministry officials to obtain decisions; inordinate procurement delays, etc.⁵ The empirical results reported above are consistent with this casual observation.

Is South Africa a large enough country to benefit from the economies of decentralization, or is it small enough that decentralization will lead to increased overhead costs? Certainly it is a smaller country than some of the world's federations, as is shown by the population comparisons in Table 1. On the other hand, it has a larger land area than some of the large federal countries, e.g., Nigeria. This large land area, coupled with the problems created by a diverse terrain and a communications system that is not fully developed in rural areas, complicates the prospects for efficient central governance. Moreover, local provision and accountability go hand-in-hand, thereby increasing the chances for cost-effective service delivery (Ostrom, Schroeder and Wynne, 1993).

One cannot make the compelling case for South African decentralization on size criteria alone, but certainly South Africa has exceeded a size threshold that would allow it to gain some cost savings by passing more responsibility for governance to the local government sector. Moreover, it can be observed that many smaller countries have long ago decentralized their government financing systems. Finally, one should note that South Africa is governed by 248 municipal governments and 48 district councils, all reporting directly to the central government. Without some significant degree of fiscal decentralization, this would be an impossible public management task.

⁵ Though one hears these same complaints repeatedly, there is little hard evidence that more autonomous local government finance significantly improve matters.

Economic Development. Comparative data show that industrialized countries are, on average, more decentralized than developing countries. The average subnational government expenditure shares are 34 percent and 15 percent, respectively. Has South Africa reached an economic development threshold that would signal its readiness to capture the benefits from decentralization? World Bank estimates of per capita GNP place South Africa in the middle-income range. Average income is roughly comparable to that in Poland and Mexico, and above that in most of the sample of decentralized federal countries shown in Table 1.

Why is a threshold level of economic development a condition conducive to fiscal decentralization? In fact, there are several explanations. One has to do with political development in general, and the existence of mechanisms for local self-governance. The latter is more likely to hold at higher levels of economic development. Certainly, South Africa has moved to a democratically elected system of governance, and there is a system in place for local self-governance, i.e., locally elected councils and locally appointed civil servants. In fact, the new constitution in 1996 mandated a unified civil service system. At the time of election of the first democratic government, there were eleven different systems of government administration operating in South Africa (Public Service Commission, 1996).

Another explanation is that economic development usually goes hand-in-hand with a capacity for local governments to manage their affairs effectively. As a country grows and urbanizes, its municipalities develop both a formal employment sector that can be reached by a modern tax system and a private sector (industrial and residential) that demands upgraded public services. With this comes an enhanced capacity for local governments to manage themselves — better educated and more experienced local officials, better management practices and more automation, and a more discerning resident population that demands accountability.

There is mixed evidence on the question of how widespread the development of South African local governments has been. The larger cities are quite effective and modern, and their local governments can absorb significant expenditure and revenue-raising responsibility. However, before the work of the boundary commission, about one-fifth of the then-existing 843

municipalities did not even have formal budgets, and are not able to absorb significant fiscal responsibility. The issue of “two South Africas” arises again and again. One is urbanized, modern and as ready for decentralization as is any industrialized country. The other is more like a developing country with less capacity to absorb significant new government finance responsibilities.

Heterogeneity and Equality. Countries with heterogeneous populations are good candidates for decentralization: they are characterized by diverse preferences for public services, and diverse views about the proper level of taxation and user charges. Uniform service standards imposed by a central government often do not match-up well with the preferences of different religious or ethnic groups, urban versus rural residents, etc. So, for example, India is very decentralized in part to take account of quite diverse differences in preferences, while Thailand is much more centralized in part because of its more homogeneous population mix. South Africa has a significant diversity in its population. One part of the country is industrialized and quite developed, while the other is more like a developing nation. The non-white and white populations have quite different cultural backgrounds, language differences exist, and there are wide urban-rural differences in the degree to which infrastructure is developed. Even within the majority black population, there are very significant differences, e.g., different languages, tribal customs, etc. This suggests that preferences for public services vary significantly within the country, and hence there is a good case for fiscal decentralization.

Regional differences in income level are also a factor to consider in choosing the degree of fiscal decentralization. In theory, there is more ability to equalize inter-regional income differences through a tax and transfer system in a centralized than in a decentralized setting. Central governments can identify donor regions and recipient regions and redistribute centrally collected tax revenues. If one had more income equality across regions, fiscal decentralization would be an easier matter. Local governments could be given more control over their tax bases, with little fear of an unfair advantage to higher income places. But, in a fiscally decentralized system where local governments have assigned taxing powers, the higher income regions can

increase their advantage. The greater the inter-regional income disparity, the greater is this danger and the stronger the resistance to decentralization. Equalization grants are a palliative, but usually a much-less-than-perfect one.

In South Africa, the average per capita income in the highest income province is about six times that in the lowest. This is about the same range as in Chinese provinces and three times that among U.S. states. Disparities within South Africa may be measured other ways to show an even greater range. There are great differences in per capita GDP between the metropolitan and rural areas in South Africa (about 10 times). Moreover, the per capita GDP difference between the black and white populations is a factor of ten, and the infant mortality rate is five times greater for black than white South Africans (Lachman and Bercuson, 1992).

Political Stability. It is not uncommon for newly unified countries to be subject to some political instability or at least to suspicions of political instability. The nature of this potential instability varies from country to country but often includes considerations such as the following:

- C Will the political leadership succeed itself without military intervention?
- C Will friction between the majority and minority factions lead to civil strife?
- C Will the new government overspend to meet expectations thereby compromising economic stability, or will it disappoint expectations and possibly lose control over its constituency?
- C Will the new government have both the technical competence to operate government and the political skill to hold things together?

As a newly unified country, South Africa is not free of such suspicions. This is not to say that signs of political maturity are not present. Certainly, there is not the politically involved military that often supports governmental centralization in an unyielding way. Thus far, differences have been settled with votes. Some public opinion surveys suggest that South Africans are patient in waiting for the long expected increases in the quality of life, and that this patience is due largely to a loyalty to the ANC. This has been interpreted to mean that economic

growth, rather than immediate increases in service levels, is an accepted goal (Nattrass and Seekings, 1998). Moreover, the new constitution, which was formed by a political process, is strong in mandating a decentralized structure of governance.

There are, however, some danger points. Patience has its limits and expectations are high for improved services and a better quality of life, especially for those who have been deprived. When coupled with the reality of limited resources, these high expectations are a recipe for political unrest. And though South Africa's transition thus far has been a peaceful one, there remain the concerns about political stability. A significant economic downturn and revenue loss could lead to too much unmet demand for public services. All other things being equal, such concerns lead to a nudge in the direction of moving more slowly in developing a decentralization policy.⁶

Economic Stability and Macroeconomic Policy.⁷ Economic instability can be an enemy of fiscal decentralization, especially in low-income countries (Bahl and Linn, Chapters 12 and 13, 1992). There are two issues here. First, control over the fiscal deficit is a major instrument of stabilization policy and central governments are loath to give up control over this economic instrument. The Ministry of Finance would not like a program that compromised their efforts at revenue raising or a program that mandated their expenditures. But, fiscal decentralization requires that subnational governments be given some control over spending and taxing, and may well compromise the central government's ability to control the fiscal deficit. Decentralization often includes provisions for local government taxing power, and the resulting tax competition may harm central government revenue mobilization efforts. Likewise, if intergovernmental transfers to local governments are legislated as some fixed share of central taxes, then the central government's flexibility to address its deficit position by reducing aggregate spending will be circumscribed. Finally, if local governments have responsibility for important expenditure

⁶ The same caution is raised with respect to the evolution of fiscal decentralization in South America in Inter-American Development Bank (1994).

⁷ For more discussion of this issue, see Tanzi (1996), Prud'homme (1995), and Spahn (1998).

functions but do not face a hard budget constraint, they will overspend and increase the size of the consolidated budget. Local government's borrowing powers present yet another challenge to the fiscal deficit.

A second issue is more generally related to capital expenditures. Both central and local governments want to control the direction of investment in public infrastructure and the level of public services provided. Central governments see the need to develop the national infrastructure and to concentrate on investments characterized by significant external benefits. To give up spending choices for infrastructure to local governments -- as a decentralized system might require -- is to invite a move away from spending for projects that have regional or national benefits and toward those that have local benefits. Some centralists would even question giving current expenditure responsibility to subnational governments, unless these are accompanied by mandates and conditions that would force the local government to adhere to central standards. Local governments, left to their own devices, will emphasize projects whose benefits "stay at home." A decentralized system would leave current expenditures for services not characterized by significant externalities to the local governments.

The debate is interesting. Centralists will say that significant fiscal empowerment of local governments will compromise economic growth. Decentralists argue that "development from below" is a better route.

South Africa must face up to both of these economic policy issues. Fiscal balance is fragile. Tax rates are already high and pressures to increase spending are great. The government is trying to walk a fine line between providing minimum levels of service, avoiding the budgetary pressures of fiscal deficits, and maintaining a favorable private sector investment climate. The macroeconomic strategy calls for holding total taxes to a ceiling of 25 percent of GDP, a limit that has already been met.

In this environment, significant, new local taxes and fixed claims on central taxes will be a tough sell. In fact, for purposes of macroeconomic policy, municipalities are required to ensure that their budgets fall within guidelines set by the Minister of Finance. In 1999/2000, the

Minister has set a limit of 5.5 percent for expenditure growth for all municipalities.⁸ This limit is approximately equal to the expected increase in the consumer price index (Department of Finance, 1999). Such expenditure control measures are a major dampening influence on fiscal decentralization. Why would a local government push for new taxing powers if it could not enjoy the increased revenues generated? Infrastructure development is also an issue, both because the backlog is so great and because many local governments can neither lead infrastructure development nor maintain a built infrastructure.

TAX ASSIGNMENT⁹

The big stumbling block for a “true” fiscal decentralization -- in virtually all countries -- is deciding on revenue sources that can be assigned to subnational government. In choosing the “right” revenue sources, one might be guided by three principles (McLure, 1998). First is the adequacy of the revenue sources assigned, i.e., how much revenue-raising authority should be given to local government and how should this amount be divided among local taxing power, local power to set user charges, and intergovernmental transfers? The second is that local governments should not have access to taxes where there is potential to export a significant part of the burden to persons who live outside the expenditure benefit zone. For example, if municipality A can export its sales tax burden to consumers who live in municipality B, then A will be encouraged to overspend and B will pay taxes that are more than commensurate with the services they receive. Third, local governments should only levy taxes that they can effectively administer.¹⁰ While these guidelines are very useful, they are also very general. As we discuss below, few taxes can meet all of the tests.

⁸ In fact, this limit is well below the 10 percent imposed in 1996/1997, and 8 percent in 1997/1998. (IMF, 1997).

⁹ This section draws heavily from Bahl (forthcoming).

¹⁰ It should be noted that if a tax is shared between the center and the local governments, it can be centrally collected. So long as the local government has rate setting powers with respect to a tax, it can be considered a local government tax. For example, many U.S. local governments piggyback their sales tax onto the base of their state government sales tax and compensate the state for collection expenses.

South Africa is ahead of most developing and transition countries in terms of the assignment of productive revenue bases to local governments. Local governments presently have access to the property value, payroll and business turnover tax bases. There has been discussion of further enhancing this list, perhaps by including motor fuel and rural land taxation. There are advantages to each of these revenue choices. However, in each case there are some important caveats and cautions to be raised. We now turn to an assessment of the pros and cons of each of these fiscal choices.

The Property Tax

The most common local government revenue source, in most of the world, is the property tax. It generally meets the tests of a good local tax, and central governments admit to being ill-equipped to levy such a tax. South African local governments do rely heavily on the property tax. It is the second largest local revenue source (behind the gross revenues of municipal electricity undertakings) and accounts for about 20 percent of total local government revenue (Department of Finance, 1999). Certainly the property tax is not a highly income elastic source of revenue, however, the annual growth in property tax revenues has averaged over 10 percent in the last decade (Bell and Bowman, 1997). The local governments are given considerable choice in property tax policy. They may tax only the land, or they may tax the combined land and improvements. They have freedom to select the tax rate (within a centrally prescribed maximum) and in some cases have chosen a differential rate on land and improvements. Assessment and collections are a local government responsibility.¹¹

In many ways, the features of South African property taxation are very consistent with fiscal decentralization. Yet property taxation in South Africa has for some time been under serious review, and some of the reform measures suggested could lead away from fiscal

¹¹ The South African property tax and its administration are well described in Bell and Bowman (1997), and Franzsen (1998).

decentralization. The following discussion covers the major issues under debate, and their implications for fiscal decentralization.

Uniformity of the Tax Base. A first policy question is whether the tax base should be uniform in all of South Africa, and defined by a central government act. Many of those who favor uniformity offer the following rationale for their position:

- The property tax would be imposed on all South Africans in the same way. This seems more fair than the present system.
- Under a uniform approach, the central government would be able to develop a measure of fiscal capacity (the value of property) that might be used for equalization purposes, to impose limitations on local government borrowing and taxing, and to allocate intergovernmental transfers.
- The valuation profession could more easily support an effective property tax if there was only one property tax system in South Africa.

There is another view: that local choice as opposed to uniformity is more consistent with a decentralized system of government. Local governments ought to be able to make their own tax choices, based on local preferences, as they do now. Moreover, continuing with the present system of local choice would impose less overall disruption on the fiscal system at a time when there is a premium on stability.

It is worth noting that South African sub-national governments have made very different choices about how they will tax property. For example, Johannesburg taxes only land, local governments in KwaZulu-Natal tax land and improvements but at different rates, and Capetown has historically taxed land and improvements at a uniform rate. The fact that different choices have been made suggests that a switch to uniformity could result in some efficiency losses.¹²

What Base to Tax? There is a longstanding debate among students of the property tax as to whether the tax base should include improvements (Bahl, 1998). The fact that the debate continues, and that there is no uniform worldwide practice, tells us that the choice is not an easy

¹² See Franzsen (1998) for a discussion of the South African system in an international context.

one. South African property tax policy also is under review and there are proposals for a uniform base that would include both land and improvements.

The advantages of taxing a base that includes the capital value of land plus improvements are that it allows a lower nominal rate, it may be more politically palatable, and it is more transparent (easily understood). If there are good data on the value of property transfers, there is an objective basis for determining the market value of each parcel. Moreover, there is a perception -- probably wrongly held -- that a tax on structures will fall disproportionately on businesses, landlords, and wealthy residential homeowners. This perception could resonate well with the large population of South African poor.

Advocates of the land value approach argue that it can be administratively less costly because the assessment of individual buildings can be avoided.¹³ Moreover, a land tax has the potential to promote better land development patterns and is more progressive in its distribution of tax burdens. Where one comes down on this issue depends on how one weights these advantages.

The Role of Exemptions and Preferential Treatment. The basic issues as regard property tax exemptions in South Africa are whether these should be given by national law or by local law, and whether specific, preferential exemptions should be allowed. The resolution of these issues has important implications for the decentralization policy of the South African government.

On the first question, decentralists would take the position that central governments should not mandate local property tax exemptions. The national government is not at risk in terms of revenue cost, and so would have little incentive to minimize exemptions. If nationally-imposed exemptions are allowed, they should be compensated by a revenue-equivalent grant to the effected local government. Centralists argue against local choice on grounds that local politicians are more susceptible to pressure by powerful local interests who want preferential

¹³ However, as van Ryneveld (1999) points out in the case of Capetown, the law requires that improvements be valued even if they are not to be taxed.

treatment. There is also the danger that they will engage in competitive subsidies as they try to outbid other local governments for new industry. Centralists argue that local governments have discretion over the tax rate and that is enough. Countries around the world are as split on this issue as are South Africans, but it seems clear that local choice fits better with a fiscal decentralization policy strategy.

Arguably a more important question is whether or not to allow preferential treatment of selected types of properties, irrespective of what level of government provides the exemption. At present, South African law allows the property tax on businesses as a deduction from company income tax liability. There are good analytic arguments and certainly political sentiment to continue this practice in South Africa. With the transitional state of business in South Africa, one should not discourage investment with higher taxes; it would be politically unpopular to withdraw such a preferential treatment; and if the property tax is viewed as a user charge that companies pay for local services, then it is a legitimate cost of doing business and might be justified as a deductible cost. On the other hand, there are some good reasons to discontinue this practice. Only firms who make a profit can benefit from the deduction, while smaller and start up companies do not receive the preferential treatment. A second concern is the revenue cost incurred by the central government.

There also is an important implication for decentralization. Targeted relief can effect some local governments more than others, and it is, in effect, an implicit intergovernmental transfer. The property tax deduction allows the local government to collect the full amount of the tax due, but part of the tax bill is shifted to the central government via the deductibility. In effect, this is a form of intergovernmental transfer that is distributed among local governments according to the location of profitable businesses. One might question whether this is the formula grant distribution that the government really wants.

Another form of preferential treatment is a property tax rebate for owner-occupiers. Most tax policy analysts would think of this as a bad idea, though it is widely practiced around the world. The problems are that this preference imposes a revenue cost and, as above, it also is an implicit intergovernmental transfer. It does not serve an equity purpose in that it is not means-tested and often does not apply to renters. Advocates in South Africa argue that this preference is in place to encourage home ownership and to “even things out” for the business tax rebate. The government of South Africa does not report the tax expenditure associated with this tax rebate, or the tax expenditure associated with the business income tax deduction.

Rate Setting. Decentralists will argue that the property tax is a local government revenue, therefore the determination of the rate should be a local government responsibility. If one wants accountability of elected local officials to local voters, then rate setting should be a local power, with few limitations. In effect, the voters would impose the limits in a political market. In spite of this logic, most countries do not give local governments unlimited rate setting powers. In fact, there usually are national limits on the rates that local governments may choose. Such national limits slow the use of property taxes to finance public services, but also give the central government some control over the overall level of tax burden.

Franzsen (1998) points out that South Africa differs from the typical case in less developed countries where effective property tax rates are quite low. Rates in the range of 5 to 10 percent of the capital value of land are not uncommon. Local governments have set high rates, but also have been able to provide generous rebates (as discussed above) to deflect some of the taxpayer resistance. The South African property tax is as decentralized as any in the world.

The RSC Levy¹⁴

The regional service council levy (RSC) in South Africa is a local government tax on payrolls and turnover. It gives local governments in South Africa access to a revenue productive and elastic tax base that, in theory, could nicely complement the property tax. Most countries around the world do not give sub-national governments access to such a broad-based tax. In practice, however, the RSC is badly structured and requires a major reform before it can serve properly as a major source of local government revenue. Depending on how one looks at the RSC levy, they can see it in several ways.

It is a local tax. Many South African local government officials think of the RSC as a local revenue source over which they have some discretion. They cannot set the rate (DOF has capped it) nor can they determine the base, but they can use moral suasion to affect the rate of revenue collections. To the extent the local governments are successful in affecting the rate of tax collection, they play a role in determining the average effective tax rate.

It is a grant. Another scenario is that the RSC levy is no more than a transfer from the central to the local governments. The central government determines the rate and the base, and locals really have little control over collections. The result is that the central government determines the amount of revenue, and the distribution of this revenue among local governments depends on the amount of revenue collected in each district. This is simply a derivation-based grant.¹⁵

It is a donation. There is yet another view. The central government prescribes a “formula” (tax rate and tax base) for the amount of tax due on payroll and turnover. But since the local government has no recourse against those who do not pay this amount, this amount becomes a suggested maximum payment. The RSC levy becomes either a donation by business or a tax on honesty.

¹⁴ This section draws heavily from Bahl and Solomon (forthcoming).

¹⁵ See Bahl and Linn, (1992), Chapter 13, for a discussion of derivation-based grants.

All of the above is true because there is much variation across the country. That is, in some places there is aggressive pressure to comply and aggressive local collection efforts. This makes the RSC more like a local tax in those places. In other places it is viewed simply as a transfer from the center, and little local effort is exerted. In other places, RSC levy revenue is determined by the amount business is willing to pay on a voluntary basis.

The first step that the government must take is to decide if the RSC levy will be a tax or a grant, and to structure it accordingly. However, a number of key policy issues must be resolved before the RSC levy can be properly selected as a major source of local government revenue for South Africa.¹⁶

First, there is the question of potential interregional disparities in revenue yield. The RSC levy is by nature counter-equalizing since it is based on total payrolls and total turnover, i.e., with any given tax rate and tax base, the per capita revenue potential is much greater in rich than in poor areas. The RSC levy accentuates the significant disparities in fiscal capacity across districts. Per capita collections range from over 1000 rand to less than 10 rand. The richer provinces do much better than the poor. On average, a ten percent higher level of *per capita* GGP (gross product) is associated with an 8.9 percent higher level of per capita collections. (Bahl and Solomon, 2000). This means that the normal revenue yield from the RSC levy will significantly offset any equalizing grant program that the government puts in place. The government must decide about the extent to which it can accommodate a tax that is “disparity-increasing.”

Second, the question of the capacity of local governments to collect a payroll and turnover tax calls for a thorough examination. There seem to be three competing ideas about how to approach this problem. One is to dismiss it as not really a problem, and to argue that local collectors and (possibly) local assessors can administer the tax. In order to evaluate this option, a survey of the capacity of the local government staff and EDP infrastructure is required. Another

¹⁶ An overriding issue to be resolved is the legality of the RSC levy. The Constitution prohibits local governments from levying either an income or a general sales tax. The RSC levy would appear to be both.

approach involves the use of contractors, kind of a “tax farming” approach. Here there is anecdotal evidence about the misuse of powers. The other idea is that the central government tax administration could assume this responsibility, and relieve the local governments of any assessment and collection responsibility.

Third, there is an employment bias question associated with the RSC levy. Since part of this tax is based on payrolls, the tax raises the relative cost of (formal sector) labor and penalizes labor-intensive activities. This is an important issue because of the high rate of underemployment in South Africa, and the preponderance of unskilled labor.

Fourth, there is a cascading question as regards the turnover tax component of RSC. Because such gross receipts taxes are levied at every level of sale, they involve “tax-on-tax” and distort final consumer prices. This is one major reason why central governments the world over have moved to value added taxes.

Finally, there is a question of the potential for exporting the burden of the tax and the unfairness this creates. Much of the RSC is collected in the six big metros in South Africa. But since these companies can shift at least part of the turnover tax forward in higher prices, the tax is really paid elsewhere in the country. Businesses pay their turnover taxes at their headquarters location. Those metro and district councils with large concentrations of headquarters firms can export their taxes to other places. Bahl and Solomon (2000) estimate that the six metros collect 57 percent of all turnover tax revenues but that their residents are only burdened with 48 percent of this tax. Residents in non-metro districts pay about 9 percent of the revenues that accrue to metro local governments. So, to some extent, the whole country is paying part of the tax bill for Johannesburg or Capetown services. If this is true, it is probably not a policy outcome that is desired by the government.

While the RSC levy has the strong appeal of good revenue potential, it is badly flawed as a local government revenue instrument. Fortunately, there are good reform options. The government could keep the current structure in place, but empower the local government to audit, collect, etc. This would be a solution consistent with fiscal decentralization, but it could

impose some heavy administrative costs on the local governments. Second, the RSC could be converted to a piggyback tax on a central government tax base, either value added or income. If local governments were to have some discretion in setting the piggyback (payroll) tax rate, this would also be a solution consistent with a fiscal decentralization strategy. Third, the RSC levy could be converted to a grant under which the center sets the tax rate and base, collects the tax, and distributes proceeds among local governments according to some objective formula. This solution is in the spirit of the present system, but two structural issues call for resolution. One is that a derivation basis for revenue sharing may not be a wise distribution choice because of the “exportability” of the RSC levy. The other is that the central government will have little incentive to collect a tax whose proceeds will be distributed to local governments.

A Fuel Levy

An interesting proposal for revenue mobilization in South Africa is the adoption of a fuel levy for local governments. There is much to recommend this. It is a potentially productive revenue source, and it has considerable revenue growth potential. But again, there are choices about how to structure this revenue source for local governments. The key question to be answered is whether the fuel levy should take the form of a local tax or an intergovernmental transfer.

The Fuel Levy as an Intergovernmental Transfer. In this case, the central government would declare that a certain portion of fuel levy revenues would be dedicated to local governments. Local government would have no say in the determination of the tax rate or the tax base. Under this scenario, the first issue to be faced is how might the total pool of revenues available be distributed among local governments, i.e., what method of horizontal sharing will be chosen? There are many choices here:

- One could take a “needs” view related to maintenance of the existing roadway and allocate the funds among local governments in proportion to miles of roads, or miles

of roads in a certain condition. The funds could be earmarked for road maintenance expenditure.

- One could fold the motor fuel levy revenues into the existing system of intergovernmental transfers, and allocate the distributable pool among local governments in the same way that the equitable shares grant is allocated.
- One could try a rough approximation of “where the revenues were generated” and allocate across local governments according to estimated motor fuel consumption.
- Another approach is a simple distribution based on readily available demographic information, i.e., land area and population.

These are only a few illustrations but suggest the range of choices that the government can consider. Each has different implications for revenue adequacy, equalization, and for maintaining a database to make the distributions on an annual basis. Before one could move to the fuel levy as an intergovernmental transfer, these possibilities would have to be evaluated. Among the evaluation criteria would be (a) whether the revenue flow would be adequate, (b) whether the local governments could count on a stable flow of revenue under such a system, and (c) whether the local governments are up to the administration and record-keeping tasks required if the grant is made conditional.

The Fuel Levy as a Local Tax. The second choice is to propose the (retail) fuel levy as a local tax. That is, let the local governments set the (piggyback) tax rate but designate the central government to make the collections on a uniform base.

The local government tax solution has some appeal, especially if an “additional” fuel levy were restricted to metropolitan areas. It could be revenue productive and increase the financial self-sufficiency of local governments. It could lead to a higher price for motor fuels in metropolitan areas, which could be thought of as exacting a higher price for urban service provision, congestion and pollution. It could also provide a rationale for shifting some expenditure responsibility for roadways to the local governments.

There are important drawbacks to local government fuel taxes. For one, gasoline prices could vary according to the tax rate chosen by the local government, a practice that the central government might not favor. The price of energy is a key variable that governments want to

control for reasons related to conservation and controlling for external effects, and the motor fuel tax base is one of the revenue sources that many central governments have claimed as exclusively theirs. Another issue is that this may be a suitable levy only for the metropolitan local governments.

Land Tax

The South African government is considering land tax as a possibility for rural local government financing. However, there are some difficult problems associated with defining a structure for this revenue source. The following are a series of questions that other countries have faced, and that South Africa will surely face, in evaluating and implementing this revenue option.

- *Will the rural land tax be part of the general property tax code, or will it be enacted under separate legislation?* This is very important because of possible conflicts in the law. Rural and urban property taxes may have very different provisions for rate setting, administration, appeals, etc.
- *Will the land tax base exclude all improvements?* The imposition of a land tax for rural areas is primarily to reach agricultural properties, other than those related to subsistence farming. A difficult question is whether improvements to the land will be considered in valuing individual properties.
- *Will valuation be based on current use or highest and best use?* Will an agricultural property be valued according to what it *could* produce in its best crop use, or as commercial property if that is its highest and best use? Or will only current use be considered? And in either case, how will this be done? Will sales assessment ratio studies be carried out, and will these values be used in fiscal capacity measurement?
- *Will the law allow for notional valuation?* This is an alternative to valuation of individual parcels of land and allows the assessor to place a general value, per hectare, on all land in a certain area. This would seem essential for a property tax in rural areas, given weak assessment capabilities, and incomplete records. However, it does raise questions of horizontal equity since some parcels will clearly be overvalued and some will be undervalued.
- *What exemptions will be provided?* The major issues here are tribal land, land with a value below a certain level, and very small plots. Issues that arise with respect to the former, are (a) if the central government dictates exemption for tribal land, will it

compensate the local government for the revenue lost? And (b) if tribal land is exempt, can it receive benefits from the expenditure of land tax revenues?

- *Will tax rates be set locally or nationally?* Will there be limits on these rates if local choice is allowed? Who will determine exemptions? These questions go to the very heart of the fiscal decentralization issue. Will rural local governments be given significant discretion in determining the amount of revenue they raise?
- *Will other forms of rural property-based tax be retained?* If the government imposes a land tax, annually, on owners (or occupiers), will it also continue to assess a transfer tax on the sale of that property?
- *What transition period will be allowed?* Some transition period must be allowed if a land tax is to be implemented. Some land is not yet surveyed, and a complete administrative system must be designed and put in place. With respect to the latter, a question is whether the administrative system will be uniform and designed by the center or whether each local government will be allowed to adopt their own system? The greatest potential roadblock to a successful rural land tax is poor advanced planning and a transition period that is not sufficiently long.
- *What is the revenue potential of the land tax?* Hard estimates of revenue yield must be made for each local government unit that is eligible to levy this tax. A related and important question is whether the land tax will be an allowable deduction against income tax liability?

Many of these questions were addressed in a thorough analysis by the Katz commission. Though many issues were raised about implementation, the commission found merit in the proposal of a rural land tax. They saw it as a local government levy, controlled by either district councils or primary municipalities, and cautioned about the need for adequate time to prepare for implementation (Republic of South Africa, 1998).

Tax Assignment and Vertical Sharing

In a system where significant taxing powers are assigned to local governments, the vertical sharing will in part be determined by the decisions those government make. Will they tax themselves to provide better services? The answer in South Africa seems to be that they will. In the case of the property tax, where rate and base can be set at the local level, the revenue take as

a percent of GDP is about 3 percent. This is one of the world's highest levels of property tax effort (Bahl, forthcoming).

The RSC levy cannot now be treated as a local tax, i.e., the district councils cannot increase the vertical share of local governments by increasing the tax rate. At present, it accounts for less than one percent of national tax revenues.

INTERGOVERNMENTAL TRANSFERS

Urban local governments in South Africa do not rely heavily on intergovernmental transfers. The primary sources of revenue are local tax levies, user charges, and trading surpluses from the electricity undertaking. The share of current revenues from grants averages less than 10 percent for all local governments, though it is higher for rural than urban governments.¹⁷

Prior to 1998, intergovernmental grants to local governments had taken the form of cost-reimbursement and conditional grants. These included direct payments for health services, certain social services, and road maintenance. There were also earmarked subsidies and general purpose assistance that was distributed through the provinces. In addition, the RSC levy and property tax deductibility against the company income tax might be thought of as implicit intergovernmental transfers.

By 1998, a policy had been adopted to shift toward an unconditional grant program (referred to as the "equitable shares"). This program will become the major form of transfer to local governments. It is being phased in over a period of years, during which the amounts allocated to the existing discretionary grant programs will be frozen. Eventually, the equitable shares allocation will have a "basic services" component, an equalization component, a municipal services transfer to those local units unable to raise revenue from own sources, and a matching grant to stimulate spending on services characterized by significant spillovers. At

¹⁷ This may understate the reliance on intergovernmental transfers, because it treats the RSC levy as a local tax. If the RSC levy is treated as a transfer, which is a reasonable assumption, the reliance on grants is higher.

present, only the basic services and assistance to smaller local governments components are operating.

One might evaluate the South African grant system in terms of its contribution to fiscal decentralization by considering its two dimensions: *vertical sharing* and *horizontal sharing*. The former refers to the method of determining the total size of the distributable pool, while the latter refers to the method of distributing this pool across local governments.¹⁸

One could classify the system of vertical sharing that exists at present as mostly an *ad hoc* system, in that the vertical share a decision of the government and not determined by a formula. This characterization applies to all of the conditional grants. This method of vertical sharing gives the central government maximum flexibility to pursue fiscal policy. The center can simply slow down the rate of transfers to local governments when fiscal conditions are tight. The more unstable the national economy is the greater the advantages of this approach to vertical sharing. There also are important disadvantages to an *ad hoc* system. It is not as conducive to efficient local government budgeting, as would be, for example, a guaranteed share of a central government tax. Moreover, the *ad hoc* approach allows the government to put off discussion of the underlying issue of the adequacy of the match between local government revenues and expenditure responsibility.

Vertical sharing under the equitable shares grant is more complicated to identify because it is partly based on a “bottom-up” approach. A minimum level of per capita transfer is specified as part of the sharing formula. In 1998, the DBSA carried out detailed cost studies and established an annual amount of per capita transfer of 230 rand for basic services. This element of the basic services grant program partially determines the total amount distributed under this program. Still it can be increased/reduced by the central government, thereby

¹⁸ This method of evaluating intergovernmental transfers is fully developed in Bahl and Linn (1992), and has been applied in evaluating the grant system in several countries (e.g., see Bahl, 1999).

increasing/reducing the vertical share of local governments. In formal terms, “S transfers” are calculated as follows:¹⁹

$$S_i = \alpha L H_i$$

where

- S_i is the services transfer to local authority i
- L is the annual per capita services transfer, set by the central government
- H_i is the population living in households with incomes less than R800 per month in 1998
- α is a coverage parameter with $0 \leq \alpha \leq 1$

The vertical shares of the implicit transfers also are more or less *ad hoc*. If the RSC levy is seen as an intergovernmental transfer, then the vertical share is determined as the product of the centrally determined rate and base, and the compliance rate. But the compliance rate is indirectly determined by the central government in its prohibition of local auditing and in terms of the degree of cooperation and data sharing offered by the income tax and VAT collectors. Property tax deductibility might also be seen as a transfer (see above) whose vertical share is determined by central rules.

FISCAL DECENTRALIZATION AND VERTICAL SHARES

What is the proper division of revenues between the central and local governments in South Africa? This is arguably the single most divisive issue in forming an intergovernmental fiscal policy in any country. It is not surprising; therefore, that it is a contentious issue in South Africa. Both the central and the local governments want a greater share, and both have valid reasons for arguing the need for a greater share. The tendency in many countries is to sweep the issue aside, on grounds that it is too politically charged, and then make the vertical sharing decision yearly and on an *ad hoc* basis.

¹⁹ As reported in *Department of Finance*, April, 1998.

This appears to be the case in South Africa. At present the government uses a variety of methods to determine vertical shares. With respect to municipalities, for example, it uses agency payments, a formula grant pool, tax deductibility, tax sharing, and cost reimbursement-conditional grants. These are essentially “bottom up” approaches. The government adds up the amounts given to all local governments, and this becomes the vertical share. Most of these vertical allocation decisions have a one-year life, but others carry a multi-year commitment. A centralist might not see this as so bad an arrangement. South Africa has a fragile economic stability, resources are scarce, basic infrastructure is short, and this arrangement gives maximum flexibility for the central government to use fiscal policy. A decentralist may see it otherwise. While an intergovernmental fiscal system for South Africa must have flexibility to accommodate a changing economy, it must also have a vertical sharing arrangement that is transparent. Otherwise it will not be possible to put elected local officials in a position of being accountable to their voters, nor will it be possible to impose a hard budget constraint on local governments.

While there is surely disagreement about whether fiscal power should tilt toward the center or toward the local governments, there is no disagreement about the basic goal: to find an “equitable” division of revenues. Surely the first step toward this goal is to agree that “equitable” means something like the following:

An equitable share of central government revenue for each level of government means that there must be a parity between the expenditure responsibility that has been assigned to that level of government and the revenues available to that level of government. The fiscal balance realized by each tier of government will depend on the government priorities as to minimum service levels, the overall government budget constraint, and the revenue raising capacity of local governments. Out of these considerations, an “equitable vertical share” can be defined for each level of government.

Unfortunately, the job of conceptually defining fiscal balance is easier than the determination of exact vertical shares. The latter will always be characterized a significant degree of subjectivity. However, in forming a workable implementation program for vertical

sharing, as South Africa must now do, three elements must be present: a clear definition of expenditure assignment, a plan for local government revenue mobilization, and a central ability to monitor and adjust the intergovernmental fiscal system.

The constitution in South Africa makes provision for an “equitable” share, but allows this to be calculated based on cabinet judgments and a consultative process. In 1999/2000, the local government equitable share of centrally-raised revenue is 1.4 percent, exactly the same percent as in the past two fiscal years (Department of Finance, 1999, p. 259).

Expenditure Assignment

The first step in any inquiry about vertical revenue sharing is a thorough review of the legal assignment of expenditures among levels of government.²⁰ This review has the purpose of identifying any murkiness in the assigned division of responsibility, and clearing up any ambiguities. This must be supported by an empirical analysis of present spending patterns. A clear understanding of the actual division of expenditures, by function, will provide the baseline numbers necessary for the government’s assessment of the present vertical balance in the system. How much is being spent by subnational governments, for what functions, and what share of this is financed from local resources? The next step is to subjectively define the level of resources necessary to provide a “minimum level of services” at the local level. This amount, less locally raised revenues at some standard level of effort, defines the level of transfers from the center required to secure a vertically balanced system. To be sure, there is subjective judgment involved, because the cost of a hypothetical minimum level of service must be determined. However, there is an element of transparency and good sense involved when one begins by establishing minimum expenditure needs.

The important lesson here is that the analysis should begin with the expenditure assignment question, and should end with the alternative methods for revenue sharing. To begin

²⁰ For a good and thoughtful discussion of expenditure assignment as a component of fiscal decentralization, see Martinez-Vazquez (1994).

on the revenue side of the budget equation is to doom oneself to never getting resolution to the issue of “equitable vertical shares.” To date in South Africa, most of the work on intergovernmental fiscal relations has dealt with the revenue side. South Africa has not yet done the complete inventory of expenditure assignment, it does not have a complete expenditure data base, and it has not established minimum spending levels for local government services. However, it has established a minimum standards approach in its formula definition of the equitable shares grant for basic services, which is a step in this direction. The Financial and Fiscal Commission (1997) clearly recognizes the problem of starting with the expenditure side, but points out that data shortcomings are too severe to do a proper job with costing minimum service levels.

Local Revenue Mobilization

The question of the relationship between equitable vertical shares and local government revenue mobilization is an essential part of intergovernmental fiscal policy. One could list a number of features of the relationship between vertical shares and local taxes and charges that need to be sorted out.

- C The balance between expenditure needs and revenues assigned should take account of local fiscal capacity *but should be unrelated to local fiscal effort*. Otherwise, local governments may have a disincentive to mobilize resources.
- C The difference between minimum expenditures and local capacity to raise taxes is equivalent to the level of intergovernmental transfers needed to fill the financing gap.
- C Local government revenue mobilization is an essential ingredient for making local officials accountable to their constituents. To make a system of fiscal decentralization “work”, the local governments must have some power to choose tax rates.

South Africa is further along on its program of local government revenue mobilization than are many countries that are classified as either “middle income” or “developing”. There is one major source of local government revenue (the property tax) where rate setting is at local

discretion. Local governments also have freedom to set levels of user charges without central government approval, and have some borrowing powers. However, some major questions remain to be answered. Will the RSC levy be converted to a local tax or a grant program? Will new property tax legislation lead to more or less fiscal discretion on the part of local governments? And finally, what is the level of revenue mobilization to which local governments must aspire?

Central Government Leadership

Paradoxically, an important prerequisite for successful fiscal decentralization is a strong central ability to lead the process. The central government took the important first step in leading the development of a policy statement on local government finance (Ministry for Provincial Affairs, 1997). With respect to implementation, however, there are many areas fiscal administration and policy where the central government must set standards, develop regulations and even monitor the performance of local governments. Among the more important of these are the following:

- Designing and enforcing the use of a uniform accounting system for local governments,
- Insuring an appropriate audit process,
- Developing and enforcing a regulatory framework for borrowing,
- Developing indexes of fiscal capacity and expenditure needs and using these indicators in allocating intergovernmental transfers according to the stated objectives of the government,
- Monitoring any limits placed on local government fiscal behavior, e.g., debt limits, tax limits, budget deficits,
- Maintaining a fiscal information system that will enable a regular evaluation of the performance of local governments, and perhaps to create a system for early warnings of fiscal distress.

In South Africa, there is progress in each of these areas. The equitable shares grant system is functioning and does rely on an index of fiscal needs, a policy statement on the

regulatory framework for local government borrowing has been accepted by government, and there is the beginnings of a fiscal information system for local governments in the Department of Finance. Particularly in the latter two areas, much remains to be done.

A problem in South Africa is that there is not enough clarity about where responsibility for monitoring and supporting local government finance will lie. The Department of Constitutional Development and Local Government, the Department of Finance, and the Financial and Fiscal Commission (FFC) all play important roles in some part of the leadership in local government finances. The lines of responsibility among these units, however, are not always sharply drawn. Especially the role that the FFC plays in the design of the intergovernmental fiscal system remains a puzzle. The FCC could play a key role in creating an efficient intergovernmental fiscal system in South Africa. Ahmad (1998, p. 250) puts it well:

“... the FFC is supposed to make recommendations on taxes proposed by local governments, the sharing of provincial revenues with local governments, and provincial guarantees of loans to local governments. Thus, in principle, the FFC could be an extremely important part of the system of fiscal relationships in South Africa. Yet, it is an appointed body, with no independent power base. Its eventual role remains to be seen.”

The existence of a fiscal information system is crucial to the vertical shares debate. This is true in most developing economics and it would appear to be true in South Africa. It is not uncommon to come up against the following issue: Every time the government embarks on a new fiscal decentralization initiative, it must go back to the data gathering exercise. Moreover, nearly every government debate on the intergovernmental fiscal reform begins with questions about the accuracy of the data.

The present fiscal information system for local governments is weak. The Department of Finance (1999, p. 108) reports the situation as follows:

“Financial information for the whole local government sphere is, at this stage, incomplete. The South African Reserve Bank publishes quarterly estimates of consolidated revenue and expenditure. The Department of Finance collects

information on local government budgets, while the Department of Constitutional Development collects data on cash-flows and payment levels. Unfortunately, none of this information is strictly comparable at this stage.”

The fiscal information system that South Africa must develop should have several features. It should be presented in a uniform format, it should contain all of the essential information for monitoring and evaluation fiscal performance, it should be timely, it should contain actual financial outcomes, and it should be user friendly. There have been several starts in developing such a system in South Africa, but none have yet yielded a database with these characteristics.

CONCLUSIONS

Defining the “equitable” vertical shares is perhaps the most contentious of all issues in structuring an intergovernmental fiscal system. This is true in South Africa, as it is in most countries. Governments cannot easily gain consensus among the major players on vertical sharing. It must be remembered that one person’s feast is another’s famine, and it is not likely that there will ever be consensus that the shares are, “equitable” no matter what reform system is chosen. The goal of any vertical sharing inquiry, therefore, will not be to find a more “fair” sharing, but to develop an objective framework around which advocates can debate and negotiate in a more transparent manner.

Centralists argue that the system must remain flexible and that a strong measure of control by the Ministry of Finance is crucial. Their preference is often a system of intergovernmental transfers where the vertical share is determined annually, by the Ministry of Finance, based on the fiscal situation of the country. On the question of local government taxing powers, there is usually a hesitance to allow a competition between central and local governments for the more productive tax bases.

Proponents of fiscal decentralization usually argue for a more transparent system, and of course, for a larger vertical share. They would prefer to tie their vertical share to the revenue yield of a particular tax, or to that of all taxes for a period of years. For example, X percent of

income tax collections, etc. The more prosperous and economically developed local governments typically will argue that, in addition, they should have access to a more productive tax base, e.g., income, sales, or motor fuels.

These traditional views of fiscal centralists and fiscal decentralists are also played out in South Africa. The result has been that provincial governments have been assigned a great deal of expenditure responsibility, but relatively little taxing powers. The local governments have been assigned little expenditure responsibility but some taxing powers.

Should the government choose to move in the direction of fiscal decentralization to local governments, the necessary fiscal instruments are at hand. Property tax autonomy could be left in tact, the RSC levy could be converted to a true local tax, and the “grant fund” (vertical share) could be tied to a productive tax base. A hard budget constraint could be imposed on local governments and “bailout grants” would be eliminated.

The final solution to the vertical sharing debate in South Africa will ultimately rest on what the leadership in the country places greatest weight upon: moving government decisions closer to the people at the local level, or protecting the stability of the macroeconomy.

TABLE 1

COMPARISON: SOUTH AFRICA AND SELECTED FEDERAL COUNTRIES (1993-95)

Country	Expenditure Decentralization	GDP per capita (US\$)	Population (millions)	Total Area (thousand sq. km)	Homogeneity Indicator	Estimated Expenditure Decentralization Ratio ¹	Expenditure Decentralization "Effort" ²
South Africa	37.26	3629	38.3	1219	1.14	17.34	2.15
Bolivia	19.71	847	7.2	1098	1.17	14.77	1.33
Brazil	36.45	3574	157.2	8512	1.13	37.81	0.96
Chile	7.77	3819	14.0	757	1.71	19.25	0.40
Dominican Republic	2.06	1386	7.7	48	1.39	13.89	0.15
Germany	39.93	26054	81.4	357	1.17	30.60	1.30
India	50.84	362	913.7	3287	1.24	41.50	1.23
Italy	23.67	18026	57.1	301	1.81	28.72	0.82
Malaysia	17.82	3705	20.1	329	1.42	16.51	1.08
Mexico	27.91	4142	89.5	1972	1.26	21.43	1.30
Nigeria	27.98	583	108.1	923	0.61	13.12	2.13
Russian Federation	44.15	1774	148.3	17075	0.74	54.89	0.80
Spain	34.53	12962	39.1	504	1.54	23.95	1.44
United States	45.08	25739	260.3	9629	1.12	56.83	0.79

Note: Total Area and Homogeneity Indicators are for the year 2000 (The World Fact Book 2000).

¹ Decentralization ration is subnational government expenditures as a percent of total government expenditures.

² Decentralization "effort" is an index where the numerator is the actual decentralization ration and the denominator is the regression-predicted decentralization ratio.

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