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International Studies Program
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FISCAL DECENTRALIZATION, REVENUE ASSIGNMENT, AND THE CASE FOR THE PROPERTY TAX 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 arrangement necessary to guarantee fiscal decentralization, the power to raise local revenues, has 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 is the subject of this paper.

In the next section of this paper, we describe the system of local government and local government finance in South Africa. We turn then to a discussion of the normative criteria for proper revenue assignment in an intergovernmental system, and to an evaluation of each of the major revenue sources. In that context, we consider the potential role of the property tax as a source of financing local government in South Africa.

LOCAL GOVERNANCE AND FINANCE

The South African system of governance is unitary, and there is no hierarchical fiscal relationship between provincial and local governments. Local governments are directly responsible to the central government. The nine provincial governments have little autonomy to raise own source revenues; through they are assigned some important expenditure responsibilities (e.g., roads, primary education, health).

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There are now three types of local government in South Africa, each with different powers and responsibilities. The six “metros” govern the metropolitan areas of South Africa. The principal unit of local government outside the metros is the municipality, of which there are now 231. These vary widely in size and capacity. Forty-nine district councils (now referred to as “C” municipalities) provide services in the rural areas.

The metros and larger municipalities are financed primarily from their “own sources,” notably, the property tax and other local taxes and user charges. A surplus from electricity undertakings generates significant local revenues. The smaller municipalities are heavily dependent on conditional grants, user charges and on a general purpose grant known as the “equitable shares.” The district councils receive revenues from grants and a local payroll and turnover tax (the RSC levy as described below). On the surface, it would appear the South African local governments are “different” from those in other developing countries because they are more fiscally self-sufficient. In fact, the rural local governments have relatively little fiscal autonomy, and receive most revenues from transfers of one kind or another. The urban local governments do show a significant degree of fiscal self-sufficiency, but their ability to set tax rates and user charge rates is limited to a greater extent than many have recognized. (See the discussion of the RSC (regional services council) levy below.)

REVENUE ASSIGNMENT

The big stumbling block for a “true” fiscal decentralization -- in virtually all countries -- is the failure to give revenue-raising authority to subnational governments. Ministries of Finance almost never want to assign significant revenue sources to local governments, but decentralization will not work if they do not. South Africa finds itself with this dilemma.

Should the issue finally be resolved by granting significant local taxing powers, the question of what taxes local governments might be given will be the center of an important policy debate. In choosing the "right" revenue sources, one might be guided by three principles (McLure, 1998, Bahl and Linn, 1992). First is the principle of revenue adequacy, i.e., the amount of local government revenue should match the amount of expenditure responsibility assigned. The second principle is that of correspondence. 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. The third principle is that local governments should only levy taxes that they can effectively administer.[1] "Effectively" in this case means administered at reasonable cost and in a fair way. Different candidates for local government taxation pass these tests to different degrees.

We would add an important, fourth criteria for a good local tax: that the local government have some discretion to adjust the tax rate. If the tax rate is centrally set, then the local government has no opportunity to adjust the "cost" of local services as seen by taxpayers, and the accountability link is broken. If changes in the local tax rate require central approval, then local officially can request rate changes but there is not full accountability to voters.

South Africa is well ahead of most developing and transition countries in terms of the range of productive revenue bases that are available to urban local governments. Local

[1] 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 government for collection expenses.

governments presently have access to the property value, payroll and business turnover tax bases, and there has been discussion of motor fuel and rural land taxation. There are significant advantages to each of these revenue choices. However, in each case there are some important caveats and cautions to be raised. And most important, the revenue-raising powers that have been delegated still do not match the expenditure responsibility that has been assigned.

The Property Tax

The most common local government revenue source is the property tax. It generally meets the tests of a good local tax as noted above, and central governments do not usually view the property tax as an encroachment on their revenue base. South African local governments do rely heavily on the property tax, and do receive significant revenue. It is the second largest local revenue source (behind the gross revenues of the municipal electricity undertakings) and accounts for about 20 percent of total local government revenue (Department of Finance, 1999). The property tax is not usually thought of as 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).

Local governments are given considerable choice in property tax policy; hence the property tax in South Africa generally meets the local autonomy test. Local governments may tax only the land, or they may tax the combined land and improvements, as provided by provincial legislation. They have freedom to select the tax rate and in some cases have chosen a differential rate on land and improvements. They may provide exemptions. Assessment and collections are a local government responsibility.[2]

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

Where the property tax fails is in the area of fairness in administration at reasonable cost. Identification of the tax base, and assessment, are very expensive propositions, and properly done, collection and appeals impose significant costs. In South Africa these costs have been avoided in some sense by failure to upgrade the property tax rolls, and failure to force a high rate of compliance.

In summary, most of the features of South African property taxation are very consistent with fiscal decentralization. Yet the government of South Africa is not fully satisfied with its property tax regime, and has for some time had it under serious review. Some of the reform measures now under consideration could change the property tax markedly, and could have an important impact on fiscal decentralization. The following discussion covers the major issues under debate, and their implications for fiscal decentralization.[3]

International Comparison[4]

One might begin an inquiry about property taxes in South Africa by examining the extent to which the tax is used. As may be seen in Table 1, the property tax is not one of the major sources of total government revenue (less than 7 percent of the total), though its revenue share has remained about the same over the past 25 years. However, the property tax finances about 11 percent of all provincial and local government expenditures in South Africa.

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[3] Certainly the issue is contentious in South Africa. At the time of this writing, the proposed new property tax law was in its 10th draft, and the debate over the provisions was more than two years old.

[4] A problem arises over how one measures the property tax when doing comparative analysis. Ideally, the measure would be revenues from the taxation of land and improvements, betterment or special assessment type levies, and transfer taxes on land and improvements. The IMF's *Government Finance Statistics* includes these categories, but also some others: estate and inheritance taxes on property, personal property taxes, and taxes on financial and capital transactions involving real and personal property (but not goods and services). In this international comparison, we use the IMF definition.

While these do not sound like large shares, the intensity of use of the property tax in South Africa is actually quite large by comparison with the world practice. Property tax payments in South Africa do not amount to a large share of GDP, accounting for only about 1.9 percent. However, this share is roughly comparable to that in the industrialized countries and is well above the GDP shares normally seen in developing countries (See Table 1). The same is true for revenue importance. South Africa's 7 percent reliance is not far below that in the U.S. (8 percent), but is above the industrialized country average and well above the average for developing countries (Table 1).

We might examine the comparative level of property tax "effort" in South Africa in a more systematic way. That is, we may take account of differences in per capita income and population size (which should lead to a higher per capita level of property tax revenues) in estimating the "expected" level of property tax revenues.[5] We estimate a cross-section linear regression for 87 developing and industrialized countries using 1995 data and find the following results:

$$PTy = -6.376 + 0.639Yp + 0.062P \quad R^2 = 0.3 \qquad (1)$$

$$(-6.9) \qquad (6.1) \qquad (0.8)$$

Where[6]

PTy = property tax revenue as a percent of GDP

Yp = per capita GDP in $U.S.

P = population

[5] The methodology for estimating tax effort using this approach is described in Bahl (1971).

[6] All variables expressed in logarithms, and t-values shown in parentheses.

These results show that higher income countries raise a significantly greater share of GDP in property taxes. On average, if a country has a 10 percent higher level of per capita GDP, we expect a 6.3 percent greater property tax share of GDP. Based on equation (1), we *predict* that South Africa would raise 0.62 percent of GDP in property taxes, but this is well below the share that was actually raised in 1995 (1.95 percent). South Africa, thus, exerts a high property tax effort. Of the 87 countries included in this sample, only four exerted a higher level of property tax effort.

Uniformity of the Tax Base.

An important policy question is whether the tax base should be uniform in all of South Africa, and defined by a central government act, or whether this should be a matter of local choice.[7] 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 provide administrative support for an effective property tax if there was only one property tax system in South Africa.
- The central government is justified in being paternalistic in policy matters because many local governments are "new to the business" of fiscal autonomy and may make unwise decisions that are harmful to the entire nation.

There is another view: that local choice (as opposed to uniformity) is more consistent with the accountability tenet of 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. Note that

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

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. Capetown has historically taxed land and improvements at a uniform rate. This means that voters in different local government areas have historically preferred different forms of property tax (though we cannot easily identify the reasons for this). The fact that different choices have been made suggests that the imposition of a uniform base could result in efficiency losses.

There is a second line of argument for continuing with the present system of local choice. It would impose less overall disruption on the fiscal system at a time when there would seem to be a premium on stability. The switch over would require all non-complying local governments to complete a new tax roll, educate taxpayers, deal with appeals, and train staff to implement a new system.

What Base to Tax?

There is a longstanding debate among students of the property tax as to whether the property 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 one. South African property tax policy is under review, and the practice of allowing local (provincial) governments to choose their tax base is under challenge. There are proposals to switch to a (mandated) uniform base that would include both land and improvements.

If there is a worldwide trend, it is toward taxing the total value of the property. One major advantage of taxing a base that includes the capital value of land plus improvements is that it allows a lower nominal rate than does a tax levied only on land. This lower rate makes the capital value tax more politically palatable, as does the fact that taxpayers can easily understand it. The tax base is the value that one's property would fetch in a free market. Moreover, the administrative difficulties with a capital value tax can be lessened if there are good data on the value of property transfers and thus an objective basis for determining the market value of each parcel. In fact, these are all advantages of a capital value tax that South Africa could capture, and the case for switching to a capital value base is stronger in South Africa than in developing and transition countries.

There is another perceived advantage of a capital value tax (probably wrongly held) that a tax on land and structures will fall more heavily on businesses, landlords, and wealthy residential homeowners, than will a land value tax, i.e., it will be more progressive. This perception could resonate well with the large population of South African poor. However, contrary to intuition, taxing land and improvements may be less progressive than a land-only tax. For one thing, landowners are heavily concentrated in the upper income brackets. Another issue is that the tax on improvements could drive investment away from real estate, reducing the supply of structures and forcing up rents. Vertical equity may be an argument in favor of the land value base.

Advocates of the land value (site value) approach argue that it has two great advantages. It has the potential to improve the efficiency of urban land use, and it may lessen administrative burdens. The argument with respect to the former is straightforward: if improvements are not taxed, the owner will have an incentive to develop the land to its most profitable use. Site value taxation has been practiced in a number of countries, including such diverse economies as Barbados, Kenya, and Taiwan (China), and in parts of Australia, and New Zealand, as well as South Africa. Despite the inconclusive results about whether this form of property taxation leads to a “better” use of urban land, academic and practitioner interest has remained high (See Holland and Follain, 1991).

With respect to the cost advantage, site value taxation also has an assessment advantage. It stands to reason that the valuation job can be done more cheaply and uniformly if improvements need not be considered.[8] Moreover, there are much better possibilities for mass appraisal, or even the use of computerized systems, under the land value approach.

There are two major disadvantages to site value taxation, which many think limit the possibilities for its use in other countries. The first is an assessment problem. There is alleged to be a paucity of evidence on sales of vacant properties, especially in urban areas; hence, sites must be valued by some residual method. That is, first, the “bundled” property value must be determined and then the value of improvements must be deducted. Such as approach makes site valuation a more subjective exercise than total property valuation. The second, frequently discussed disadvantage is that the value of land is a much smaller tax base than the value of land and improvements, and therefore can produce sufficient revenue only at higher nominal rates. There can be no question but that it is politically easier to levy a lower (nominal) property tax rate on a broader base (one that includes the value of improvements) than *vice versa.* This argument is not easily dismissed. Financial officers and politicians of fiscally strapped local governments will naturally see downtown office buildings, hotels, and luxury residences as legitimate and fruitful objects of taxation. Some countries have made exceptions to the site base to capture this value of luxury improvements.

[8] 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.

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.

A major question is the tax treatment of government property. Some argue that it should be exempt by national law, i.e., one government should not tax another. Others argue that government properties are users of services, and should pay for these with a property tax charge. If the latter option is chosen (no national exemption) some local governments would gain significant revenues. Some provincial and central government departments might be called on to make significant property tax payments.

A broader question is which level of government should make the decision about whether a property should be taxed. Decentralists 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 or even to carefully scrutinize proposed exemptions. If nationally imposed exemptions are to be allowed, they should be compensated by a revenue-equivalent grant to the local government. Centralists argue against local choice on grounds that local politicians are more susceptible to pressure by powerful local interests who want preferential treatment. There is also the danger of costly competitive subsidies as local governments bid against each other for new industry. Centralists argue that local governments now have discretion over the property tax rate, and that is enough. Moreover, because there is no hard budget constraint imposed on local governments in South Africa, there is little incentive to deny the proposals for preferential treatment. 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 real property 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 deducible 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 companies and start-up companies do not receive the preferential treatment. A second concern is the revenue cost incurred by the central government, and how it is to be made up. That is, are we happy with a public policy that exempts companies in sector X from taxation (or affords them preferential treatment) but makes up the revenue loss by raising the tax rate on all other companies?

Exemptions also hold 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 paid by the central government via the deductibility. In effect, this is a form of intergovernmental transfer that is distributed among local governments according to the property value of profitable businesses located within their boundaries. For example, if a local government was home to 10 percent of the assessed property value of all profitable businesses in South Africa, its companies would receive 10 percent of all the property tax deductions given. That local government would then have less resistance to holding its property tax rate at current levels, or to increasing the property tax rate. One might question whether this is the (implicit) formula-based grant distribution that the government really wants.

Another preferential treatment offered in South Africa 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.

Another approach, not yet on the table for discussion, is for the central government to outlaw concessions altogether, including its own deductibility provisions. This would level the playing field among taxpayers, allow a lower nominal rate, and improve taxpayer confidence in the system.

Rate Setting

Should tax rate setting should be a local government power? 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 local officials to local voters, then rate setting should be a local power, i.e., the voters would impose the limits. In spite of this logic, most countries do not give local governments unlimited rate setting powers (Bahl, 1998). In some countries, the central government prescribes the exact property tax rate, or requires that any proposal to change the tax rate be approved by the central government. In many other cases, there are national ceilings on the rates that local governments may choose. Such limits slow the use of property taxes to finance public services, and restrict local autonomy, 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. Nominal rates in the range of 5 to 10 percent of the assessed capital value of land are not uncommon. However, effective rates are much lower. Local governments have been provided generous rebates (as discussed above) and underassessment is widespread. There are no hard estimates of the effective rate of property taxation in South Africa. We can note, however, that property tax in South Africa accounts for between 1 and 2 percent of GDP, and has remained at about that level for past 25 years. In the United States, by contrast, the ratio of property tax to GDP is closer to 3 percent. In most of the world, however, it is far lower than in South Africa.

There is also the issue of whether the property tax rate should be uniform across types of property. Most tax policy analysts would argue that it should, that different property tax liabilities should reflect only different property values. Yet many countries do have classified property tax systems where different land uses are subjected to different rates. In effect, this allows the government to offer preferential property tax treatment to certain classes of users. South Africa is presently considering the merits of a classified property tax.

THE RSC LEVY[9]

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 developing countries 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 (the central government has capped it) nor can they determine the base. The only discretion they have is to use moral suasion (and collectors) to affect the rate of revenue collections. To the extent the local governments are successful in affecting the rate of tax collection, they do play a role in determining the average effective tax rate.

It is a grant. Another view 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 local governments have little control over collections. The result is that the central government determines the tax structure, 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.[10]

[9] For a detailed discussion and analysis of the South African RSC levy, see Bahl and Solomon (2000).

[10] See Bahl and Linn, (1992), Chapter 13.

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, the RSC levy becomes either a donation or a tax on honesty.

All of the above is true because there is much variation across the country. That is, in some places, pressure to comply is placed on businesses by the local government and by aggressive collectors. This makes the RSC more like a local tax in those local government areas. In other places it is viewed simply as a transfer from the center, and little local effort is exerted. In yet other places, RSC levy revenue is determined by how much business is willing to pay on a voluntary basis. The attitude in the latter two cases is, "we get what we get."

The first reform 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.[11]

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. This means that the normal revenue yield from the RSC levy will significantly offset any equalizing grant program that the government puts in place. Bahl and Solomon (2000) found that a local government with a 10 percent higher level of per capita GDP could expect about a 9 percent higher level of per capita RSC revenues. The government must decide about the extent to which it can accommodate a tax that is "disparity-increasing."

[11] 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.

Second, the question of the capacity of local governments to collect a payroll and turnover tax calls for a thorough examination. Unless this issue is resolved, the RSC cannot be a viable source of local government revenue in the long run. There are 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 approach involves the use of private contractors, kind of a "tax farming" approach. The use of contractors is a common practice in South Africa, and there is considerable anecdotal evidence about the misuse of powers. The third proposal 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, it 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. On the other hand, the payroll tax rate is so low that many would argue that it could not possibly affect employment decisions.

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 pay of the tax bill for Johannesburg or Capetown services. This is probably not a policy outcome that is desired by the government.

So, 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 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 would 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.

The first two of these solutions are in the vein of fiscal decentralization, and local governments are given more discretion. The third is a centralizing solution, and the local governments have little choice as to the amount of be raised.

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 policy question to be decided is how the total pool of revenues available should be distributed among local governments. There are many choices here:

- One could take a "needs" view related to maintenance of the existing roadways 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, (c) whether the local governments are up to the administration and recordkeeping tasks required if the grant is made conditional, and (d) whether the right level of equalization is achieved.

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. Certainly it fits the criteria of a good local tax, in that it's burden is borne locally, it can be administered at reasonable cost, and it will generate significant revenue.

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 national governments want to control for reasons related to conservation and controlling for pollution/congestion, 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, leaving open the issue of financing rural local governments. Finally, there is the possibility of "fuel carrying" to avoid payment of an urban area tax.

Notwithstanding the drawbacks, the motor fuel tax would seem a good candidate for metropolitan government financing. It has efficiency, revenue yield, and administrative advantages that make it, in many ways, an ideal local tax.

Land Tax

The South African government has considered a 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 some 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. Many is South Africa argue to include rural property in the general property tax law.

- *Will the land tax base include or 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, but cautioned about the need for adequate time to prepare for implementation (Republic of South Africa, 1998).

INTERGOVERNMENTAL TRANSFERS

South African urban local governments do not rely heavily on intergovernmental grants. 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, but is higher for rural than urban governments.[12]

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"). The plan is for this program to 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 present, only the basic services and assistance to smaller local governments components are operating.

[12] This calculation 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 much higher.

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.[13]

One could classify the system of vertical sharing that exists at present as mostly an *ad hoc* system, in that the vertical share is ultimately a decision of the government. Apparently, it is a decision made each year, and the size of the distributable pool may change from year-to-year. This method of vertical sharing is used by many countries and has the attractive feature that it 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, the greater the advantages of this approach to vertical sharing. There 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.

The method of vertical sharing in South Africa is not completely *ad hoc*. As to the "implicit" transfers, the vertical share of the RSC levy "transfer" is determined by the total amount of tax paid by businesses, and the property tax deduction "transfer" is based on the amounts claimed against income tax liability. With respect to the equitable shares grant, 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

[13] 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.

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 increasing/reducing the vertical share of local governments.

In formal terms, S transfers are calculated as follows:[14]

S_i = " 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

" is a coverage parameter with 0#"#1

This formula for horizontal distribution among local governments has some desirable features from a point of view of fiscal decentralization.

C It is transparent in that it is driven by an explicit formula.

C It is equalizing in that it includes a poverty component.

C It contains no disincentive for the local government to reduce the rate of revenue mobilization.

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

[14] As reported in *Department of Finance*, April, 1998.

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.

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 may see this as a reasonable 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.[15] 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

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

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.[16] To begin 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 database, 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 argues that data shortcomings are too severe to do a proper job with costing minimum service levels.

[16] For a discussion of the "expenditures first" rule of fiscal decentralization, see Bahl (2000a).

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.

- 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.

- 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.

- 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 most countries that are classified as 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 developing a policy statement on local government finance. This document serves as a blueprint for policy development. With respect to implementation, 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. A policy statement on the regulatory framework for local government borrowing has been accepted by government, the equitable shares grant system is functioning and does rely on an index of fiscal needs, and there is the beginnings of a fiscal information system for local governments in the Department of Finance.

The problem in South Africa is that there is no clear definition of where responsibility for monitoring and supporting local government finance will lie. The Department of Provincial 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. To produce such a system in South Africa will require significant design work.

CONCLUSIONS

What is the future of the property tax in South Africa? What role will it play in the fiscal decentralization program that is now being structured?

There is a real possibility that South Africa will become a major user of the property tax, possibly even operating at the level of industrialized countries. In the United States, for example, the property tax accounts for about 3 percent of GDP, whereas in South Africa it accounts for about 2 percent. Based on international comparisons that make adjustments for per capita income level and population size, South Africa is shown to make one of the higher property tax efforts in the world.

There are now major questions before Legislators in South Africa. These questions are about the structure of the property tax, and principally about whether the center will mandate uniformity in the tax structure and whether it will mandate the inclusion of improvements in the tax base, or, whether it will give local governments complete control over setting the tax rate and determining the tax base. Solutions that move toward the latter scenario, especially rate-setting, would provide the local autonomy necessary to underpin a true fiscal decentralization.

Finally, there are the questions about whether the property tax will be levied in an asymmetric way (equal in urban and rural areas), and whether local governments will be given other taxing powers. It would appear that there is much greater potential to finance urban services with property taxes, whereas rural areas will continue to be heavily dependent on intergovernmental transfers. As to other urban taxes, the taxation of motor fuels and the imposition of a payroll tax are major and viable options. If a second productive base is taxed, the property tax can be worked at a reasonable effective rate and has a better chance to become a successful and less contentions local government financing source.

TABLE 1

REVENUE PERFORMANCE OF THE PROPERTY TAX: SOUTH AFRICA IN INTERNATIONAL PERSPECTIVE

	1970s	1980s	1990s
Property Tax Revenue as a Percent of Total Central Government Tax Revenue[a]			
South Africa	7.36	5.82	6.74
Average for Developing Countries	3.45	3.24	3.30
Average for Industrialized Countries	5.23	6.37	5.54
Property Tax Revenue as a Percent of GDP			
South Africa	1.66	1.41	1.87
Average for Developing Countries	0.50	0.46	0.48
Average for Industrialized Countries	1.63	2.22	1.93
Subnational Government Property Tax Revenue as a Percent of Subnational Government Revenue			
South Africa	12.22	11.49	11.44
Average for Developing Countries	15.86	16.21	9.63
Average for Industrialized Countries	12.68	13.54	12.99

Source: Computed from data taken from IMF (various years).

[a] Budgetary Account.

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