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Overview of Fiscal Decentralization in South Africa

Roy W. Bahl
Georgia State University, rbahl@gsu.edu

Paul Smoke
New York University, paul.smoke@nyu.edu

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Restructuring Local Government Finance in Developing Countries

Lessons from South Africa

Edited by

Roy Bahl, Georgia State University, USA
and
Paul Smoke, New York University, USA

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Roy Bahl and Paul Smoke

INTRODUCTION

South Africa has undergone major changes in its local government system since the demise of apartheid in 1993. The 1996 Constitution and subsequent legislation have dramatically redefined the public sector, mandating the development of a separate sphere of democratic local governments (municipalities) empowered to provide a wide variety of public services. The definition and implementation of anticipated new local government functions and revenues and the supporting development of democratic decision-making and managerial capacity, however, are emerging more slowly than expected in the complex political, institutional, and fiscal environment that prevails. Some difficult choices and challenges remain in laying a foundation for local governments to meet the substantial role given to them in the Constitution.

South Africa is a case that many governments and students of fiscal decentralization are following closely because there have been a number of noteworthy successes in normally problematic areas of reform. First, many elements of a solid constitutional and legal framework for decentralization are already in place. Developing such a framework is a major challenge in many developing countries. Second, the restructuring of the intergovernmental system set up direct relations between the national government and the municipalities, greatly reducing hierarchical arrangements through the provinces. Many countries struggle with how to appropriately structure intergovernmental relations in multi-level systems, and developing an appropriate degree of local autonomy from the intermediate tier is often particularly difficult. Third, the South African government recently constituted a boundary commission, the Municipal Demarcation Board, which eliminated about two-thirds of all municipal governments. Developing countries often struggle to deal with the politically challenging problem of having many small local governments that are unlikely to be viable and effective. Fourth, many key elements of a local government revenue system are already in place. South African municipalities have some productive local revenue sources, a system of recurrent intergovernmental transfers that has had a positive re-distributional effect, a newly defined mechanism for monitoring municipal fiscal condition, and a municipal borrowing framework that is in an advanced stage of development.

Despite this impressive progress, some great challenges remain. There is a lack of clarity in the definition of local service assignments outside of the large metropolitan areas. In many cases, service delivery arrangements are also needed at the settlement level below the formal municipal government structure, especially now that the recent demarcation has created larger jurisdictions that are more 'distant' from their constituents. Municipal revenue generation is uneven and often inadequate, especially outside the urban centers, and there are some major design and administration problems with a number of the most important local revenue sources. The system of intergovernmental transfers also requires further significant development. There are indications that the share of national recurrent resources going to municipalities may not be commensurate with the responsibilities they have been assigned, the principal recurrent transfer formula measures fiscal need relatively crudely, and the system of conditional capital transfers is complex and fragmented. Another major issue is that even after the recent local government consolidation, fiscal and administrative capacity and needs vary greatly across the new municipalities. Far more attention has been given to defining the elements of the fiscal system than to developing a fiscal decentralization implementation strategy that takes account of such inter-jurisdictional differences.

As in many developing countries, fiscal decentralization is in process in South Africa, so that there is still an opportunity for the government to make critical decisions that would greatly influence the eventual form and performance of the local government system. The research reported in this volume focuses on how to deal with these outstanding challenges. This discussion and evaluation also should have considerable relevance beyond South Africa.

The Approach[1]

In considering the South African case, we focus on the typical elements of fiscal decentralization analysis – expenditure assignment, revenue assignment, and intergovernmental transfers – and use standard analytical criteria and techniques.[2] The approach taken to this work, however, has three features that distinguish it from most other studies on this subject.

First, policy advice on fiscal decentralization in developing countries is typically normative and very limited by the weak data base on which analysis must be built. Our research is normatively driven and is also limited by data availability. However, we conducted detailed quantitative and qualitative analysis of South African data, and we developed new data sets specifically for this work. This has enriched the analysis markedly. We also consider and empirically document the likely implications of a range of options for local government fiscal system design rather than rigidly define a particular normatively 'ideal' solution for South Africa.

Second, much of the empirical work on fiscal decentralization provides a broad-brush overview of the entire intergovernmental fiscal system or more detailed treatment of one particular aspect of the system in a specific case. We use an approach that examines in detail several key elements of fiscal decentralization in South Africa, but we also demonstrate the important linkages among them, such as the correspondence between the expenditure and the revenue sides of the budget and the inter-relationships among key elements of the revenue structure. Also considered is the relationship among the fiscal, political, and institutional aspects of decentralization.

Third, much of the international work on fiscal decentralization focuses primarily on the design of reforms. We focus not only on design, but also on the challenges of developing an implementation strategy.[3] This analysis heavily emphasizes the theme that the decentralization program should recognize the different characteristics and capacities of the local governments in the system. As is typical in developing countries, much needs to be done to get the local government finance system in order, and it cannot be accomplished all at once or in exactly the same manner in all local governments. We give significant attention to strategic issues, such as how to sequence reforms in a way that does not too rapidly give too many responsibilities and resources to all local governments, potentially overwhelming their ability to perform and/or straining the tolerance of the central agencies that lose functions and resources through devolution.

Although the analysis in this volume focuses on the South African experience, it also draws from the international experience. This approach should provide guidance for analysts working on other countries facing similar fiscal decentralization policy challenges.

The Context of Reform in South Africa

Even prior to the election of Nelson Mandela as president in 1994 and the subsequent dismantling of apartheid, the Republic of South Africa had begun to restructure its public sector. This restructuring has intensified in recent years, with a focus on creating a more decentralized and democratic system of government.[4] In undertaking reform, the country faces the special challenge of redressing enormous disparities in service levels among jurisdictions that had long been subject to strict racial segregation.

Provincial governments were originally given a strong role by the Constitution that created the Union of South Africa in 1910. The 1986 Provincial Government Act, however, abolished provincial legislatures and replaced them with appointed executive authorities. New powers, such as responsibility for delivering health services, were subsequently given to provincial administrations, but provincial budgets still required ratification by the national Parliament. The 1996 Constitution empowers provincial legislatures, more clearly defines the role of provincial governments, and allows them some degree of autonomy.

On the local government side, which is the focus of this volume, non-white areas were managed during much of the apartheid era by local bodies that had had few powers and resources. This continued to be the case even after they were elected in later periods. The Black Local Authorities (BLAs) were established in 1982 but never enjoyed political legitimacy. They were commonly seen as a desperate attempt by the regime to provide a façade of local democracy for blacks, while essentially reinforcing segregation and keeping apartheid intact. BLAs were never able to develop productive tax bases, largely because of apartheid restrictions on economic development in the black areas. Service levels typically lagged far behind those in the White Local Authorities (WLAs). Poor service levels and attempts to impose rents and service charges in the BLAs angered local communities and led to the infamous rent boycotts, fueling the drive by civic organizations and activists to topple apartheid.

In the late 1980s, the national government tried to defuse escalating tensions and to salvage the government system. It established a substantial intergovernmental grants program to channel infrastructure resources to poor black areas through umbrella institutions called Regional Service Councils (RSCs) and Joint Service Boards (JSBs). In the end, these late interventions were ineffective, and the situation continued to worsen.

In response to the severity of the crisis, a Local Government Negotiating Forum was established in 1990 to develop a new local government system that would be more widely accepted. This resulted in the passage of the Local Government Transition Act of 1993, which provided for a three-stage process of transition. During the pre-interim phase, local forums were established to negotiate the appointment of temporary councils that would govern until local elections were held. Municipal elections marked the start of the interim phase, which ended with the definition of a new local government system described below.

South Africa's current unitary system of governance includes national, provincial, and local governments. The two types of sub-national government are not hierarchical, but separate 'spheres', each with direct responsibility to the national government. During the initial transitional period, two-tier local governments were established in large urban and rural areas, with the primary tier composed of units closest to the people and the secondary tier being larger umbrella units. Thus Transitional Metropolitan Councils (TMCs) were established as secondary tier governments in six of the largest urban areas, and a number of smaller primary tier Metropolitan Local Councils (MLCs) operated within each of them.[5] Single-tier Transitional Local Councils (TLCs) governed non-metropolitan urban areas, but many were at least partially dependent for infrastructure funding on broader-area District Councils (DCs), or in KwaZulu-Natal the Regional Councils (RCs), which evolved from the old RSCs and JSBs established during the apartheid era. Transitional Rural Councils (TRCs) were established as the primary tier in rural areas, but most relied on the secondary-tier District Councils (DCs) for various services and assistance.[6]

As discussed more fully in Chapter 2, the 1996 Constitution and the Local Government Municipal Structures Act (1998) consolidated a complex system of urban and rural transitional governments into three municipal categories, abolishing the two-tier structures in metropolitan areas.[7] Metropolitan municipalities (category A, or 'metros') exclusively cover large urban areas. Local municipalities (category B), which were created primarily from the TLCs and TRCs, cover non-metropolitan localities, which vary in size and degree of urbanization. District municipalities (category C) geographically encompass several B municipalities and coordinate integrated development planning for the entire district. The districts also provide services on behalf of less capacitated B municipalities situated within their borders, particularly in more rural areas. A Board constituted under the Local Government Municipal Demarcation Act (2000) designed a reorganization and consolidation of local governments in South Africa, resulting in a reduction in their number from 843 to 284, and created a system of 'wall-to-wall' municipalities. The total includes six metropolitan (A) municipalities, 231 local (B) municipalities, and 47 district (C) municipalities.[8] In addition, there are 25 district management areas (DMAs), which are special areas (essentially non-viable local municipalities) under the jurisdiction of district municipalities. The presentation in Table 1.1 summarizes this local government structure in terms of the A, B, and C labels.

The Constitution gives higher levels of government appropriate oversight and control powers over local governments. Assignment of certain powers and revenues to local governments is at the discretion of the center and, to an extent, the provinces. The center develops national objectives and guidelines and ensures adequate coordination among all levels of government. The center also designs and administers the intergovernmental transfer system. Particularly important players are the Department of Provincial and Local Government (DPLG) and the National Treasury. Finally, the national and provincial levels of government monitor municipal affairs – and can intervene as necessary – to ensure that basic standards of good governance, service provision, and financial discipline are being met.

Various major reforms are still in process. DPLG designed the Local Government Municipal Systems Act (2000) to regulate internal municipal arrangements, focusing on support of economic development and establishment of participatory mechanisms. In addition, the Act mandates reforms in human resource management and service delivery arrangements. These reforms are being operationally defined and implemented. Parliament is considering a new Local Government Property Rates Bill that is intended to improve municipal property taxation (see Chapter 4). The National Treasury is moving forward the

Table 1.1 The structure of local government in South Africa

Type of settlement	Type of municipality	Category	Number
Urban	Metropolitan	A	6
Urban and Rural	Local	B	231
Rural	District	C	47

Source: Adapted/updated from Vaz (1999).

Local Government Municipal Finance Management Bill, which includes provisions about municipal financial management systems, municipal debt, and monitoring municipal fiscal condition. Based on their successful provincial reforms, the National Treasury has taken important concrete steps to improve the budgeting and financial management system and capabilities of municipalities.

SOUTH AFRICAN FISCAL DECENTRALIZATION[9]

Provincial governments have responsibility for a wide range of functions. Most important among them are elementary and secondary education, health care, social welfare, and public transportation. The Constitution allows provincial governments to impose taxes on any base except personal and corporate income, general sales, value-added, customs, and property. The provinces are given authority to levy a flat-rate surcharge on personal income subject to approval of the Parliament, but this approval has not yet been granted. Provincial own-source revenue collections have to date been quite modest. Provincial governments are also entitled to an 'equitable share' of national revenue in the form of a grant. There is a framework in which they are allowed to borrow, but they have generally not done so except to provide bridging finance.

Municipal governments in South Africa are given substantial powers and functions by the Constitution. The most important municipal services are water, sanitation (including solid waste), roads, stormwater drainage, and electricity. A few functions are assigned through legislation.[10] The actual distribution of responsibilities, however, varies widely within and across types of local governments. Some municipalities, particularly in larger urban areas, take responsibility for a significant range of functions and services, while other local governments, particularly but not exclusively in rural areas, provide few services independently.

Local governments are granted a number of sources of revenue by the Constitution, and they are also given the right to borrow, except to finance a recurrent deficit.[11] The main sources of revenue are rates on property and surcharges on fees for services provided by or on behalf of the municipality. Other sources of revenue may be allowed by national legislation, but local governments are specifically excluded from imposing income tax, value-added tax, general sales tax, and customs duties. The Constitution also entitles the local governments to an 'equitable share' of national revenues.[12] This is provided as an unconditional transfer. Local governments may receive additional grants from the national or provincial governments on either a conditional or an unconditional basis.

Although responsibility for some basic services has been assigned to both provincial and local governments, the local governments are considerably smaller partners in the intergovernmental fiscal system.[13] They account for only about one-third of total sub-national government spending, and they receive only about a 3 percent share of total national government revenues. The provincial governments are financed primarily by transfers from the center, with provincial own-source revenues accounting for less than 5 percent of their total revenues. The situation is quite different for the local governments, which raise, in the aggregate, over 90 percent of their revenues from own-sources. However, there is a wide variation among the local governments, from the large metropolitan governments that raise nearly all of their revenues to small, rural councils that have very little fiscal capacity and depend heavily on national government transfers.

The drastic reduction in the number of local governments under the December 2000 demarcation was designed to improve the efficiency of local public service delivery, but it has raised some concern about distancing constituents from their elected officials. The existence of 284 elected local councils in a country of 43 million people, however, does bring government relatively 'close' to the population. Moreover, because the local governments raise most of their revenues from own-sources, their elected leaders might be seen as more accountable to their constituents than are officials of the provinces where most financing comes from the center. Thus, local governments in South Africa come

Table 1.2 Percent distribution of South African local government revenues and expenditures: fiscal year1999–2000

Revenues		Expenditures	
Source	Percent	Object	Percent
Transfers	8.0	Salaries	31.0
RSC levy	7.0	General expenses	14.0
Utility fees	32.0*	Bulk services	30.0
Property tax	21.0	Maintenance	8.0
Other	32.0	Capital	13.0
		Other	4.0

Notes: * Amounts reported are gross of some expenditures for providing electricity services.

Source: National Treasury (2001) Chapter 9.

much closer to fitting the concept of 'self-governance' than do the provincial governments.

Good comparable data on local government finance are not easy to come by in South Africa because of weak accounting, budgeting, and reporting systems. This problem has been further compounded by the recent boundary changes and municipal consolidations. However, from various available government reports, we can piece together some basic information on the structure of local government revenues and expenditures in South Africa.

As can be seen from Table 1.2, the local government revenue structure is dominated by utility fees, particularly the surplus revenue derived from the electricity undertakings of municipal governments. While these data are reported net of some bulk charges, many costs of providing electricity services have not been removed. Therefore, the reported figure overstates the total amount of resources available from this local source of revenue for general budget financing.

The property tax and RSC levy, the latter a combination payroll and turnover tax, together account for less than one-third of municipal revenues. The property tax is available only to category A and B municipalities, while the RSC levy is available only to category A and C municipalities. Particularly in the case of the property tax, the local governments have significant discretion in controlling the revenue yield. South African local governments differ from those in most developing countries in that the dependence on intergovernmental transfers is relatively light, at least in the urban municipalities.

Ideally, we would report the level of expenditures by service function in order to describe how local governments choose to allocate their revenues among sectors. In fact, functional breakdowns of spending for all local governments are not currently available in South Africa. The disaggregation of expenditures by object, shown in Table 1.2, reveals that salaries and general operating expenditures account for nearly two-thirds of the budget, excluding electricity bulk services expenditure. A relatively small share is allocated to capital purposes, but this 13 percent figure for South Africa is not atypical for developing countries.

SOUTH AFRICAN FISCAL DECENTRALIZATION IN COMPARATIVE PERSPECTIVE

Is the South African fiscal system more decentralized than that in other, similar countries? International Monetary Fund data (IMF, 2001) indicate that the share of sub-national government (provincial and local) expenditures (in total government expenditures) in South Africa averaged 48 percent during the period 1994–1999.[14] This is well above the international average for developing countries of about 14.7 percent during this period.

A straightforward comparison with the average for other developing countries may be misleading. Such averages do not take into account the very great differences among countries in size, income level, diversity, and other factors that are thought to be associated with a greater preference for fiscal decentralization. A better approach is to make adjustments for those factors that one would expect to lead to a higher degree of fiscal decentralization. Then, it would be possible to argue whether South Africa's level of fiscal decentralization is higher or lower than we should expect it to be based on broad international patterns. To address this issue, we have estimated an Ordinary Least Squares (OLS) regression of the relationship between the provincial and local government share of total government expenditures (*ES*) in 93 countries (using averages for the period 1992–1997), and four independent variables hypothesized to be associated with decentralization:

1. *Gross Domestic Product (GDP) per capita in US\$* (*Y*). The expectation is that higher income countries will be more decentralized because higher income families demand more services and have a greater ability to pay for services.
2. *Land Area* (in square miles) (*A*). Countries with greater land areas tend to be more decentralized, because of the greater difficulty and cost of governing from the center.
3. *Ethnic Diversity* (*E*). Diverse populations tend to demand different services from government, hence countries with more homogeneous populations tend to be less decentralized.[15]
4. *Transition Country dummy variable* (*T*). This is included because transition countries (mostly those in the former Soviet bloc) are 'different'. The division of expenditure responsibilities between the public and private sectors is not comparable to that in most developing and industrialized countries, and sub-national governments often have significant responsibilities in the area of social welfare and for operation of state-owned enterprises. We expect that, all else held constant, transition countries will show a greater sub-national government expenditure share than non-transition countries.

The results of the estimation (with all variables expressed in logarithms) are:

$$\begin{array}{l} ES = -3.81 + 0.36Y + 0.27A - 0.01E + 1.05T \\ \qquad\quad (-5.35) \quad (6.12) \quad (6.48) \quad (-0.03) \quad (5.73) \end{array} \tag{1.1}$$

$$\overline{R}^2 = 0.50; \qquad N = 93$$

All of the significant independent variables show the expected signs. We find that there is a significantly larger sub-national government expenditure share in higher income countries, those with greater land area, and in transition countries (t-values are shown in parenthesis). The ethnic diversity variable is not statistically significant. About one-half of the total variation in expenditure shares across the 93 counties can be explained with this equation.

Based on these results, can we say that South Africa has a level of sub-national government expenditures that is higher or lower than what one might expect? We use this equation to predict the level of expenditure decentralization for all countries in the sample (Table 1.3). The predicted expenditure share for South Africa is 19.9 percent, which is well below the actual share of 48.1 percent.[16] Definitive conclusions are difficult to draw because of data issues, but this result indicates that South Africa is considerably more decentralized than might be expected based on international comparisons. We might conclude that expenditure decentralization plays a greater role in discretionary national policy in South Africa than in other, similar countries.

We have used the same equation to compare South Africa with other African countries for which data are available. The data in Table 1.3 indicate that Nigeria, Uganda, Cameroon, Zimbabwe, Cape Verde, Morocco, and Maritius also have 'expected' decentralization levels that are below their actual levels. However, we find that neighboring Madagascar, Botswana, and Swaziland, as well as Ghana, Senegal, Benin, Togo, Zambia, Kenya, Cote d'Ivoire, Ethiopia, Burkino Faso, and Mali have lower than expected levels of decentralization.

In order to better understand the revenue side of fiscal decentralization, we have performed a similar statistical experiment on sub-national government tax revenues. The dependent variable in this regression analysis is the percent of total government tax revenues raised by sub-national governments (*TS*). The independent variables and the rationale for their inclusion are analogous to those given above. International Monetary Fund (IMF) data for this analysis are available for 60 countries, but only a few of them are in Africa. All data are averages for the 1992–1997 period.

The regression results, with all variables expressed in logarithms, are presented in equation 1.2:

$$\begin{array}{l} TS = -5.75 + 0.39Y + 0.33A - 0.23E + 1.37T \\ \quad\quad\;\; (-4.16) \;\; (3.36) \quad (4.74) \quad (-0.72) \quad (4.20) \end{array} \tag{1.2}$$

$$\overline{R}^2 = 0.39; \qquad N = 60$$

The sub-national government revenue share is significantly related to the level of economic development of the country, and to the size of the country. We cannot explain as much of the international variation as in the case of the expenditure shares, but the patterns are much the same.

The tax results for South Africa are quite different than the expenditure results. The level of sub-national government taxation in South Africa is considerably lower than would be predicted given the

Table 1.3 Fiscal decentralization effort across 22 African countries for the 1990s

Country	Decentralization	Predicted decentralization[a]	Decentralization effort[b]
Benin	2.9	4.4	0.7
Botswana	5.9	15.6	0.4
Burkina Faso	1.2	4.9	0.3
Cameroon	15.9	8.1	2.0
Cote d'Ivoire	3.2	7.6	0.4
Ethiopia	1.5	5.2	0.3
Ghana	4.1	5.5	0.7
Kenya	4.0	6.7	0.8
Madagascar	4.7	6.0	0.8
Mali	1.4	7.5	0.2
Mauritius	4.8	3.3	1.4
Morocco	15.0	10.3	1.5
Nigeria	28.9	6.9	4.2
Senegal	5.5	6.0	0.9
South Africa[c]	48.1	19.9	2.4
Swaziland	1.8	4.4	0.4
Togo	1.7	3.5	0.5
Trinidad and Tobago	4.4	4.7	0.9
Uganda	27.2	5.0	5.5
Zambia	3.2	7.8	0.4
Zimbabwe	10.7	7.8	1.4

Notes:
a. Predicted from equation (1.2).
b. Decentralization divided by predicted decentralization.
c. Data for South Africa are for the period 1994–1999.

Source: Basic data for this analysis are taken from International Monetary Fund (2001).

income level and size of the country. The actual value of 6 percent is well under the expected value of 14 percent. This 6 percent tax figure is also well below the actual expenditure level of 48 percent. This result reflects the limited revenue powers and significant expenditure responsibilities assigned to provincial governments. Though municipalities do raise most of their own revenues, they are the smallest sphere of government in the intergovernmental fiscal system.

Overall, these numbers suggest that the South African government is willing to deliver services through sub-national governments to a significant extent, but is much less willing to devolve revenue-raising powers. There are a number of explanations for this: a belief that control over macro-economic policy requires more central control over the revenue raising function, a focus on income distribution and a belief that this is best done through national government fiscal instruments, and an unwillingness to allow sub-national governments to 'compete' with the center for the same tax base.

There is an important qualification to these conclusions. The analysis is based on an international comparison of sub-national government taxes, which in South Africa includes both the provincial and local governments. It may well be the case that local governments are above the internationally expected levels, but this result is hidden because the provincial governments raise so little revenue. International comparisons of only local governments are not possible because of the lack of appropriate data and the wide variation in expenditure assignment between the middle and bottom tiers.

It is also important to recognize that these data can overstate the effort of a country toward fiscal decentralization. The expenditure and revenue shares of sub-national governments probably do not indicate the true degree of local budgetary discretion. This ratio measures only the degree to which public services are delivered by sub-national governments. There may be significant constraints in the form of centrally determined wages and salaries and other national mandates. On the revenue side, local discretion may be limited by conditional grants, and tax rates and bases may be outside the control of sub-national governments. In fact, in South Africa, the provincial governments, which account for two-thirds of sub-national government spending, do not have great discretion in determining the level of their budget and in practice make little use of the taxing powers that have been given to them. Hence the 49 percent share of sub-national governments in total government spending probably does overstate the collective degree of fiscal autonomy of the South African provincial and local governments.

Despite this overall conclusion, we can argue that the fiscal autonomy of the local government sphere in South Africa is greater than that in many other countries. The municipal governments as a group have more discretion to determine the size of their budgets than do the provincial governments, particularly those in the larger urban areas. The intergovernmental transfers to local governments are not very significant in size, and are mostly in the form of unconditional transfers. Local property taxation is relatively unconstrained, and in fact, South African local governments' use of property tax financing is high even by comparison with some Organization for Economic Cooperation and Development (OECD) countries. The RSC levy is more limited by national government rules in terms of rate and base determination, but collection is an initiative that is left to the local governments. We shall return in greater detail to the revenue situation of South African local governments in subsequent chapters.

THE FRAMEWORK FOR ANALYSIS

In moving forward with developing the intergovernmental fiscal system, the South African government must make a number of choices about the structure and objectives of the local government system. The most important choice concerns the assignment of municipal functions. The Constitution and various laws, as noted above, outline basic responsibilities of municipalities, but considerable elaboration is needed, particularly to accommodate the post-demarcation transition. The functions of category A municipalities are relatively clear, although decisions remain to be made about desired levels and appropriate costs of basic services. Moreover, the situation will change as new policies, such as the pending regionalization of electricity distribution and the devolution of health care services, are implemented in the coming years. Functional assignment is less clear for category B and C municipalities, which have widely divergent needs and expenditure delivery capacities. A Local Government Municipal Structures Act amendment in late 2000 assigned responsibility for certain municipal services to the Cs, but it is widely recognized by South African policymakers that some flexibility in assignment is needed to reflect the inter-jurisdictional variation in capacity.

The second important choice is how to raise local revenues. Municipalities have access to a variety of local revenue sources. Category A and B municipalities use property rates, while category A and C municipalities have the RSC levy. All municipalities can charge for services, and many introduce a general tax element into certain user charges. Several proposals have been set forth to reform the present structure. Some of these proposals would involve adjustments to existing taxes and methods of tax administration. Others would involve new arrangements. Depending on decisions regarding service assignments, proposed reforms could include category B municipalities sharing property rates with category Cs, and/or category C municipalities sharing RSC levy revenues with category Bs. This sharing would allow the revenue bases of municipalities to reflect the functions they are expected to undertake. Given the considerable service demands placed on municipalities, adoption of selected new revenue sources, such as motor vehicle taxes, might also be considered. Finally, the National Treasury is also placing considerable emphasis on increasing the capital market access of municipalities, at least fiscally stronger ones, so that they might play a greater role in financing infrastructure investments.

The third important choice has to do with the design of a transparent and stable intergovernmental transfer system. As in most countries, municipal service cost in South Africa often exceeds revenue capacity. The vertical fiscal gap has not been fully documented in South Africa. But to the extent a gap exists (see Chapter 6), a decision must be made about how to close it – by reducing service expectations, raising more local revenues, or increasing transfers. As noted above, the Constitution entitles local government to an 'equitable share' of national revenues, and it also allows for the use of other transfers. The equitable share formula has been based on the recurrent financing needs for selected basic services for poor residents of A and B municipalities. Although this approach has served a useful purpose, the equitable share system and the formula must evolve as the municipal fiscal system matures and as there is greater clarity about expenditure and revenue assignments and capacities. A decision to include the C municipalities in the equitable share distribution for the 2002–2003 fiscal year was made, and additional reforms to the intergovernmental grant system are inevitable. The National Treasury is also working on the consolidation of a complex and fragmented set of conditional capital transfers.

It is important to emphasize that these basic decisions about the intergovernmental fiscal system are interrelated. Service assignments should be based on the capacity of municipal governments, and revenue assignments should be consistent with expenditure responsibilities. Intergovernmental transfers should help to overcome the gap between municipal expenditure requirements and fiscal capacities, as well as to meet other national objectives. At the same time, key elements of both the expenditure and revenue systems need to work in harmony. For example, recurrent expenditures should be based on the operating requirements of existing infrastructure facilities, and intergovernmental transfers should not undermine incentives for municipalities to raise local revenues or to tap capital markets for investment resources.

Critical Choices that Reflect System Objectives

Embedded in these decisions about expenditure and revenue assignments and the structure of intergovernmental transfers are a number of critical choices related to broader system objectives. Throughout the chapters in this volume, we consider the implications of alternative policy options for these choices.

There is an important question about the desired degree of asymmetry in the treatment of municipalities. In a world where municipal governments have similar needs and capacities, uniform fiscal treatment is appropriate. In South Africa, however, there are differences among municipalities in terms of settlement patterns, service needs, revenue access, and capacities to perform effectively. Less dense rural jurisdictions, for example, have very different needs than more urbanized areas. Equally important, some of the legally empowered Cs have weak capacity, while some of the legally subsidiary Bs have long been providing services independently of the Cs. Service delivery also has various dimensions, such as the distinction between capital investment and service operation, which can in some cases be managed effectively by different categories of local government. In addition, it is possible to separate service responsibility and service provision, where the latter may be done on behalf of municipalities by private agents or by community groups at the settlement level. Finally, it is critical to distinguish between desired service responsibilities and what is currently possible given capacity constraints. The rules and guidelines for service delivery arrangements should take into consideration this substantial local government diversity, the multi-dimensionality of service delivery, and the gap between the desired system and present realities. This could well lead to an asymmetrical treatment of local governments in terms of expenditure assignment.

Another key issue is the extent and form of local autonomy, which defines how genuinely decentralized the system is. This is a complex matter in South Africa, where the Constitution mandates universal provision of basic services and gives municipalities access to revenues, but it also requires the national government to share a portion of its resources with local governments unconditionally, according to court interpretations. In an ideal decentralized world where municipalities were capable and accountable to their constituents, there would be a high degree of autonomy in both local expenditure and revenue decisions. Autonomous municipalities that failed to perform would be subject to the discipline of elections and a financial system that enforces fiscal discipline. Advocates of stronger local government fiscal autonomy might suggest that South African local governments are ready to accept a hard budget constraint. Alternatively, a case can be made that in the present South Africa, where many municipalities are just learning how to deliver services effectively and to function in a democratic environment, weaker municipalities should be required to meet certain standards before higher levels of local autonomy are allowed.

Finally, what is the desired degree and form of redistribution of income in South Africa, and what is the role of local governments in achieving this goal? What are the implications for the intergovernmental fiscal system? The decision, for example, that certain basic services should be provided at a minimum level throughout South Africa means that poorer municipalities require assistance to fund these mandates. To some extent, redistribution can be funded locally. For example a portion of property rates collected from wealthier areas in any municipality can be used to finance basic services in poorer neighborhoods. There are, however, constraints on this approach. From a national perspective, wealthier municipalities will be more able to effect intra-jurisdictional redistribution than their less-well-off counterparts. From a local perspective, ratepayers in wealthier areas of a particular municipality will not have an unlimited political tolerance for subsidizing services in the former black townships and rural areas. The way in which the national government structures municipal revenue sources and the intergovernmental transfer system will have substantial implications for the degree of redistribution that occurs.

The Rest of the Volume

With this framework and these choices in mind, the authors of the following chapters consider various dimensions of intergovernmental fiscal reform in South Africa.[17] In the second chapter, Larry Schroeder focuses on the current status of local government powers and functions, and the choices that need to be made to fully rationalize municipal service assignments. In Chapter 3, Roy Bahl, Paul Smoke, and David Solomon present an overview of the local government revenue system in South Africa and some of the reforms being considered. In Chapter 4, Peter Vaz takes a closer look at the structure and effects of the property tax, as well as proposed reforms to it. Roy Bahl and David Solomon evaluate in Chapter 5 the Regional Services Council levy and outline options for restructuring it. In Chapter 6, Andrew Reschovsky examines the present intergovernmental transfer system and considers how to further develop it as the expenditure and revenue assignment picture evolves. Finally, the contributors collectively conclude the volume with a review in Chapter 7 of options for local government fiscal reform in South Africa. In this chapter, we focus on implementation concerns and further highlight the relevance of the South Africa experience for other developing countries.

NOTES

1. Although each chapter in this volume can stand alone as an individual analysis, there was substantial coordination and integration of the work, which is based on a two-year policy research effort in which all of the authors participated. The basic research was carried out for the South African government under a contract between USAID and Research Triangle Institute. See the preface for additional information.
2. The theory of fiscal federalism is set forth in detail in Oates (1972). More recent reflections on theory and practice in the developing country setting are provided in Oates (1999); Bahl and Linn (1992); Shah (1994); Smoke (1994); Ter-Minassian (1997); Bird and Vaillancourt (1998); Bahl (2000); and Smoke (2001).
3. A number of recent writings have focused on the importance of implementation. These include: Bird and Vaillancourt (1998); Litvack, Ahmad, and Bird (1998); Vaz (1999); Bahl (2000); Smoke (2000); and Smoke (2001).
4. The history of local government in South Africa is examined in Ministry of Provincial Affairs and Constitutional Development (1998). Other useful references include: Manche (1994); Donian (1997); Financial and Fiscal Commission (1997); and Vaz (1999). A broader perspective on public sector reform in South Africa is provided in Cameron and Tapscott (2000).
5. For a good discussion of the early development of metropolitan local governments, see Ahmad (1996).
6. These structures are detailed in Ministry of Provincial Affairs and Constitutional Development (1998).
7. In the language of the Constitution, all sub-provincial governments are referred to as 'municipalities'.

8. Since demarcation, an additional ten district councils were added (including 'cross-border' DCs), bringing the total number to 57.
9. The information and data used here come from: Department of Constitutional Development (1997a); Department of Constitutional Development (1997b); Vaz (1999); and National Treasury (2001).
10. For example, the Local Government Transition Act (Second Amendment) assigns local governments the responsibility for integrated development planning.
11. Sections 229 and 230 of Chapter 13 of the Constitution (1996).
12. Section 227 of Chapter 13 of the Constitution (1996).
13. National Treasury (2001).
14. The provincial and local government share of total government expenditure reported for South Africa by the IMF (2001) is lower than that reported by the government (National Treasury, 2001, 2001a). The differences appear to be due primarily to the classification of local level expenditures, as is indicated by the following comparisons (in million rand) for fiscal year 1998–1999:

	IMF	Government
Central	133,788	117,074
Provincial	95,368	97,275
Local	25,915	54,800
Total	*255,071*	*269,149*

Under the IMF definition, the sub-national government expenditure share was 47.5 percent in 1999. Under the government definition, it was 56.5 percent in 1999.

15. The commonly used *Ethnic fractionalization index* is a probability that two randomly selected individuals will belong to different ethnic groups:

$$Fractionalization = 1 - \sum_{i}^{M}\left(\frac{n_i}{N}\right)^2$$

M = number of ethnic groups, N = total population, n_i = number of people who belong to i^{th} ethnic group. So, in our regression model, heterogeneity is measured as a probability that two randomly selected individuals will not belong to same ethnic group. In other words, it is analogous to one minus the Herfindahl index of concentration.

16. There are different views about how to measure the level of fiscal decentralization in South Africa. We have chosen to include debt service as a national government expenditure, and to include all intergovernmental transfers as sub-national government expenditures. Some analysts have made different choices about what to include, resulting in different distributions of expenditure shares between levels of government. (See also endnote 14.) The expenditure share measure reported here for South Africa is an average for the post-Constitution years 1994–1999.
17. Note that this work was conducted before, during and after the municipal demarcation that reduced the total number of local governments in 2000. Thus some portions of the field research and data analysis were conducted in the 'old' municipalities, while others were conducted in the 'new' municipalities. Where possible and relevant, we tried to convert the data based on the old municipal boundaries to data based on the new boundaries.

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