Intergovernmental Finance in South Africa: Some Observations

M. Govinda Rao

Abstract

This paper examines the evolution and functioning of fiscal decentralisation process and intergovernmental finance in the Republic of South Africa (RSA). It analyses the system of dividing revenues among the three spheres of government. The paper highlights the challenges of designing and implementing intergovernmental fiscal policies and institutions in the post-apartheid era.

The paper argues that the costed norms approach developed by the Financial and Fiscal Commission (FFC) has tremendous potential in evolving a simple, objective, and fair system of transfers. However, significant additional work in terms of research, its meaningful dissemination to various governmental units, and building the information system undertake the task is necessary to make it operational. The absence of revenue equalisation in the transfer system is an important weakness of the transfer design. However, provinces do not have much revenue powers. Revenue equalisation in the transfer formula is meaningful only when some broad-based tax handles are assigned to provinces. It is also an important moral and a policy question as to whether there should be incentive to raise revenues from sources such as, gambling taxes and hospital services.

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Introduction

This note deals with the analysis of intergovernmental fiscal system in the Republic of South Africa (RSA). It examines the evolution and functioning of the fiscal decentralisation process and analyses the system of dividing national revenues between the three spheres of government and effecting *inter-se* allocations within each of the three spheres. The note also attempts to identify the strengths and weaknesses of the system and highlights the challenges in designing and implementing the fiscal decentralisation and transfer system in the post-apartheid political regime. This examination is done keeping in the background the principles of, and the best practices in fiscal decentralisation intergovernmental fiscal system based on contemporary experiences.

Of particular emphasis in the note is the system of making vertical and horizontal division of national revenues. It argues that the "costed norms" approach to determining the division of revenues recommended by the Fiscal and Finance Commission (FFC) is in the right direction in terms of providing incentives and accountability and holds tremendous promise. The advantage of the approach lies in its ability to take account of multiple factors impacting on expenditure needs and cost disabilities of sub-national governments in providing public services assigned to them. In contrast, the prevailing practice of determining the allocations takes account of only selected and partial indicators of need, involves judgments in terms of the factors chosen and weights assigned. However, much more work needs to be done in terms of both building a proper information system to help identify the determinants of fiscal capacity and need and refining the methodology to estimate them to minimise subjectivity in allocations. Besides, it is also important to bring in the incentive elements by linking revenue – expenditure decisions at the margin in the transfer system. It is necessary to ensure that while the revenue sharing system is simple and formula based, it should be designed to address the principal objective of the transfer system namely, offsetting fiscal disabilities arising from deficiencies in revenue capacity and higher unit cost of providing public services in the case of general-purpose transfers and ensuring minimum standards of services in the case of specific purpose transfers.

Analysis of the intergovernmental fiscal system in the RSA is important for a variety of reasons. First, the troubled history of apartheid and the extreme inter-personal and inter-regional inequality and poverty has underlined the importance of instituting an efficient and a fair fiscal system. Second, fiscal decentralisation in RSA has been evolving drastically in the post-apartheid period. The large-scale reorganisation of boundaries at both provincial and municipal levels since the new constitution was adopted in 1996, and the change in the multilevel fiscal organisation seen in the country is unique. Alongside reorganisation, there has been a significant increase in the roles and responsibilities of sub national governments in providing public services. This has brought to the fore, the need to build institutional capacity for both raising revenues and implementing expenditure decisions at provisional and even more at municipal levels. Third, the fiscal arrangement involves designing and implementing general purpose and specific purpose transfer system. While the objective of the former is to provide opportunities to the residents in various jurisdictions to exercise their choices of public service levels and tax-prices, the latter should ensure minimum levels of 'meritorious' services in all jurisdictions. Besides there are non-economic objectives and that includes the nation-building role of intergovernmental finance. Therefore, it is necessary that the system should be objective, simple, and incentive compatible. In the post-apartheid era, both policies and institutions are being calibrated *de novo*, and the boundaries of the sub national governmental units are substantially redrawn and therefore, it is necessary to ensure incentives and accountability in the new system.

The design and implementation of the intergovernmental fiscal system in the RSA poses a number of important challenges. The first is to ensure delivery of essential public services to poorer households. Chapter 2 of the constitution expands on 'the Bill of Rights' according to which everyone should have access to adequate housing (section 26), health care, food, water and social security (section 27), basic and further education (section 29). It stipulates, "the State must take reasonable measures, within its resources, to achieve progressive realisation of each of these rights." The second major challenge arises from the redrawing of boundaries and significant organisational and transaction costs of delivering public services that go with it. Third, is of building capacity at sub national levels. This requires particular attention in local areas, more specifically in non-metropolitan municipalities. Equally important is the challenge of building a proper information system to enable efficient and equitable design and implementation of national revenue allocation on the one hand, and prioritisation of public service provision within each of the spheres on the other.

The paper is divided into five sections. In the second section the system of budgeting and intergovernmental fiscal arrangements including the role of FFC in RSA is critically reviewed. In section 3, challenges of designing appropriate general purpose and specific purpose transfer systems are analysed in the light of prevailing vertical and horizontal fiscal imbalances. Section 4 deals with possible areas of improvement and reform in designing and implementing the intergovernmental fiscal system in RSA. Finally, concluding remarks are summarised in the last section.

II. Intergovernmental Fiscal System in RSA

II.1. Assignment system:

South Africa has a unitary and yet, a highly decentralised system of government with three spheres[1] of government – the national government, nine provinces, and 284 local governments. The new government after it came to power restructured the intergovernmental system in keeping with the philosophy of ensuring equality of opportunity in the post apartheid regime. The four white provinces and nine black homelands were reorganised into nine provinces. Similarly, in 1995, local governments were reorganised into 843 transitional municipalities by combining the black and white areas and eventually in 2000, they were consolidated into 284 local government units comprising of six one tiered urban metropolitan governments, 232 primary municipalities falling under 46 district municipalities (Momoniat, 2002)[2]. It is the political and historical factors rather than purely fiscal considerations that have shaped the organisation of intergovernmental fiscal system in RSA.

Assignment of functions to the three spheres of government is done in the constitution itself. Accordingly, the national government looks after the criminal justice system (police, justice, prisons), defence, external affairs, higher education and such other functions with nation-wide spillovers. It also provides social services such as school education, health, welfare and housing concurrently with the provincial governments. While the national government determines the policies relating to these sectors, the provinces implement these policies in terms of actually providing the services. Provinces, in addition have the responsibility of constructing and maintaining provincial roads. Local governments have the responsibility of providing electricity, water sanitation, municipal administration, streets, streetlights, and garbage collection.

In terms of revenue assignment, the fiscal system in RSA has ruled in favour of fiscal uniformity, harmony and efficiency even as it meant lower fiscal autonomy to subnational governments. All broad-based taxes such as income and corporate taxes, VAT, excises, fuel levy and customs are assigned to the national government. Provinces can levy minor levies such as gambling taxes, motor car licence fees, and user fees on hospital services. In terms of the constitution, they can levy surcharge on personal income tax and fuel taxes but actually no province levies them. The local governments have substantially higher tax powers than provinces. Almost two-thirds of their expenditure requirements are met by their own sources of revenues. They can levy property taxes, turnover/payroll regional levies on businesses and user charges on electricity and water. Both provinces and local governments can borrow for bridging purposes or for financing capital expenditures. The provinces have borrowed only for bridging purposes mainly in the form of overdrafts. In the absence of national government guarantees, the local governments have not been able to borrow.

II. 2. Fiscal decentralisation:

The relative roles of the three spheres in raising revenues and implementing expenditure decisions are presented in Table 1. It is seen that provinces show overwhelming dependence on transfers. In 2001/02, they raised only 1.3 per cent of total revenues raised at all spheres of government and this could finance only about 3.2 per cent of their expenditures. Thus, provinces depended on national transfer system to finance about 97 per cent of their expenditures. In contrast, the local governments raised 22 per cent of total revenues and their own revenues could finance almost 79 per cent of their expenditures. The remaining expenditures were financed from transfers (9.7 per cent) from the national government and loans (11.5 per cent).

Table 1: Fiscal Decentralisation in South Africa

Bn. Rands

Sphere of govt.	Own revenue	Borrow-ing	Transfers	Expendi-ture	Per cent of own revenue in expendi-ture	Per cent of total revenue	Per cent of total expendi-ture
National	213.4	21.7	-115.2	73.7	100.0	78.46	28.83
Provincial	3.6	0	108.4	112.0	3.2	1.32	43.82
Local	55.0	8.0	6.8	69.8	78.8	20.22	27.31
total	272.0	29.7	0	255.6		100.0	100.0

* Excludes debt servicing of 46.2 Mill. Rands.
Note: Fiscal year for the national and provincial spheres is from April to March whereas for the local level, from July to June.

The actual expenditure allocation for the assigned functions is determined according to the targets and parameters determined by the Medium Term Expenditure Framework (MTEF). Allocation is made according to the three-year budget cycle consistent with the MTEF. This imparts a measure of stability to the budgeting process, enables a better link between policy and budget formulation and helps in planning the decisions on provision of public services better. At the same time, the multi-year budgeting brings in some degree of inflexibility and only marginal changes in the year-to-year allocations are possible in such a system.

The budget preparation involves vertical and horizontal division of national revenues. The total revenues collected by the national government net of debt servicing expenditures and contingency reserves are divided between the three spheres according to political judgements. The division of revenues between the spheres is done in terms of providing equitable shares of national revenue to the provinces and local governments and making conditional grants. Equitable shares of the spheres is determined by the cabinet and in taking this decision, the cabinet considers the recommendations of the Budget Council,[3] the Budget Forum, the Ministers' Committee on the Budget, the FFC and the recommendations of the Inter-governmental Division of Revenue Workshop. The prioritisation done in the MTEF provides the basis for the division of revenues between the spheres. Similarly conditional transfers are given to provinces for identified purposes for the prioritised schemes. There are seven schemes within the health sector mainly aimed at augmenting hospital facilities besides the integrated nutrition programme. There are two schemes in the education sector, three in housing, a flood disaster reconstruction scheme, and some aimed at augmenting the physical infrastructure and capacity building in financial management.

Horizontal distribution of national revenues assigned to provinces is determined on the basis of sets of factors laid down for seven (7) different expenditure functions (Table 1).[4] The baseline allocation to provinces as their distribution inter se has been done according to the policy and priorities determined in the MTEF and any changes in the allocation is possible only with additional resources if any, available for distribution. As already mentioned, the baseline allocation different provinces has already been done in the three year budget cycle and changes are introduced from year to year to take account of new information/data or any additional relevant considerations.

The equitable share from the national government to local governments is determined according to the formula based on the extent of poverty in the municipal areas. The basic package includes assistance to meet the cost of providing water, sanitation, and other municipal services for all households earning less than R, 800 per month. These services are estimated to cost R. 80 per month/ household. The local governments do not receive conditional transfers.

II.3. Financial and fiscal commission:

An important feature of the South African fiscal system is the institution of Financial and Fiscal Commission (FFC). The framework document of the FFC (1995) defines the FFC as “an independent and impartial statutory institution, accountable to the legislature, with the objective of contributing towards the creation and maintenance of an effective, equitable, and sustainable system of intergovernmental fiscal relations, rendering advice to legislatures regarding any financial and fiscal matter which has a bearing on intergovernmental fiscal relations.”

Table 2: Criteria for Inter-provincial Distribution of National Revenues

Sector	Weight assigned (percentage)	Variables chosen for distribution
1. Education	41	(i) Size of school age population (6-17years) (ii) Enrolment ratio
2. Health	19	Proportion of population without access to medical aid
3. Social security	17	Estimated number of persons entitled to social security payments (Old, disabled, and children weighed with poverty index derived from 1995 Income and expenditure survey.
4. Basic share	7	Population share of the province.
5. Backlog component	3	(i) Capital needs in the school register of needs (ii) Audit of hospital facilities (iii) Share of rural population.
6. Economic output component	8	Distribution of total remuneration in the country
7. Institutional component	5	Equal division among provinces

Source: Medium Term Budget Policy Statement, 2000. National Treasury, Republic of South Africa.

The constitutional mandate for the FFC is to make recommendations on:

- the system of sharing of revenues with the provinces;
- taxes, surcharges, and user charges to be imposed by provincial governments;
- borrowing by provincial and local governments;
- guarantees of loans to the provinces.

Section 214 of the constitution provides for the enactment of legislation to divide revenues equitably between national, provincial and local spheres every year. The process, however, requires the government to consult the FFC and Section 10(5) requires an explanatory memorandum in the Division of Revenue Bill to state how the FFC's annual recommendations have been taken account in the revenue allocation.

The FFC, in its recommendation covering the period of MTEF (2001-04), has adopted the "costed norms" approach to estimate expenditure needs of provinces. The cost of providing three basic services namely, basic education, primary health care and social security has been estimated using this approach. Normative cost of basic education is estimated by taking into account the cost differentials for different categories of actually enrolled students weighted with judgements on their differential resource needs. Special adjustment is made to reflect government's deemed policy with respect to funding inappropriate age learners. In estimating the resource requirements for primary health care, after taking the national per capita norms, cost disability arising from poverty is separately taken account of. The cost of providing health care is estimated by taking account of need differences due to different age and gender groups of population. Here again, cost disability due to poverty is taken account of. As regards welfare payments, the number of eligible individuals in respect of each of the six social security programs is taken into account and an administrative component is added to the estimate.

In addition to the three sectors, the FFC also estimated the cost of grant for all other services to be provided by the provinces and an institutional component – minimum cost of operating government institutions. The FFC did not consider fiscal capacity equalisation grant in its recommendations.

The government, however, has not accepted the recommendations for a number of reasons. First, in a multi-year budgeting framework within the MTEF, changing the methodology of the transfer system mid-way could bring in an element of instability to the budgets of sub national governments. Second, the bottom up approach implicit in the scheme is not considered appropriate to determine the priorities. Political judgements and trade-offs have to be exercised. Third, adopting costed norms approach to basic education, primary health care and social security tends to impart bias against other functions. Fourth, although in principle, the FFC has suggested that the approach can be used to make both vertical and horizontal distribution of revenues, this is not possible at the present stage of conceptual clarity and information availability. Finally, the data requirements for practicable application of the approach are enormous.

II. 4. Costed norms approach: an evaluation:

There is much to be said in favour of the costed norms approach that the FFC has applied and this certainly has the potential to be applied more generally to evolve a more scientific approach to fiscal transfer system in South Africa. Before highlighting the merits of the approach, it is useful to briefly point out the shortcomings of the approach currently adopted to distribute national revenues to the provinces and municipalities.

The major shortcoming in applying the approach at the present stage is that there is no information on the various relevant factors influencing expenditure needs for all the seven functions referred to earlier. Surely, some important factors have been considered, but these are not the only cost factors beyond the control of provinces. Each of the seven functions is constituted by different components of public services benefiting different target groups of population and therefore, standard of public services will have to judged in relation to these target groups. The costed norms approach takes into account multiple factors affecting both unit costs of the services provided and other factors affecting the quantity and quality of public services. The Australian Commonwealth Grants Commission has successfully been estimating expenditure needs in respect of a number of services provided in the states and the approach has received general acceptance.

Methodological improvement in estimating expenditure needs over the FFC's approach lies in two areas. First, instead of taking the cost disabilities exogenously based on judgements, it should be possible to employ multiple factors affecting cost, and standards of public services and take account of all cost factors which are beyond the control of provinces estimate. Cost disability can be estimated on the basis of actual expenditure differences in respect of individual functions across different provinces. Second, norms can be developed on the basis of actual expenditures by relating them to the factors affecting the quantity and quality of public services. Developing the norms on the basis of actual expenditure patterns has the advantage of being practicable for the norms will be based on the average behaviour of the States. The FFC for example, considers poverty ratio or rural-urban population ratio as cost disability factors. It is possible to estimate cost disabilities based on actual expenditures incurred and use these as weights rather than making judgements on them.

Estimation of expenditure needs by the Commonwealth Grants Commission in Australia based on actual cost disability factors[5] is conceptually similar to the approach adopted by the Ninth Finance Commission to estimate expenditure needs of the states in Indian federation (India, 1990). In Indian context, states' expenditures were disaggregated into three categories:

- those which can be related to public service provision in terms of cost, quantity and quality of public services;

- maintenance expenditures on items related to stock of assets (road and building maintenance, maintenance of irrigation works); and

- expenditure items that are purely random.

In the case of the first category, expenditure needs were estimated by relating per capita expenditures of various services in different States on cost, quantity and quality variables in cross section regression equations. Setting quantity and quality variables at normative levels and taking actual cost, expenditure requirements for providing normatively determined standards of services could be estimated. Expenditure requirement in respect of the latter was estimated on the stock of capital assets to be maintained. (expenditure on road maintenance was estimated on the basis of length of various types of roads).

Determining expenditure needs of states for education provides a useful example. In this case, the beneficiary age group of population, teacher - student ratio, ratio of administrative personnel to teachers and ratio of salary expenditures to total can be taken to represent the factors affecting the standard of the service whereas, the salary differences of teachers, density of population and urban-rural population ratio can be taken to indicate cost differences. This approach can be extended to cover a number of services.[6]

The expenditure requirement of the second category of services can be estimated by applying engineering norms. The example of this is the maintenance expenditures on roads, irrigation works and buildings.

The third category of expenditure relates to items like disaster relief. In these cases, the average expenditure of the last few years in real terms may be taken as norms.

The costed norms approach adopted by the FFC can be improved on these lines. There is a good scope to determine the norms using the regression analysis. As there are only nine (9) provinces, cross section estimate will be constrained by inadequate degrees of freedom. It is however, possible to overcome this problem by combining different cross sections observations in a covariance model. Of course, the approach is very data intensive and concerted efforts will have to be made to build the information system. That would add to the quality of decision-making and help in imparting greater objectivity to the transfer system.

Building an information system is critical to estimating expenditure requirements of local governments. The local government structure is still evolving. Although on an average they raise about 80 per cent of their expenditures, there are wide variations in the fiscal capacity among the municipalities. While the six metropolitan municipalities make up more than 50 per cent of total municipal budget and 20 biggest municipalities claim 80 per cent, most of the municipalities are very small with budgets less than R 100 million (Momoniat, 2002). Building a proper information system on the standards of municipal services, tax bases, own revenues including taxes and user charges is critical to developing an appropriate approach and methodology for determining the expenditure needs of municipalities.

III. Designing Intergovernmental Transfers

III.1. Conceptual issues:

The foregoing discussion on the intergovernmental fiscal system brings out a number of shortcomings of the transfer system in RSA. First, there is overwhelming dependence of provinces on the transfer system as they have hardly any revenue raising powers. Thus unconditional transfer is designed not to deal with offsetting revenue disabilities, but simply attempts to provide resources to meet the expenditure needs. Similarly, conditional transfers do not require matching contributions from the recipient. The total lack of link between revenue-expenditure decisions has both adverse incentives and accountability. At the municipal level, even though they have revenue raising powers, poor information inhibits evolving a scientific transfer system. While the FFC's attempt to develop the 'costed norms' approach is a significant improvement over the prevailing methodology, much needs to be done to evolve a transfer system that will promote equity, efficiency, and at the same time is incentive compatible.

This section deals with the conceptual issues of designing the transfer system in RSA, keeping in the background the principles of intergovernmental transfers and some of the best practices available. The emphasis is on evolving a conceptually a sound system of transfers to offset vertical and horizontal fiscal imbalances at both provincial and local spheres and to ensure minimum standards of meritorious services in them.

In the literature, arguments for general purpose transfers are made on horizontal equity grounds (Boadway and Flatters, 1982). Accordingly, economic objective of general purpose transfers is seen as enabling the sub national governmental units to provide a given normative bundle of public services at a given tax-price. Thus, the residents of various jurisdictions, irrespective of their location are able to receive their comparable bundle of public services by paying comparable tax rates.

Violation of horizontal equity in a multilevel fiscal system arises because of revenue and cost differences among different jurisdictions. While in some systems, the existence of origin based tax system can be a source of horizontal inequity, the principal reason for inequity is the differences in fiscal capacity among the jurisdictions. Thus, a poorer jurisdiction has to levy higher tax rates on its residents to provide the level of public services provide by its richer counterpart. To enable it to provide the same bundle at uniform tax rate, Central transfers would be necessary.

Another source of horizontal inequity arises from the differences in the unit cost of providing public services. If cost differences are due to factors within the control of sub national jurisdictions, there is no need to offset them. However, when cost differences are due to factors beyond their control, it is necessary to offset these differences through intergovernmental transfers. Thus, the objective of unconditional transfers is to offset the differences in fiscal capacity and unit cost of providing public services due to factors beyond the control of sub national jurisdictions.

III. 2. Lessons from experience:

In actual practice, however, there are very few countries that have designed unconditional transfers to offset revenue and cost disabilities. The closest to this ideal is in Australia where the relative shares of the states are determined on the basis of 'relativities' estimated by taking into account both revenue and cost disabilities. The equalisation payment in the Canadian transfer system only attempts to offset differences in fiscal capacity. The normative standard is set at the average of five-province capacity excluding the province of Alberta (high income with significant oil revenues) and the poorer eastern provinces. Among the developing countries, Indian transfer system comprises central tax devolution and giving grants to states. The distribution of central tax revenues to states is not done according to direct measures of revenue and cost disabilities, but the formula includes the factors that are assumed to be determinants of capacities and needs of the states such as population, per capita income and area.[7]

III. 3. Designing a transfer system in RSA: important issues

There are significant differences among the provinces in terms of their economic characteristics to case variations in the ability to raise taxes, even from the few handles assigned to them. At one extreme is the province of Gauteng with the highest mean monthly household expenditure (R. 4270), which is over 2.5 times the expenditure in the poorest province of Eastern Cape. Gauteng also has the highest human development index, lowest poverty ratio and highest degree of urbanisation. As in the case of mean monthly household expenditures there are significant variations in human development index, urbanisation as well as poverty ratio among provinces. This implies that there are significant differences in the ability to raise revenues among the provinces.

A major shortcoming of the transfer system in RSA is that it does not consider the revenue side of the provinces or municipalities in its design and takes account of the estimates of 'expenditure needs' for the assigned functions in its design of unconditional transfers. The principal reason for this is that provinces do not have much revenue raising powers. The provinces can raise revenues from only from motorcar licence fees, betting taxes in casinos and horseracing, and hospital fees. Although they have the power to levy surcharge on the national income tax, they have not exercised this power. Unless provinces are assigned more important tax powers, it does not make much sense to design the transfer system to offset fiscal capacity differences. To that extent, inequities arising from fiscal capacity differences among provinces will continue.

It is important to explore additional revenue handles for provinces in South Africa to augment their own revenue raising capacity. Linking revenue raising and expenditure decisions at the margin is important for reasons of efficiency and accountability. Unless the provinces raise substantial part of the revenues to finance public services provided by them, they may not get a sense of ownership and accountability to the taxpayers. Of course, there could be a trade off between fiscal autonomy and efficiency in the tax system. And the decision to provide additional tax powers to provinces should be weighed against the possible efficiency loss due to tax competition and disharmony. Perhaps incentive should be provided to the provinces to levy surcharge on income tax. Another possible source is a piggyback levy on VAT. In terms of the new tax handle, a possible source that may be assigned to provinces is stamp duty on transfer of property.

Table 3: Selected Economic Indicators of Provinces

Province	Per cent urban population 1999	Mean monthly household expenditure (Rand) 1996	Poverty rate (%) 1996	Human developm ent index 1996
Western Cape	88.9	3816	0.12	0.727
Northern Cape	68.8	2396	0.35	0.648
Free State	70.5	1819	0.48	0.650
Eastern Cape	33.2	1702	0.48	0.603
KwaZulu Natal	46.3	2579	0.26	0.623
Mpurnalanga	40.3	2394	0.25	0.626
Northern Province	11.6	1855	0.38	0.566
Gauteng	96.5	4270	0.12	0.727
North West	36.6	2137	0.37	0.615
South Africa	53.9	-		0.672

Source: Intergovernmental Fiscal Review, 2000, Republic of South Africa – National Treasury, October, 2000.

Even with the prevailing assignment system, it would be useful to develop the information system and appropriate methodology for estimating the taxable capacity of provinces. The representative tax system approach could be employed to estimate the relative taxable capacity effort. The data requirements for employing this methodology include information on the tax bases or their proxies and revenue from each of the sources. Australian and Canadian federations have done considerable work in estimating revenue capacity and effort in these federations and it should be possible to adopt this with appropriate modifications to take into account the nature of the taxes levied and information availability.

Another issue relevant for discussion at the provincial level relates to the conditional transfers. At present, as the provinces do not have adequate tax powers, entire spending requirement of the selected functions is given by way of transfers. It may be necessary to incentives the conditional transfer system by requiring matching contributions from the provinces. Even if the matching requirement is kept at 10-15 per cent of the cost of the scheme, it would provide incentives to raise revenues and provide a sense of ownership and participation in the service delivery.

III. 4. Fiscal capacity differences among municipalities:

As mentioned earlier, in contrast to provinces, the municipalities have significant powers to raise their own revenues from property taxes, turnover/payroll levies on businesses and user charges on electricity and water provided to the residents. The municipalities raise almost 20 per cent of total revenue collections in the country and this finances 78 per cent of their expenditures.

It appears, fiscal capacity differences between municipalities are much more than between the provinces. This is natural, given the troubled history of the country and race segregation that went with the apartheid regime. Although attempts have been made to restructure the municipalities combining the previously demarcated black and white areas, the six metropolitan municipalities account for more than 50 per cent of the aggregated local budget and the twenty biggest municipalities account for 80 per cent. Most municipalities are very small with budgets less than R 100 million.

Unfortunately, paucity of information makes it difficult to get a clear picture of fiscal capacity differences, the structure and operation of property taxes and ability of the municipalities to collect proper user charges on electricity and eater supply from the consumers. Nor is there any information on differences in institutional capacity to administer taxes and provide public services. It is extremely important collect information on taxes, user charges and the value of the tax bases to understand the degree of horizontal imbalances among the municipalities in RSA.

As mentioned earlier, conceptually, it is important to offset both revenue and cost disabilities in designing a proper transfer system at both provincial and municipal spheres. This calls for building up proper information system required to estimate differences in fiscal capacity and cost disabilities across different provinces and municipalities. The standard methodology available for estimating fiscal policy can be modified to apply to particular situation obtaining in RSA. However, the viability of any approach ultimately depends on the availability of quality information on various tax bases and variables representing cost and standards of public services on the other.

V. Concluding Remarks

The shaping of intergovernmental system and fiscal arrangements between the three spheres of government in RSA is at an important stage of evolution. The drastic measures have been taken to restructure the boundaries and provide meaningful roles to sub national levels of government in the provision of public services. It is important to evolve a simple, fair, objective and equitable system of intergovernmental fiscal arrangements to enable the system to play the critical role of nation building in RSA. The paper has attempted to identify a number of important issues that should be addressed in the short and medium term to enable the intergovernmental fiscal system to play such a constructive role. These are summarised in the following:

- The costed norms approach developed by the FFC has tremendous potential in evolving a simple, objective and fair system of transfers. This is distinctly superior to the prevailing approach to distributing transfers. However, significant additional work in terms of research and building the information system should be undertaken to make it operational.

- It is possible to evolve the norms on the basis of existing information instead of making normative judgements. Of course, judgements are unavoidable in any normative schemes of transfers, developing the norms based on the actual fiscal values will make evaluation based on the relative performances rather than externally imposed judgements.

- An important pre-requisite for adopting the costed norms approach and extending it to assess the expenditure requirements of municipalities is the building of reliable information system. The data requirements for this is enormous and concerted effort must be made to identify and collect data relating to general economic, demographic conditions as well as tax bases and service levels in different provinces and municipalities. Building of information system is critical to evolving a scientific and acceptable methodology for evolving intergovernmental transfer system.

- The absence of revenue equalisation component in the transfer system has taken the attention away from the need to augment revenues at sub national spheres. Revenue equalisation is necessary not only for creating a building in proper incentive structure in the transfer system but also to ensure better accountability to voters and to avoid the 'free-riding' problem. It is also necessary to identify additional sources of revenue to the provinces so that their reliance on the transfers is reduced to forge a better linkage between revenue and expenditure decisions.

- There is a need to consolidate conditional transfers by identifying clear goals and targets. It may also be appropriate to incentives the conditional transfers by requiring matching contributions from recipient governments. At present, most of the conditional transfers are in the health sector or for infrastructure development. Given the significant poverty levels in particularly poorer municipalities, it may be necessary to evolve direct anti-poverty interventions through specific purpose transfers on the lines of "food for work" program.

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End Notes

[1] The vertical division of the intergovernmental system is made in terms of "spheres" rather than tiers to denote that the levels are distinct governments – each accountable to its elected legislature or council. *See*, Republic of South Africa (2001).

[2] For an interesting account of the transitional issues, *see*, Ahmad (1998).

[3] Budget Council is constituted by the national and provincial ministers of finance. Budget Forum consists of members of Budget Council and the national and provincial chairpersons of local government associations.

[4] The formula involving the 10 factors were adopted based on the recommendation of the Financial and Fiscal Commission in 1996.

[5] *See* Rye and Searle (1997).

[6] There can be problems of endogeneity of explanatory variables and single equation models may be biased. But it should be possible to estimate the needs based on simultaneous equation models. It would be useful to estimate the equation using both approaches and see the differences in the need estimates. Single equation approach has the advantage of simplicity.

[7] For a critical analysis of Indian transfer system, *see*, Rao (2002).