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# Fiscal decentralization: Lessons for South Africa

Roy Bahl

## Introduction

What is the best arrangement of fiscal powers and responsibilities between the different levels of government? This is a question at the center of policy debate in countries around the world (Bird, 1993). It is not an issue restricted to big countries, as many believe. Though it is an important concern in China and the United States, it is also under study in Nicaragua and the Baltics. Nor is it restricted to higher income countries - it is presently a major concern in Russia, India and the United States. Some countries answer the fiscal balance question with new policy thrusts, some with newly elected politicians with different views, and some even attempt to solve the issue by means of force.

If the question of the proper fiscal balance between central and subnational governments is more important in any particular setting, it is in the developing and transition countries. These nations are torn between trying to control unstable economies and trying to invest more decision making power in populations that have long been disenfranchised. Interest has been heightened in recent years because of the trend toward popularly elected provincial and local councils, and the improved technical ability of local governments to deliver and finance services. Yet many of these countries, facing budget deficits and pressure on prices, recognize that fiscal decentralization could impose a considerable cost and perhaps even an economic risk.

The concern about the division of fiscal powers among levels of government has come to be discussed under the heading of intergovernmental fiscal relations, a subject that many associate with the issue of revenue sharing. In fact, it involves far more. Intergovernmental fiscal relations also includes the assignment of taxing powers and expenditure responsibility, the method of transfers between levels of government (both central-state and state-local), borrowing powers, local autonomy in taxing and budgeting decisions, and many civil service issues. It is a big set of issues, and most are politically charged.

This paper is about the costs and benefits of fiscal decentralization, and the practice. It is less about South Africa *per se*, but there are important lessons to be learned from the experience elsewhere. The next section of this paper deals with the advantages and disadvantages of decentralization (vs the alternative of continued fiscal centralization). We turn then to the issue of the assignment of revenues, methods of intergovernmental transfers, and finally to some general rules that might guide planning for fiscal decentralization in South Africa.

## Theory and fiscal decentralization

Fiscal decentralization has to do with the degree of fiscal autonomy and responsibility given to subnational governments. It is a subject on the policy agenda in many developing, transition, and industrialized countries. There always has been a cry for more decentralization of government, resulting from a combination of people wanting to get more involved in the process of government and the inability of central governments to "get the job done".

Yet, many countries around the world have remained highly centralized and have been loathe to relinquish any taxing and spending powers to lower level governments. Others have moved toward more decentralized structures in the past two decades, but quite different paths have been taken. China and Russia are examples of countries that have been decentralizing the flow of resources; that is, subnational governments have been claiming an increasing share (Bahl, 1994a; Bahl and Wallich, 1992; Bahl and Wallich, 1995). Current policy in China, however, seems to be in the direction of finding a way to reclaim a larger share for the Center. In the United States, policy and practice have been in the direction of cutting the dependence of the state and local sector on the federal government. Unlike the U.S., neither China nor Russia has granted taxing autonomy to their subnational units of government.

Empirical research has shown that countries that have given greater fiscal powers to their state and local units tend to be higher income and further along in the development process, larger in population and land area, and to have a more heterogeneous mix in their populations. It also has shown that countries at war or threatened by war or civil unrest tend to be more centralized (Bahl and Nath). By these criteria, South Africa would seem to be a candidate for a greater degree of fiscal decentralization.

Another way to examine the determinants of fiscal decentralization is to consider the *a priori* reasons why a country might choose decentralization of its fiscal structure, i.e., the theory of fiscal federalism (Oates, 1972). These might be thought of, as below, as the advantages and disadvantages of fiscal decentralization.

## Advantages of decentralization

Economists invoke an efficiency criteria in arguing for smaller local government, i.e., in arguing for fiscal decentralization. If preferences for public services differ across subgroups of the population, and if externalities are not present, then national welfare is maximized if local communities vote their preferences and provide the level and mix of public services that they want.

Non-economists might take the same view, but couch it in different terms: getting government closer to the people will lead to more participation in government, will likely provide an outcome that is closest to the preferences of the median voter, and will allow the political process to guarantee a more efficient operation of local government. Either way, the results should be the same:

- The mix of services provided will match the demands of the local population.

- Government officials will become more accountable to voters for the quality of services they provide.
- Local populations will be more willing to pay for public services, since their preferences will be honoured.

A second argument for fiscal decentralization, not often made, is that it can enhance revenue mobilization. Some taxes are suited to local government in that their assessment and collection requires familiarity with the local economy and population, and because they are perceived as quasi-benefit charges that finance local services. The property tax and other land based taxes are usually thought of as local government taxes. It is also true that central government value-added and income taxes often do not reach smaller enterprises. Typically, small firms are legally exempt from income tax and VAT for administrative reasons. Workers outside the formal sector often escape taxation because the administrative apparatus cannot find them. Local governments, it could be argued, might be able to capture this untapped fiscal capacity because of their greater familiarity with the local tax base.

Are these arguments, particularly the efficiency argument, really valid? Can local governments actually respond to citizens' preferences for more or few local services, or to a willingness to pay more tax to receive local services? In fact, the efficiency case for fiscal decentralization is much stronger in industrial than in developing or transition countries. Consider first the notion that moving service provision closer to the people can lead to gains in the welfare of consumer-voters. Because the theory of fiscal assignment was developed in industrial countries, it was heavily influenced by democratic processes of budgetmaking, for example, the median voter theories of public expenditure determination. In this model, the level of tax effort and the expenditure mix in local areas are responsive to changes in relative prices and income, and the potential losses in efficiency caused by interference from a higher level of government can be substantial (as can the potential efficiency gains from the greater fiscal autonomy of local government). Although the model is based on a number of simplifying assumptions, empirical research has shown that the behavior of U.S. state and local governments more or less squares with it (Bocherdering and Deacon, 1972).

The assumptions and this general model do not so easily fit developing or transition countries, however, and the efficiency gains from decentralization therefore may not be so great. This is partly because voter preferences are not as readily translated into budget outcomes as in industrial countries. Local councils are often not elected, chief officials are often not locally appointed, and adjustments in the allocation of local resources are often severely constrained by central government controls. These controls include approval of the budget, central appointment of chief local government officers, central government regulation of tax administration, mandates as to salary levels of local government employees, and the general absence of a mechanism by which local voters can reveal their preferences for a larger or smaller government. In this setting - where the devolution of revenue authority and expenditure responsibility is not accompanied by a relaxation of central government control over local fiscal decision making - there is less to be gained from decentralization of taxes and expenditure than would be the case in industrial

countries.

Given this state of affairs, the situation in a transition country which could give maximum gains from a more decentralized local government structure would include: (a) enough skilled labor, access to materials, and capital to expand public service delivery when desired, (b) an efficient tax administration, (c) taxing power sufficient to capture significant portions of community income increments, (d) an income-elastic demand for public services, (e) popularly elected local officials, and (f) some local discretion in shaping the budget and setting the tax rate. This list suggests that the setting for decentralization is clearly present in most industrialized countries, but often is not present in transition and developing countries. Where these conditions are present in lower income and transition countries, it is usually in the wealthier provinces. This suggests that fiscal decentralization initiatives might have their best chance of success in the higher income regions and might initially be limited to such places. This would not likely be a politically popular feature of a decentralization reform movement.

## Advantages of centralization

The arguments for fiscal centralization, on the other hand, are stronger in transition and developing than in industrial countries. History has shown that stabilization policy is an especially important concern in developing economies and in those economies that are in transition to a capitalist system. This argues for central government control of the main fiscal instruments (taxation, spending, and borrowing). Under a highly decentralized system where the local governments have a built-in claim on a share of total revenues raised, the central government will find itself in a difficult position insofar as increasing revenues to reduce the total deficit is concerned, or passing structural tax reforms that might be aimed at stimulating savings or reducing imports. By the same token, controlling inflation by limiting government spending may be compromised if local governments have the power to set their own budgets.

A related issue is the relationship between control of the central government budget deficit and intergovernmental fiscal relations. Where the central government has power over all the major fiscal instruments, it can target on an acceptable level of the deficit and control this with either tax increases or expenditure control. In more decentralized countries, central governments experiencing deficits are tempted to try and off-load their shortfalls onto local governments by reducing grants or other subsidies. This is the case in the United States in the past few years, and in present day Russia. Countries with chronic deficit problems would do well to avoid the dilemma of policy makers being unable to disentangle the question of what to do about the central deficit from the question of what is the right fiscal balance between the central and local governments.

In transition countries that are undergoing privatization and building a public and industrial infrastructure, the need for a coherent investment policy is also an argument for fiscal centralization, because capital resources are scarce and must be controlled by the central government to maximize returns. If local governments are given access to major tax bases, they may compete with the central government and therefore limit the

amount available for the central tax. As a corollary, centralization allows the national government to allocate fiscal resources to goods and services with national benefits, whereas local autonomy would inevitably lead to greater expenditures on those services that have more local benefits. Several arguments for income distribution also support fiscal centralization. The most important is that regional (and rural-urban) disparities in income and wealth may be accentuated by fiscal decentralization because wealthier urban governments will benefit most from greater local taxing powers. Centralization allows the national government more discretion in shaping regional differences in levels of public service and taxation, which is an especially important consideration for governments that intend to use tax and subsidy policy to shape the spatial distribution of economic development. China, Russia, and the U.S. are all characterized by significant fiscal disparities. China and Russia in particular have faced difficult choices as regards equalization. China was forced to choose between funneling more resources to the lower income provinces and leaving the revenues in the higher income coastal provinces. Russia has faced the difficult decision of choosing among equalization, central government fiscal solvency, and appeasing the potential breakaway provinces. In both cases, the central government retained control over the fiscal resources and was in a position to make the important policy decision. The U.S. federal government is in much less of a position to affect a regional redistribution of resources, since it directly collects only about 60 percent of revenues.

## Assignment of revenues

There is not uniform agreement among policy makers about which taxes should be assigned to which level of government (Musgrave, 1983; McLure, 1994, Oates, 1993). But three general principals that might guide decisions on this questions are:

- Local governments should be assigned taxes whose burdens are local, i.e., are not easily exported to residents who do not benefit from the local services that are being financed by the revenues raised,
- Local Governments should not levy taxes that cause businesses to adopt inefficient methods of doing business that might harm the growth in the local (and national) economy,
- Local governments should not levy taxes that impose heavy administrative and compliance costs.

### Value Added Tax

The value added tax is unsuitable for use by local governments. It must be a central government tax. A primary reason for this rule is that administration would become hopelessly complicated if each local government were permitted to set its own standards for creditable and non-creditable transactions, set its own tax rates, and follow its own methods of administration. Moreover, local governments would almost certainly attempt to arrange protectionist-type safeguards to keep more of the revenue in the home province. They could do this by placing penalties on purchases from "foreign" suppliers.

Even if the VAT is held to a uniform national rate and base structure, it is not suitable for sharing on a derivation basis, i.e., a system whereby each local government retains all or a share of what is collected within its boundaries. This is because some resource rich and processing areas would benefit greatly while those who export would be in the zero-rated zone and would collect little net revenue (McLure, 1994). China and Russia do share the VAT between the Central and Provincial governments on a derivation basis, but the problems are mitigated because in both countries the tax is collected by a central tax service, and in China, at least, the zero rating credits are paid by the central government. Even so, protectionist policies have arisen in some Chinese provinces.

## Business income tax

Corporate income taxes can be used by sub-national governments, and are in fact used by 41 of the 50 U.S. states. However, this tax fails all three tests suggested above: it imposes a high compliance cost, it causes firms to adopt inefficient practices to avoid taxation, and it offers the opportunity for one state to export its tax burden to (non-benefitting) capital owners, workers and residents in other states.

The use of a subnational corporate income tax requires that the provinces use a formula to allocate taxable profits among the provinces where the corporation operates. This introduces enormous administrative and compliance costs, and if states have different tax rates, it opens the door for transfer pricing to reduce overall tax liability. In many developing and transition countries, the problems of formula allocation have not yet arisen because enterprises tend to operate in a single province. Russia, China and the Eastern European countries are examples. But as multi-province operations begin to emerge, the practice of separate accounting for each enterprise location will no longer be possible, and the complexities that plague the provincial level company income tax will become apparent (Bahl, 1994a).

The appeal of the corporate income tax is that it can yield significant revenue, though in Russia and China it has dwindled as a revenue source (Hofman, 1993; and Bahl and Wallace, 1994). It is a particularly difficult revenue source for transition countries because the process of privatization and the switch to a market-driven economy may compromise enterprise profits significantly. Moreover, the corporate income tax can be quite cyclical in its flow of revenues, and this is undesirable if the local governments are responsible for essential public services.

## Individual income tax

The individual income tax meets most of the tests for a good provincial (or local) level tax. First, it can be relatively easy to administer to the extent it focuses on payroll employment, and it can be linked to the central government income tax bases. Most of the American states do choose the same definition of gross income as does the federal government, and there is cooperation between the two levels of government in the administration of the tax. Second, the individual income tax is resident based, and therefore

the burdens may be thought to fall mostly in the levying jurisdiction, i.e., there is a correspondence between where the tax is paid, and where the benefits from the public services financed by this tax are received. An advantage of the individual income tax, of course, is that it can yield quite a significant amount of revenue. In addition, it is more stable in yield than is the company tax.

All would not agree with the conclusion that the individual income tax is a proper source of revenue for local governments. The following are among the criticisms most often levelled: it is often seen as an instrument that may be used to shape the distribution of income; income distribution is a central and not a local responsibility, and therefore this instrument should be left to the central government; anyway, local governments may choose tax rate structures that will offset some of the progressivity intentions of the center. Some former eastern bloc countries overcome this problem by having a uniform rate and base structure that is centrally determined, but revenues that are shared with the local governments.

The individual income tax is an effective instrument of stabilization policy, i.e., it can be cut in times of recession to stimulate economic activity, etc. Local governments are notorious for behaving in a countercyclical way to cover deficits, and their use of the individual income tax may compromise central government policies. This has created problems in the United States where state and local governments regularly raise tax rates during periods of economic contraction. There is not always a perfect correspondence between where one pays taxes and where one receives public service benefits. In the United States, commuters into the central city often reside in another taxing jurisdiction. To compensate for this, U.S. cities often have a local income tax on both commuters and residents. In Russia, the individual income tax is returned 100 percent to the local governments, but all to the place of employment and none to the place of residence. As labor mobility increases and housing becomes less dear, this will become a significant problem with the individual income tax sharing in Russia.

There are major administrative problems with taxing the self employed. In transition countries the tax is usually collected by the enterprises as withholdings, and small businesses are not easily identified and audited. Most developing and transition countries are forced to live with this exclusion from the tax base, which creates a revenue loss and a significant source of unfairness in taxation. In transition countries, central decisions about wage rates and other limitations on the compensation of employees may compromise the yield of the individual income tax.

## Foreign trade taxes

There is little disagreement but that taxes on international trade should be assigned to the central government (McLure, 1994; Musgrave, 1983). Local governments should not be allowed to set tariffs or export tax rates or decide what to exempt, for obvious reasons. Sharing on a derivation basis would likewise be inappropriate, because the revenues would accrue to the Port cities. There are few examples of local governments having any significant claim on revenues from international trade taxes.

## Retail sales taxes

The flat rate ad valorem tax on retail sales, commonly used by state and local governments in the United States, also meets the tests of a good local tax. The burden mostly falls in the taxing jurisdiction (most business purchases are exempt), and administration is relatively straightforward. The revenue yield is quite significant. In 1992, retail sales taxes accounted for 14 percent of all state and local government revenue in the U.S. (ACIR, 1994). The elasticity of the retail sales tax remains near unity, i.e., revenues grow about in proportion to personal income.

But there are problems with the retail sales tax as a local government revenue source, especially in the transition and developing countries. The most important problem is administration. Where there is a proliferation of small shops, whose books of account are irregular, and where modern cash register equipment is not present, collection and audit become difficult. Second, the coverage of the retail sales tax is narrow and in the United States most services are not taxed. This is because of the difficulties of tracking interstate transactions, the difficulties of separating business input purchases from individual purchases, and of course politics. It leads to an erosion of the tax base and a horizontal inequity as regards the treatment of those with different consumption patterns (Snell, 1993).

## User charges

Clearly local governments should rely more heavily on benefit and user charges. Charges for locally provided services are efficient, and they are relatively easily administered. Revenues can be significant. In the United States, user charges accounted for about 14 percent of total state and local government revenues in 1992 (ACIR, 1994).

The problem with user charges in transition and developing countries is that essential services - where user charge potential is greatest - are often provided at subsidized rates. In China and Russia, public transit, utilities and housing are not self-sustaining and in fact are part of national wage policy. The same is true in most developing countries where the low income population is substantial, and where affordability (and politics) are major problems. Bird (1993, p. 212) notes that "The potential for improved user charge finance as a means of financing local government thus remains more potential than reality".

## Commercial ventures

Many transition countries still use commercial ventures as a source of revenue raising for subnational governments. This meets none of the tests of a good local tax. The tax burden is divorced from where the benefits are received, government competes (unfairly) with the private sector, and administration becomes difficult when government is both owner and regulator.

## Property tax

The residential property tax is perhaps the ideal local tax in many ways. It is a rough form of benefit charge since land owners are primary beneficiaries from most local services. It is a tax best administered by local governments since it requires identification of each parcel of land, identification of each new improvement, and identification of changes in ownership. Clearly the tracking of such changes is well beyond the reach of the central government. The property tax accounted for 18 percent of all state and local government revenue in the United States in 1992, but 30 percent of the revenues of local governments in the same year (ACIR, 1994). On the other hand, few countries in the world approach this intensity of use of the property tax. And there are good reasons for this. Administration of the tax is difficult, especially in the transition countries where the identification of property ownership is difficult. Moreover, there is a major problem with valuation of property, especially where the tax base is defined to include improvements as well as land. Finally, many if not most governments are loathe to strictly enforce the property tax by seizing property. The result is that the yield of the property tax is rarely more than one percent of total national revenues.

The property tax in the United States is widely unpopular and has been the source of a taxpayer revolt. In most states it is subject to limits on its growth, and many wonder if it can continue to be the mainstay of education finance in the U.S. (Snell, chapter 9).

## Borrowing

There is a strong case for local government borrowing to finance capital projects. These projects have a long life; hence it is reasonable that they be paid for as they are used up. Not to allow this form of financing is to introduce a bias against capital spending and in favor of consumptions spending, which is not likely a policy in the interest of most local governments in low income or transition countries. Moreover, the higher income local governments have an ability to repay loans, either through taxes or user charges, and it seems reasonable to substitute loan for grant-financed capital projects.

## Conclusions

The assignment of revenue sources to local governments is a difficult problem at best. It has been made more difficult by the growth in the VAT as a major source of government revenue around the world. The VAT is not suitable for local governments, as a local source revenue or as a shared revenue. Neither are foreign trade taxes, commercial ventures, or the business income tax. Arguably the best sources of local government revenue are the individual income tax, the property tax and user charges. Retail sales taxes can also work, but only in more industrialized countries that possess the administrative infrastructure necessary to assess and collect the tax. Higher income local governments should be given borrowing powers for capital project financing.

## Intergovernmental transfers

Transfers are a compromise solution in the debate over the division of revenue-raising authority and expenditure responsibility. They permit national governments to retain the authority to tax productive resources bases, but guarantee state and local governments a flow of revenues. A system of grants is a step toward fiscal decentralization in that it finances local government services, but the degree of autonomy it gives local governments in making their budget decisions depends on the structure of the grant system.

### Taxonomy of grant systems

Grant distribution systems have two dimensions: the method of determining the size of the divisible pool and the method of determining the distribution among subnational governments. (See Table 1). Consider first the determination of the total amount to be distributed in a given year (i.e., the divisible pool). The current practice in developing countries suggests three basic approaches: a specified share of national government tax revenues; an ad hoc decision (such as an annual appropriation voted by a parliament); or reimbursement of approved expenditures. Once the amount of the pool is determined, allocations among local governments are typically made in four ways: by returning shares to the jurisdictions from which the taxes were collected (i.e., using a derivation principle); by formula; ad hoc; or by reimbursing costs.

This two-way classification gives a taxonomy of twelve grant "types." The eight types that seem more or less common in transition and developing countries are displayed in Table 1.

**Table 1**
**Alternative forms of intergovernmental grant programmes**
**Method of determining the total divisible pool**

| Method of allocating the divisible pool among eligible units | Specified share of national or state expenditures | Ad hoc decision | Reimbursement of approved government tax |
|---|---|---|---|
| Origin of collection of the tax (Derivation) | A | | |
| Formula | B | F | |
| Total or partial reimbursement of costs | C | G | K |
| Ad hoc | D | H | |

Type A is a shared grant in terms of both the determination of the pool and its allocation among jurisdictions; these funds are usually not earmarked. Types B and D are probably the most common. The pool is determined as a share of a national or state tax and is then allocated by formula or on an ad hoc basis. For types F and G, the pool is determined in an ad hoc manner (usually on a political basis) as part of the national government's regular budgeting process. For type F, the allocation is by formula, whereas for type H, it is purely ad hoc.

## The pure shared tax

The purest form of shared tax (type A grants) requires that some proportion of the amount collected in the jurisdiction of a local government be returned to that local government (i.e., that a derivation principle of revenue sharing be applied). The national or regional government deducts a fee for collection, usually a specified percentage of total receipts. Under this system, the local government has no control over the determination of rate and base. Type A is thus an intergovernmental transfer and not an assigned local tax.

Why would a shared tax be used instead of an outright grant or a local tax? There are at least three reasons. First, the national government may be pursuing a *bona fide* program of fiscal decentralization, intent on guaranteeing the subnational government some share of locally generated revenues. Brazil designates shares of the value added tax (VAT) for state and local governments; Colombia shares beer tax revenues with Bogota and the departments; Malaysia has shared excise taxes on petroleum with the states; the Chinese central, provincial, and local governments share the revenues from income and sales taxes; and the Russian federal and subnational governments share income and value added taxes. Second, the national government may see the need to mobilize more resources from local tax bases, thinking that local governments do not have the administrative capacity or political will to carry it off. Third, the government may want - through shared taxes rather than independent local taxes - to keep open a line of fiscal control while quieting somewhat the calls for a better vertical fiscal balance.

There are three important advantages to pure shared taxes (type A). First, by comparison with allocation by formula or ad hoc arrangement, the amount of transfer to the local unit is certain and the fiscal planning of local governments is improved by this certainty. If ad hoc (type D) methods of distributing earmarked national tax shares are used, there is much room for debate over the proper method of allocation; and for cost-reimbursement allocations (type C), the national government may make ad hoc changes in the conditions under which costs may be covered. Second, pure tax sharing might give local governments access to an income- and inflation-elastic revenue base, such as consumption or production, and thereby improve the adequacy of revenues raised by local governments. Third, if conditions are not imposed on the use to which the funds are put, local fiscal autonomy might increase significantly under a pure shared tax. This third advantage, of course, depends on the national government's willingness not to tamper with the vertical fiscal balance once it is created. From the point of view of the

national government, sharing arrangements tend to be inflexible, because it is politically difficult to change the earmarked percentages - the vertical balance - and because it is difficult to make year-to-year adjustments in the total budget allocation to specific local governments. Such flexibility is important in economies that are exposed by external events (e.g. rising energy costs, declining world prices for minerals, typhoons) or to economic uncertainty.

An even more important problem with the pure shared tax is that it is not equalizing. The return of revenues on the basis of point of collection will further enrich the higher income urban communities. The fact that this form of national assistance is effectively a local area tax over which the local government has no control creates other advantages and disadvantages. The advantage is that the lack of local control frees local officials from having to make unpopular decisions about increasing tax rates and enforcing collection. This feature probably makes the tax more productive than would be the case if it were an independent local tax. However, the potential disadvantage with any form of national assistance is that the separation of the pleasure of the benefits of expenditure from the pain of taxation means that local governments are given less incentive to operate more efficiently, to reallocate expenditures among functions, and to increase the total level of spending or tax effort. The shared tax is better than the other forms of grant assistance on this count, and the greater the percentage of the tax to be retained, the more incentive local residents will have to comply. The issue here is the extent to which local taxpayers perceive the shared tax as being "kept at home" to finance local services.

## Formula grants

An alternative to the pure shared tax is to distribute the grant pool among eligible local units on the basis of some formula. Formula grants may be differentiated according to whether the total grant fund is determined as a shared tax (type B), or on an ad hoc basis (type F). The shared tax or earmarked version of a formula grant requires that the total amount to be distributed among eligible units be determined as a fixed percentage of a national tax, but that the allocation among local units be made by formula. The shared-tax formula grant is probably the most common form of intergovernmental transfer, but the central taxes that are shared cover the spectrum (e.g., income taxes in Turkey, sales taxes in Colombia, and a pool of nearly all national revenues in Nigeria and the Philippines).

The ad hoc version differs in that the total grant pool is determined by political decisions on a year-to-year basis; that is, the national assembly or the President's office makes a budgetary allocation of some amount to each grant program in each budget year, or the amount is determined in some other arbitrary way. This divisible pool is then allocated to state and local governments by formula. Ad hoc determination of the pool is not uncommon.

The choice between the shared tax and ad hoc methods depends on how much control the national (or state) government wants to retain over the division of fiscal resources among units of government, and on how much faith the national government has in the

ability of its localities to absorb increased revenues efficiently. Since the mid-1970's, Jamaica and Korea have both changed from a shared tax to an ad hoc method, though both have retained a formula for distribution among local governments. Jamaica has had little confidence in the ability of its local governments to use revenues productively, whereas Korea - although it makes substantial allocations to the local sector - reserves the power to vary this amount as national needs dictate. In Brazil, India, and Nigeria - large countries that use a tax share to determine the grant fund - the inclination has been for the share to creep up over time.

The formula for allocating the pool among local governments also varies widely, but seems to reflect some combination of the desires to equalize fiscal capacity (or to reduce disparities in levels of public service) and to encourage local governments to mobilize resources. Although the idea of giving more funds to poor jurisdictions is straightforward, the practice is disappointing. The problem is finding an operational measure for making an equalizing allocation. Measures of personal income are commonly used for this purpose in industrialized countries, but are rarely available below the national level in developing and transition countries. There are some exceptions to this general situation: Brazil and India allocate certain grants partially according to per capita income, and a certain part of the grant may simply be reserved for those areas of a country that are known to be poor: for example, the Northeast in Brazil, the "backward areas" in India, and the "deficit provinces" in China.

Some countries have attempted to build measures of tax effort directly into the formula in order to stimulate local resource mobilization. The Korean system is one effort to try to hold tax rates at or above their present level; if a city drops below the standard tax rate, there is a built-in penalty in the form of a lower allocation. Other programs are more aggressive and try to reward higher tax efforts in the allocation. For example, India's Plan Grants include a measure of tax effort in the formula, as does the Nigerian formula for sharing national revenues with the states. Few countries can follow this practice, because they do not have adequate measures of local personal income.

## Grants to reimburse costs

A third way to transfer resources to local governments is to reimburse costs (types C, G, and K in Table 1). Under such schemes, the national government agrees to reimburse the locality for all or a portion of the cost of an activity. Grants to reimburse costs are typically tied to a particular government expenditure.

An important issue is whether reimbursement is full or partial. The choice suggests quite different consequences. Full reimbursement of costs amounts to national government financing of a locally administered service; hence, no incentive is given to the local government for improved efficiency in the delivery of the service. Moreover, full reimbursement is likely to be accompanied by a rigid national government approval process, and local government fiscal choices may be minimized if not eliminated.

National governments have attempted to overcome the problem of incentives by subsidizing less than 100 percent of costs, i.e., by requiring a match from the recipient

government. Such grants can stimulate the tax effort of local governments on behalf of the aided function. Despite its merits, this type of grant imposes important costs on the residents of recipient communities, and perhaps on society. The stimulation of expenditure induced by the grant will distort the local budget in favor of the aided service and against other services that local residents might have chosen. Another potential cost is that such grants may be counter-equalizing: many of the takers will be those most able to put up the match (i.e., wealthy communities).

Another problem with grants that reimburse costs partially is that they tend to carry national restrictions on reimbursable costs. The most common restriction is a requirement that all local governments participate, and that reimbursed expenditures be approved by the national government. The usual procedure is for national officials to provide a list of eligible expenditures, such as number of approved positions, compensation levels, and construction standards. This practice eliminates some of the problems of regional equity, but in reducing the options for local fiscal choice, it gives up the chance for a maximum stimulation of tax effort.

### Ad hoc grants

Perhaps the extreme case of centralization in grant design is an ad hoc program (type H grant) in which the size of the divisible pool is determined annually by the national government and the distribution is made on some subjective basis. Examples include: (1) open-ended construction grants that require approval of each project, (2) any grant allocated on a discretionary basis by the state or national government, and (3) supplementary grants allocated for special purposes during the fiscal year.

The great advantage (and disadvantage) of ad hoc grants is that they do not mandate a particular vertical fiscal balance between the national and local governments. This gives the national government maximum flexibility to redirect resources to the sectors of greatest need, but it leaves local governments vulnerable and uncertain about the finances available to them. In many instances, the creation of an ad hoc grant program is motivated by a desire to limit the financial autonomy and importance of state and local governments.

No optimal grant structure exists. What is a good feature of a particular type of grant depends on whether one takes a local or a national government view, and on which objectives the government most wants to achieve. Most reviews suggest that governments have quite different objectives. Some do push fiscal decentralization and local autonomy but others, particularly in the developing world, are more concerned with tax effort, equalization, or the stimulation of local expenditures on particular activities.

## Conclusions: lessons and guidelines

What lessons from the experience with fiscal decentralization might be useful to South Africa as it plans for a new system of governance? What options for a balance between central and local governments are open and what are the pitfalls to be avoided? The following are seven principles that might be considered by fiscal planners in thinking

through the development of the new system.

1. There is no one best intergovernmental system. Many different divisions of powers and responsibilities among levels of government, and many different kinds of transfer payment systems, can work effectively. Everything depends on how the government weights its objectives. If investing decision-making power in the local councils is of paramount importance, then it is essential to give autonomy to the local governments to form budgets and set tax rates. It is also essential to give them political autonomy as regards election of local councils and appointment of local officers. If on the other hand, national objectives such as macroeconomic stability or equalization are most important, then the tilt should be toward more centralization. In that case, local governments should be given less taxing and spending autonomy, less power to borrow, and the direction of investment should be given by the central level. This is the strategy that most transition and developing countries follow.

2. Intergovernmental Fiscal Relations is a system, and all of the pieces must fit together. The system that any country designs must take into account, in some consistent way, the following:

- the assignment of taxing and spending powers and responsibilities,
- local government autonomy in setting tax rates, determining tax bases, and setting budgets,
- the degree to which local councils are popularly elected, and the degree to which local councils appoint and dismiss the chief local operating officers,
- whether the number and salaries of local government employees are determined by the local or the central government,
- whether, and how local governments will be able to borrow for capital purposes,
- the structure of intergovernmental transfers.

If an intergovernmental system is designed without considering all of the pieces, it is not likely to accomplish the objectives that the government has set for it.

3. The place to begin in designing a proper fiscal balance between levels of government is with the expenditure side. Until the assignment of expenditure responsibilities is decided, it is not possible to decide on the proper division of local taxing and borrowing powers, and the "right" level of transfers. Policy makers should "run the numbers" associated with any particular expenditure assignment to determine revenue needs. Unfortunately, most studies of intergovernmental finances begin with the revenue side, often with the redesign of the revenue sharing system, and predictably end up without having solved the mismatch problem (Martinez-Vazquez, 1994).

4. Recognize that intergovernmental systems are always in transition, and plan for this. Among the reasons for instability in systems of federalism are :

- Regional balances in economic power shift over time. As recently as 20 years ago when the U.S. federal system was going through a major overhaul, there was little

thought given to the possibility that Florida and Texas would be the third and fourth largest states by 1990, and that grant formulas would have to reflect this new power.

- The oil and mineral rich provinces of Russia have realized a new economic power, and this has partly shaped the emerging federalism in that country.
- Ethnic differences take on more importance, either because of changing political power or because of civil unrest.
- Politicians change and bring new views and biases with them. For example, China's economic reform begun in 1983 had profound implications for the system of fiscal relations between central and local governments, moving the balance of fiscal power towards the lower level. The recent 1994 reform shifted the balance back towards the center. Similarly, virtually every new President in the US in the past three decades has introduced a new federalism.

What can a country do to protect itself against the disruptions caused by these circumstances? How can one protect the certainty needed by local governments to plan effectively for the expenditure of tax moneys? One possibility is to set up commissions, as in India and Australia, to periodically review the intergovernmental system. Another is to put in place a data system that will enable a careful tracking of the fiscal performance of subnational governments, and the evaluation of the impact of changes in the federal system on these governments.

5. It should be recognized that the age of VAT means that there is much less room for assignment of revenues to local governments. VAT is not suitable as a local government revenue source, or as a shared tax on a derivation basis. This suggests that grants allocated on a basis other than derivation will play an increasing role in the intergovernmental fiscal structures in many countries. The individual income tax has many characteristics that make it suitable as a local government tax. Other good prospects for local taxes are the property tax and user charges.

6. In order to capture the benefits of fiscal decentralization, there must be significant local autonomy given, and it must be given on both the taxing and expenditure side. If local governments do not have the power to set tax rates, then their officials cannot be held fully accountable by voters for the quality of public services delivered. It is also necessary for local councils to be elected, and for local chief officers to be appointed by the council. Otherwise neither will be accountable to the local voting population, and the efficiency gains of decentralization will be lost.

7. There is an intraprovince dimension to intergovernmental fiscal relations and this should be taken into account in planning the system. If the central government worries only about the distribution of resources among the provinces, it may miss the more important issue of how resources are distributed among the rich and poor local governments within the province. Oftentimes, the disparities in income and wealth within a province are much greater than those among provinces.

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