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Fiscal Federalism

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1. Introduction

Fiscal federalism is concerned with understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralised levels of government[1]. In other words, it is the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across the different spheres of government. Much of the literature on fiscal federalism consists of models for the assignment of powers, discussions of intergovernmental spillovers and intergovernmental grants, fiscal mobility and migration, and vertical fiscal imbalance and dependence[2]. Initially, stabilisation and distribution were considered to be essentially central of national government functions, with the only role for subnational governments arising in the allocative sphere. From this perspective, the main analytical task of fiscal federalism is to define the appropriate functions and finances of subnational governments as efficiently as possible in order to maximize community welfare.

Fiscal decentralisation has achieved much popularity in recent years. Some analysts have attributed this to globalisation and deepening democratisation the world over on the one hand and increasing incomes on the other[3]. Other specific reasons for increasing demand for decentralisation are:

- Central governments are increasingly finding it impossible to meet all the competing needs of their various constituencies, and are attempting to build local capacity by delegating responsibilities downward to their regional governments.
- Central governments are looking to local and regional governments to assist them on national economic development strategies.
- Regional and local political leaders are demanding more autonomy and want taxation powers that go along with their expenditure responsibility.

Moreover, in recent years, decentralisation has become a feature of the reform agenda promoted and supported by the World Bank and other multilateral institutions. The rationale for this has been in part that decentralisation promotes accountability. It is not therefore surprising that by 1997, 62 of 75 developing nations had embarked on one form of decentralisation or another[4].

An important part of the subject matter of fiscal federalism is the system of transfer payments or grants, by which a central government shares its revenues with lower levels of government. There are two primary types of transfers, conditional and unconditional. A conditional transfer from a national government to a province or municipality involves a certain set of conditions. If sub-national government is to receive this type of transfer, it must agree to the spending instructions of national

[1] http://en.wikipedia.org/wiki/Fiscal_federalism
[2] Bird (2005)
[3] Tanzi (2000)
[4] World Bank (1997)

government. In South Africa, The two main instruments for national transfers in South Africa are unconditional shares (equitable share) and conditional grants. These transfers follow the recommendations of the Financial and Fiscal Commission (FFC), which annually proposes the share of the budget to be allocated to each tier of government. The equitable share is based on a complex set of formulas that consider the specific social, economic and institutional needs of each sphere, and conditional grants are allocated to address backlogs and specific sectoral and regional needs. The provincial formula allocates funds to each province according to its demographic and economic profile, taking account of the services for which provinces are responsible, including health and education. It also includes a component to address backlogs in infrastructure and provision of services. The local government formula is designed to enable municipalities to deliver a package of basic services to low-income households affordably. Despite this, there is still a mismatch between the expenditure assignment of subnational levels of government and their financial resource capacities.

2. The Economic Goal of Fiscal Federalism

Economics emphasizes the need to focus on the necessity for improving the performance of the public sector and the provision of their services by ensuring a proper alignment of responsibilities and fiscal instruments. While economic analysis, as encapsulated in the theory of fiscal federalism, seeks to guide this division by focussing on efficiency and welfare maximisation in determining optimal jurisdictional authority, it needs to be recognised that the construction of optimal jurisdictional authority in practice goes beyond purely economic considerations. Political considerations, as well as historical events and exigencies, have in practice, played major roles in shaping the inter-governmental fiscal relations in most federations.

Since 1994, the South African fiscal system has decentralised tremendously, with budgetary decisions being made at all three levels of government simultaneously. Decentralisation is the key concept in intergovernmental fiscal relations and fiscal federalisation, as it is concerned with the fiscal implications of a decentralised system of multilevel government. The most important justifications for sub-national governmentsô involvement in budgetary and allocative issues are that they have the potential to improve allocative efficiency[5]. A proper fiscal decentralisation[6] system requires economic and political efficiency, macroeconomic stability and a proper redistribution of resources.

Fiscal decentralisation generally opens the door for potential allocative efficiency. However, the resultant gains from the system will depend much on how the system of intergovernmental fiscal relations is implemented in the country. In the South African context, the impetus for the creation of a decentralised fiscal configuration tends to be primarily political, given the countryôs apartheid legacy, where everything was highly regulated and centralised. The need to redress past imbalances has been a powerful force shaping the emerging system of intergovernmental fiscal relations.

5 Allocative Efficiency is concerned with whether, subject to budget constraints, the public sector produces the level and mix of public services (public expenditures) that citizens demand and which correspond with their preferences.

6 Fiscal Decentralisation entails the relative roles of the three spheres of government in raising revenues and implementing expenditure decisions.

The South African intergovernmental fiscal relations system is founded in the Constitution. In this regard, Sections 229 and 230 of the Constitution grant municipalities significant taxation and borrowing powers, subject to national legislation and regulations such as the Local Government White Paper and the Municipal Finance Management Act. Amongst others, the White Paper listed the principles of sustainability, effective and efficient resource use, as well as accountability, transparency and good governance for the new Local Government finance system.

Public finance theory offers some guidelines on revenue and expenditure responsibilities to various levels of government. The focus is on maximising efficiency in the provision of public services, mainly through the assignment of expenditure functions and revenue sources to the appropriate level of government. In general, the assignment of expenditure functions should precede the assignment of revenue sources because the latter needs to be informed by the former. The main objective of the South African assignments system is to reduce interregional inequalities and improve, through the provision of public services, social indicators inherited from past policies.

3. The Link between Fiscal Federalism and Fiscal Decentralisation

The difference between fiscal federalism and fiscal decentralisation is that while *fiscal federalism* constitutes *a set of guiding principles, a guiding concept* that helps in designing financial relations between the national and subnational levels of the government, *fiscal decentralization* on the other hand is *a process of applying such principles*. In this regard, fiscal decentralisation refers to the percentage of total government expenditure executed by subnational governments, considering the size and character of transfers, or the level of tax autonomy of subnational governments, or both. The borrowing capacity of subnational government is also taken into account.

Fiscal decentralisation encourages public participation in decision-making, since local and provincial governments are supposed to be closer to the communities. In South Africa, fiscal decentralisation aims to provide a framework for the efficient provision of public services by aligning expenditure with regionally based priorities. The questions to be addressed relate to the aims and impacts of the way in which responsibilities are assigned across levels of government:

- The authority who expends the money (expenditure assignment).
- The manner in which expenditure is funded (revenue assignment).
- The extent to which there is an imbalance between the revenue and expenditure of subnational governments (the vertical imbalance that is rectified with intergovernmental transfers).
- The manner in which equilibrium is achieved between the varying needs and capacities of governments at the same level (the horizontal imbalance, usually rectified through interregional compensation).

4. Fiscal Decentralisation in South Africa

The Constitutional recognition of the three spheres of government introduced greater complexity into the arrangements required for executive/administrative, legislative and financial intergovernmental relations. The Constitution established three separate, interdependent and interrelated spheres of

governments: a national government, nine provincial governments and 284 local governments. Each sphere is assigned its own powers, functions and responsibilities. National government is responsible for managing the countryôs affairs, and shares responsibility for the provision of basic social services with subnational governments. National governmentôs power to intervene in the decisions of provincial or local governments is defined and limited by the Constitution. Provincial and local government functions consist of exclusive competences and concurrent competences, the latter being responsibilities shared by more than one sphere of government.

The Constitution recognises the importance of minimising inefficiencies, as these are bound to cause undue complexities between the three spheres of government. The Constitution contains a number of provisions that could impact on and improve Intergovernmental Relations, especially between provincial and local governments. These include the right of local government to conduct its own activities within the framework of the Constitution. The Constitution further provides for National Government to adopt legislation to establish, provide and facilitate Intergovernmental Fiscal Relations. Chapter 7 of the Constitution, in particular, is devoted to Local Government, its powers and its relationship with other spheres of government. National and provincial governments have a duty to support and strengthen the capacity of municipalities to exercise their powers and to perform their functions. In addition, provincial government is required to provide for monitoring and support of local governments and promote their capacity to manage their own affairs (s155 (2)).

Fiscal decentralisation in South Africa involves shifting some responsibilities for both revenue and expenditure to subnational levels of government. The Constitution deals with various aspects of Intergovernmental Fiscal Relations (IGFR), including the devolution of revenue and expenditure assignments to subnational governments, which acts as a disciplinary force by establishing a closer link between the raising and spending of money. Based on the Division of Revenue Act, which annually allocates national revenues to each of the three spheres of government, the South African intergovernmental fiscal system provides a framework of fiscal arrangements aimed at ensuring that government responsibilities are met, while the right level and mix of public services are delivered to enhance the socioeconomic rights of citizens, especially the disadvantaged. The IGFR system determines the way in which taxes are allocated and shared among the various levels of government, and how funds are transferred from one level to another.

5. Assignment of expenditure responsibilities[7]

Fiscal decentralisation in South Africa is evolving towards a significant increase in the role and responsibilities of subnational governments in providing public services. The subnational governments are allocated a proportion of nationally raised revenue and have the legal autonomy to formulate their budgets and spend the funds as they wish. Subnational governments are now empowered to determine some of their own resource allocation decisions within the context of the governmentôs broad medium-term strategic objectives. However, they are still heavily dependent on national revenue, especially provinces.

[7] IDASA (2005)

The current assignment of expenditure functions in South Africa agrees in many ways with the public finance decentralisation theory, according to which each service should be provided by the jurisdiction with control over the minimum geographic area that would internalise the benefits and costs of such provision[8]. The design of expenditure assignment in South Africa aims to achieve three main objectives:

- An efficient allocation of resources through a responsive and accountable government.
- An equitable provision of services to citizens in different jurisdictions.
- Macroeconomic stability and economic growth.

The functions allocated to national government have a national dimension. These include mainly expenditures related to defence, tertiary education, justice, correctional services, water affairs and foreign affairs. Expenditures with macroeconomic and redistributional implications, such as pensions and unemployment compensation, are also the responsibility of the national government. Correspondingly, the Constitution assigns certain expenditure responsibilities for the delivery of goods and services with provincial or local benefit areas to the subnational governments, either individually or with national government.

6. Assignment of revenue responsibilities

Responsibility for revenue generation is unequally distributed between national, provincial and local spheres of government. National government draws revenue from a wide variety of tax instruments, such as direct, indirect, general, specific, business and individual taxes, while the Constitution gives the subnational sphere limited taxation and borrowing powers. The funds collected nationally are divided among national and subnational governments. The funds divided vertically for expenditure is made up of the nationally raised revenue, minus debt service funds and the contingency reserve. Fiscal decentralisation in South Africa provides subnational government with lower fiscal autonomy than national government, which levies broad-based taxes such as income and corporate tax, value-added tax (VAT), customs and excise, and fuel levies. The South African Constitution provides for an elaborate and complex set of revenue transfers from national to the subnational governments. The primary objective of these transfers is to enable subnational governments to provide public services and perform their constitutional functions, taking into account each sphereôs ability to raise its own revenue.

The responsibilities of revenue generation and service provision are unequally distributed between national, provincial and local government. Transfers from national government form the largest part of provincial revenues, as the taxing and borrowing powers of provincial government are limited. In addition to transfers, subnational governments, particularly local government) also raise their own revenue by taxation and borrowing. In terms of provinces, provinces are allowed to impose taxes, levies and duties other than income tax, VAT, sales tax, rates on property or customs duties. They can also levy flat-rate surcharges on the tax bases of any tax, levy, or duty imposed by national legislation, except corporate income tax, VAT, rates on property and customs duties. Provincial own

[8] Idasa (2005)

revenues accounts for a small proportion of provincial budgets. In addition, provincial borrowing is highly regulated: provinces can only borrow for capital and bridging finance. Provinces are therefore highly dependent on intergovernmental transfers from national government, even though they are mandated to deliver a vast range of services.

Local governments, on the other hand, have extensive powers to raise their own revenues through property and business taxes and to impose fees for services such as electricity, water, and sewerage. They also receive substantial grants and subsidies from provincial and national government. The allocation of functional responsibilities to local governments appears to be somewhat more balanced in relation to their share of resource mobilisation. Intergovernmental fiscal transfers are a prominent feature of South Africaôs public finance structure, and take the form of revenue sharing or grants. Financial resource transfers are executed in four stages, these are:

- From national to provincial government.
- From provincial to local government.
- From national to local government.
- From local to local governments.

An exploration of fiscal decentralisation in South Africa reveals three fundamental features. Firstly, national government has a specific responsibility for spearheading action and creating a positive framework, while subnational governments have a vital role to play in meeting the needs of residents through the delivery of basic social services such as health, education, water, sanitation and housing. Secondly, the allocation of revenue-raising capacity among subnational governments is uneven, which necessitates compensation between levels of government (vertical) or among the subnational governments themselves (horizontal). Thirdly, the success of public service delivery is still limited, suggesting a need for a strong social policy environment based on equity and socioeconomic justice.

Conclusion

This paper has examined the framework of fiscal federalism and decentralisation in South Africa. The primary goal of fiscal decentralisation in South Africa is to achieve a broad-based, sustainable improvement in the standard of welfare of all citizens. The paper also explored a potential challenge of decentralisation, which is a vertical fiscal imbalance. A vertical fiscal imbalance exists if the expenditure responsibilities of subnational levels of government are extensive, but their revenue-raising abilities are minimal. The gap between expenditure and revenue obliges subnational governments to depend on transfers from national government in the form of equitable shares and conditional grants. The allocation of revenue through equitable shares enables subnational governments to achieve the prescribed norm of equity. Conditional grants are allocated to subnational government to meet specific regional and sectoral needs and to correct backlogs.

The South African Constitution provides that national revenue be divided into equitable shares for national, provincial and local governments. The revenue-sharing formula proposed by the FFC is aimed at ensuring that each subnational government receives an equitable allocation. The provincesô

shares, ideally, should be sufficient to allow them to provide the nationally mandated basic levels of education, health and other services.

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