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CONSTITUTIONAL ASSEMBLY

WORKSHOP ON FINANCIAL & FISCAL MATTERS

**KEY ISSUES FOR THE
CONSTITUTION**

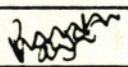
**7 & 8 APRIL 1995
PRETORIA**

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**WORKSHOP
FINANCIAL AND FISCAL MATTERS - KEY ISSUES FOR THE CONSTITUTION
7 & 8 APRIL 1995
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FINANCIAL AND FISCAL ISSUES

INTRODUCTORY STATEMENT

According to Constitutional Principle XXV both the national government and provincial governments shall have fiscal powers and functions, defined in the Constitution. Furthermore, principle XXVI provides for the constitutional right of each level of government to an equitable share of revenue collected nationally, to ensure that provinces and local governments are able to provide basic services and execute the functions allocated to them.

In accordance with principle XXVII, a Financial and Fiscal Commission, in which each province is represented, must recommend equitable fiscal and financial allocations to provincial and local governments from revenue collected nationally. This allocation must take into account the national interest, economic disparities between provinces, and the population and development needs, administrative responsibilities and other legitimate interests of each province.

Principle XXI (1 and 2) indicates that the level of government responsible and accountable for the quality and rendering of services must be that level at which such decisions can be taken most effectively; while the maintenance of minimum standards is the responsibility of national government. This implies that adequate levels of finance will be available at provincial level to discharge functions for which provinces are either constitutionally empowered or mandated by the national government.

How should fiscal and financial provisions be constitutionalised?

Questions:

- (a) Which economic 'principles' or criteria should play a dominant role in determining the revenue powers assigned to provinces by the Constitution?

An optimal system of subnational government financing would:

- ensure a correspondence between subnational recurrent and capital expenditure responsibilities, and subnational revenue resources (taxes, non-tax revenue and borrowing);
- encourage the power and incentives to mobilise subnational revenues and fiscal responsibility;
- not compromise the macroeconomic management policies of the

central government; the inter-jurisdictional mobility of factors of production such as capital and labour; nor introduce distortions in inter-jurisdictional economic decision-making (locational neutrality);

- be consistent with national redistribution goals;
- give appropriate expenditure discretion to subnational governments and improve their accountability; and
- be transparent, and based on objective, stable, non-negotiated criteria, as well as being administratively cost-effective and efficient.

Some of these principles or criteria might be in conflict and no one intergovernmental system will meet them all. Different countries and different levels of government attach different priorities to each of these criteria. In addition, priorities might change over time in response to the socio-dynamics in a country or province. There is no single 'correct' system of intergovernmental financing.

(b) What constitutional provision should be made for:

- exclusive revenue (tax and non-tax) powers to central and provincial levels (separation of revenue powers); and
- concurrent powers over revenue sources (sharing of revenue bases)?

Are the existing provisions adequate?

In this regard it should be noticed that the revenue powers of subnational governments could be limited by requirements of uniformity derived from provisions that no tax shall discriminate between provinces or give preference to one province over another; by provisions to encourage interprovincial commerce and the mobility of factors of production; and by provisions for safeguarding macroeconomic stabilisation and redistribution policies.

Taking into account these provisions, what level of fiscal independence should or could feasibly be accommodated in the constitution? (Fiscal independence refers to the ability of subnational governments to finance a large proportion of their expenditure needs through their revenue over which they have a high degree of discretion).

Where and at what levels of government should taxpayers be taxable? Should the Constitution deal explicitly with this matter?

(c) How explicit should be the assignment of revenue sources in the constitution?

To ensure correspondence between subnational expenditure responsibilities and subnational power over income sources and certainty regarding this income, an explicit assignment of revenue seems to be desirable. However, a developing economy such as South Africa's might experience major structural shifts in socio-economic conditions - per province and in the country as a whole. Therefore, to what extent should the need for flexibility be taken into account in the constitutionalisation of revenue powers?

Furthermore, the financial implications of expenditure/functional powers of the respective levels of government are not yet clear. How should this be taken into account in the constitutionalisation (explicit or otherwise) of revenue powers?

- (d) Should provinces have borrowing powers? For what purposes? Should these be constitutionalised? Is the existing constitutional provision adequate or should it be amended?

The national government will seek to exert control over the borrowing activities of subnational authorities in pursuit of macroeconomic policies, although borrowing for investment purposes is regarded as efficient and fair from an economic perspective. How should this issue be dealt with in the constitution if at all?

- (e) How could a rational, accountable and predictable structure of intergovernmental transfers be safeguarded?

Exclusive and concurrent powers to revenue sources mainly seek to address the issue of vertical fiscal balance, i.e. the matching of revenue and expenditure responsibilities. However, the assigned revenue powers of subnational governments might render revenue which is insufficient in relation to expenditure responsibilities, as well as for ensuring responsible decision-making on public expenditure. If a relatively centralised revenue structure is accompanied by a relatively decentralised expenditure structure, how should the intergovernmental transfer system be structured to address:

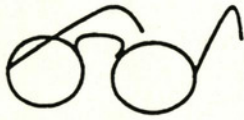
- vertical fiscal capacity equalisation? (e.g. revenue sharing for vertical fiscal capacity equalisation could be made through unconditional, lump sum transfers)
- interjurisdictional spillovers? (e.g. transfers to correct for interjurisdictional spillovers, mainly due to public infrastructure and human capital development, could take place through conditional matching grants)
- horizontal fiscal capacity equalisation? (e.g. transfers for fiscal capacity equalisation across subnational governments, could also take place through unconditional matching grants)

- provision of minimum standard basic services? (e.g. transfers for ensuring a minimum standard of basic services could be done through conditional lump-sum transfers)

Should the provision [Section 155 2(c)] be amended? e.g. to accommodate these different objectives of a transfer system, as well as to ensure that the system is rational, predictable and accountable. If so, how? Or should these issues be addressed statutorily?

To ensure a predictable flow of revenue to the provinces, should the basis be

- (i) prescribed in the Constitution; or
 - (ii) dealt with in separate legislation; or
 - (iii) left to the Fiscal and Financial Commission?
- (f) What financial arrangements, if any, should provinces be able to enter into with foreign parties? e.g. aid, trade agreements, etc.
- (g) How should fiscal disputes between provinces and the national government be settled?
- e.g. through the constitutional court; political decision making; or other institutional arrangements? Should the Constitution provide for such an event?
- (h) Should any other provision in the interim Constitution be modified? If so, which and why?



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**ASSIGNMENT OF EXPENDITURES & OF TAXES
BETWEEN LEVELS OF GOVERNMENT FOR THE
REPUBLIC OF SOUTH AFRICA**

Rémy Prud'homme

March 1995

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I - Introduction

There is widespread agreement that in a modern country there must be several levels of government, or, to put it otherwise, that there must be a certain degree of decentralization.

Decentralization, however, has many dimensions, and can take many forms. How many levels of government should there be? What expenditures responsibilities should be assigned to each level of government? What taxes? Should the expenditures and the taxes allocated to each level of government be equal? If not, how should the resulting grant system be organized? Should some expenditures responsibilities be shared between two or more levels of government? Should local governments be controlled by regional governments or by the central government? And what form should such a control take? Should sub-national governments be allowed to borrow? Should all local governments be treated exactly in the same fashion, or could the larger ones have greater responsibilities?

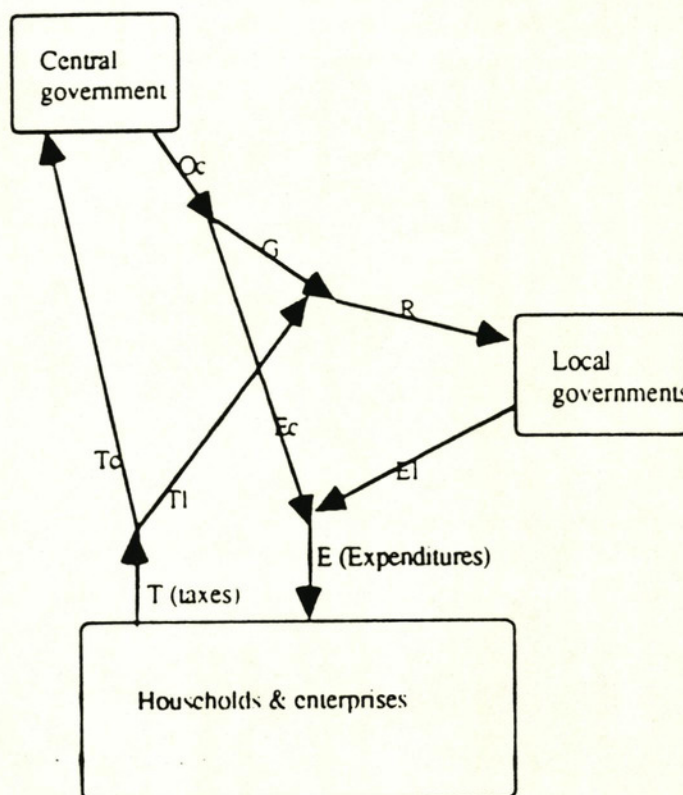
The design of a decentralized system implies answers to all these questions, and to many others. Note that all these issues are interrelated. The magnitude and the nature of grants, for instance, are a function of expenditure and tax assignments. Note also that these issues have widespread implications, which are social, economic as well as political. Note finally that they have nowhere found definitive and satisfactory answers. In most countries, existing decentralization systems are —and have been for decades— the subject of discussions, criticisms, proposals and modifications.

This paper will focus on only two of these issues: expenditures responsibilities assignment and tax assignment between the various levels of government. It will attempt to bring to bear the teachings of theory and the lessons of international experience. But it should be seen as a contribution to current debate, not as a ready-made recipe.

Figure 1 might help understand what could be called the macro dimension of tax and expenditures assignment. It represents a very simplified model of a decentralized system, with the associated money flows. Taxes raised in the country (T) are allocated to the central government (Tc) and to local or sub national governments (Tl): $T=T_c+T_l$. We can define a *tax decentralization ratio* t, which is the ratio of local taxes to total taxes: $t=T_l/T$.

Government expenditures (E) similarly consist of central government expenditures (Ec) and of local or sub national governments (El): $E=E_c+E_l$. We can also define an *expenditure decentralization ratio* e, which is the ratio of local expenditures on goods and services to total government expenditures: $e=E_l/E$.

Figure 1 - The Structure of a Decentralized System



In a "pure" model of decentralization, in which there would be no grants, things would be simple. Taxes collected by the central government would be equal to central government expenditures on goods and services: $T_c=E_c$; and similarly taxes collected by local governments would be equal to local governments expenditures on goods and services: $T_l=E_l$. In such a case, the tax decentralization ratio would be equal to the expenditure decentralization ratio: $t=e$.

In reality, this never happens. For reasons that will be discussed below, central government taxes are always more important than central government direct expenditures:

$T_c > E_c$ and local governments taxes less important than local governments expenditures: $T_l < E_l$. This is made possible by grants from central to local governments. Total expenditures of the central government (O_c) consists of direct expenditures on goods and services (E_c) and of grants to sub national governments (G): $O_c = E_c + G$. It follows that total resources of local governments (R_l) are made of local taxes (already defined as T_l) and of grants: $R_l = T_l + G$. The relative importance of local taxes in local governments resources is important because it is a measure of the autonomy of local governments. The nature of grants also plays a role here, but, all other things equal, the greater the share of local taxes, the more autonomous local governments will be. We can define an *autonomy ratio* a , which is the ratio of local taxes to local government resources: $a = T_l/R_l$.

This model is a very simplified one. It ignores the other sources of income of both central and sub national governments, such as fees and borrowing. It also ignores government expenditures which are not made for the provision of public goods and services, such as interest payments or reimbursement of loans. It assumes only one level of sub national governments, thus ignoring the fact that there are usually two (provinces, communes) or three (provinces, communes, intermediate) levels of sub national governments in most countries. It also ignores the non financial relationships that exist between governments of different levels, such as expenditures mandates or tax ceilings. Nevertheless, this model does suggest several points about decentralization: (i) the tax decentralization ratio need not be the same as the expenditures decentralization ratio; (ii) the greater the gap between the two ratios, the larger the grants will be; (iii) the lower the ratio of the ratios, the lower the autonomy ratio of sub national governments¹.

Table 1 gives the value of our three ratios for a number of countries (actually, for the countries for which the relevant data is available in the *IMF Yearbooks of Government Finance*).

¹ It can be shown that $G/T = e-t$ and that $a = t/c$

Table 1 - Indicators of Decentralization, Various Countries

	Tax decentralization ratio	Expenditures decentralization ratio	Fiscal autonomy ratio
Sweden 1992	34	74	29
Denmark 1991	31	69	43
Norway 1990	21	63	32
USA 1991	32	60	48
Germany 1991	28	53	45
Austria 1991	14	33	50
France 1992	10	30	49
Finland 1990	27	71	23
Belgium 1991	5	30	33
Netherlands 1992	3	51	56
Italy 1989	3	48	32
United Kingdom 1991	4	42	31
Australia 1991	18	65	38
Spain 1990	13	50	46
Israel 1990	7	22	18
Ireland 1990	3	53	33
Portugal 1990	4	12	50
Argentina 1989	40	62	26
Mexico 1987	12	17	54
Brazil 1991	35	66	44
South Africa 1990	4	12	41
Chile 1988	2	9	40
Paraguay 1989	2	4	41
Bolivia 1992	8	6	61
Indonesia 1993	4	26	37
Kenya 1990	2	6	28
India 1990	28	52	53

Source: calculated from: IMF, *Government Finance Statistics 1993*, various pages.

Notes: Countries for which the information is available are ranked by their 1992 GDP per capita, as estimated in the World Bank *World Development Report 1994*. The tax decentralization ratio is defined as the ratio of local and regional taxes to total taxes. The expenditures decentralization ratio is defined as the ratio of local and regional expenditures on goods and services (excluding investments) to total expenditures on goods and services. The fiscal autonomy ratio is defined as the ratio of non grants total resources of local and regional governments to their total resources. The classification of many taxes as local or regional taxes is debatable, particularly in the case of shared taxes; a different, but equally or more appropriate, classification would yield different (and in many cases very different) ratios.

The figures in table 1 must be handled with care. The way certain local or regional resources are classified is questionable (the local share of shared taxes is counted as local tax; we shall argue below that it should rather be counted as a grant). Countries differ widely in terms of size: sub national governments in certain countries, such as India, are much larger than certain nations. One must therefore beware of comparisons. Nevertheless, table 1 suggests great disparities between countries, even between rather similar countries in terms of size and GDP. This would mean that the choices offered in the area of decentralization are rather open.

II- Assignment criteria

Before we begin discussing the possible assignments of expenditures responsibilities and of taxes, it is useful and perhaps even necessary to discuss the objectives that these assignments should help reach. What purposes should be aimed at?

What criteria can be utilized to judge potential assignments? Five such criteria can be considered: equity, stability, efficiency, autonomy, and simplicity. The first three criteria refer to the three classical objectives of public finance, as identified by Musgrave: redistribution, stabilization, and allocation. The last two are equally important. All these criteria are relevant to the general discussion of an appropriate decentralization level, and to the specific choices that have to be made about the allocation of taxes and of expenditures to the different levels of government.

Equity

A first objective of the assignment system should be to introduce more equity in the nation. More equity can be understood in two ways. It can mean more equity between the different people or households; it can also mean more equity between the various sub-national governments. Such an objective is particularly important for South Africa, because both interpersonal and inter jurisdictional disparities appear to be very large by international standards. Reducing them is therefore a major task of public finance (although, of course, not the only one). The basic point here is that, all other things equal, decentralization is inimical to equity.

This is easy to see in the case of interpersonal equity. Redistribution policies should be conducted at the national level, not at sub national levels. Otherwise, the worst off of the richer regions will be better treated than the better off of the poorer regions, and total redistribution will be minimized. This is illustrated by table 2. Let us assume that there are only six people (or groups of homogeneous people) in a country, regrouped in two different jurisdictions. region Rich and region Poor. The initial income distribution is very unequal: the maximum/minimum ratio, one of the possible indicators of inequality is 9.

Table 2 - Centralized v. Decentralized Redistribution

Income distribution:	Initial	After decentralized redistribution	After centralized redistribution
Region Rich			
A	9	8	7
B	7	7	6
C	5	6	5
Region Poor			
D	5	4	5
E	3	3	4
E	1	2	3
Max/min ratio	9	4	2.3

Let us assume first that redistribution is carried out in a decentralized fashion, by each jurisdiction. It is hard to imagine that it could produce something very different from what appears in the second column. The maximum/minimum ratio for the country as a whole will be reduced to 4. Note that C and D, which had similar initial incomes (of 5) now have different incomes (6 for C and 4 for D). This will induce D to move from region Poor to region Rich. This will in turn make it more difficult for both regions to continue their redistributive policies. Let us assume now that redistribution is carried out in a centralized fashion, for the country as a whole. It could quite easily produce the income distribution of the third column. The maximum/minimum ratio is decreased to 2.3, and all equals are treated equally.

The case of inter jurisdictional equity is equally important. All other things equal, and particularly in the absence of redistributive grants, a centralized system will ensure more public expenditures in the poorer jurisdictions. To show that, we only have to

assume that public expenditures are distributed equally over space, a fairly reasonable assumption which is borne out by empirical studies. Let us consider the hypothetical country illustrated by table 3. It consists of two regions, region Rich and region Poor, of equal population, but of very different incomes. (1,000 in region Rich, and only 100 in region Poor). Both national and local taxes are proportional income taxes. Local taxes are spent locally, in the form of local public expenditures. National taxes are spent nationally in the form of national public expenditures that benefit equally region Rich and region Poor.

Table 3 - Inter jurisdictional Redistribution as a Function of Decentralization

	Decentralization	Centralization
Country as a whole (Income = 1,100)		
National taxes	110	220
Local taxes	220	110
Total taxes	330	330
Region Rich (Income = 1,000)		
National taxes	100	200
Local taxes	200	100
National public expenditures	55	110
Local public expenditures	200	100
Total public expenditures	255	210
Region Poor (Income = 100)		
National taxes	10	20
Local taxes	20	10
National public expenditures	55	110
Local public expenditures	20	10
Total public expenditures	75	120

In the more decentralized case, national taxes are raised at a 10% rate and local taxes at a 20% rate; it is the reverse in the more centralized case. The model shows that public expenditures in region Poor, which are 75 in the decentralized system increase to 120 in the centralized system. This does not wipe out differences with region Rich, but it decreases them substantially. Only a completely centralized system could wipe out differences in public expenditures. The lesson of this model can be generalized. National budgets do redistribute income spatially, from the richer areas to the poorer areas. Local budgets, by definition, do not. It follows that a shift from local to national budget, that is centralization, is usually redistributive over space. It can even be shown that this could be the case with a slightly regressive tax system coupled with a somewhat regressive expenditure system. But of course, the more progressive the tax and the expenditure systems, the more important will be the spatial distribution generated by a national budget.

Stability

An important function of public finance is its potential contribution to macro-economic management. Taxes, and public expenditures, do influence overall demand, and can be utilized to conduct counter cyclical policies. At times of inflation, a decline in public expenditures is desirable. At times of recession, on the contrary, an increase in public expenditures might help. It is easy to see that this function can only be performed by *national* taxes and expenditures.

Sub national governments have neither the will nor the means to conduct counter-cyclical policies. A given local or even a given regional government does not control enough of taxes or of expenditures to influence significantly overall demand. Many sub national governments are not allowed to run deficits, which restricts their ability to

contribute to stabilization. Even if a given regional government wanted to manipulate its taxes and expenditures to influence the regional economic situation, it would not succeed. Because national economies are usually very integrated, there would be many "leakages"; the regional economy will be more influenced by what happens in the rest of the country and the regional efforts would be frustrated: even if other regions were to benefit from the efforts of our regional government this would not bring to it any political benefit.

National governments must therefore have the control of a sufficiently large amount of taxes and expenditures, if they are to be able to contribute to stability. Assuming a given total amount of taxes and expenditures, this means that the more centralized a system, the more likely it is to perform this stabilization function. This of course makes sense only all other things equal: there are centralized systems that do not fare well in macro-economic management, and also decentralized systems that are successful in that respect. But there is every reason to believe that the former would do even worse if they were more decentralized, and that the latter would do even better if they were more centralized.

Efficiency

If decentralized systems of taxes and expenditures are bad from the viewpoints of equity and stability, why are they so widely desired and recommended? The answer is that they are widely believed to be superior in terms of efficiency, or to put it otherwise, of resource allocation. There are two types of efficiency that are influenced by decentralization: allocate efficiency, that refers to *what* is produced, and production efficiency, which refers to *how* it is produced.

A decentralized system can be expected to produce public goods and services which are closer to what is wanted by the people. In part, this is because local and regional governments will know better what people want. In part, this is because they will have a political incentive to do so: in order to be re-elected, local and regional politicians will have to give their electorate (who pays taxes, and obtains public expenditures in return) what ~~they~~ it wants, in terms of total amount of taxes/expenditures and in terms of structure of taxes/expenditures. Each sub national government will have the bundle of taxes and expenditures that maximizes the satisfaction of its people. No central government could provide this assortment. If this is true, a shift from a centralized system to a decentralized one will increase welfare.

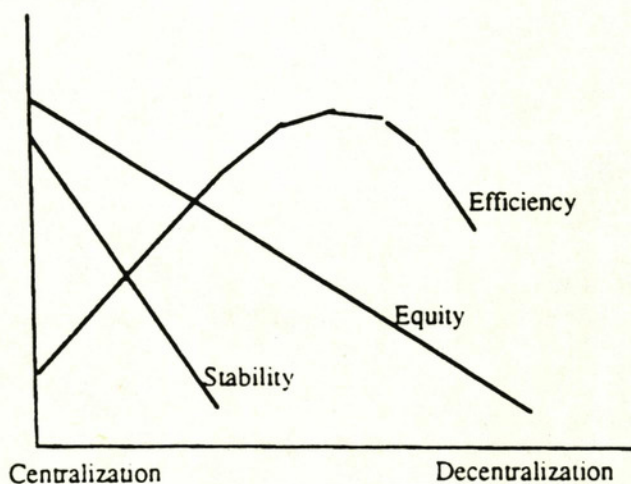
It is also maintained that a decentralized system will produce public goods and services at a lower cost. Local or regional officials will know better how to take advantage of local opportunities. Transaction costs will be minimized. Competition between decentralized units will also be beneficial. More value for money will thus be obtained.

This standard view of the efficiency of decentralized systems has been questioned (Prud'homme 1994). It is very much an act of faith. The hypothesis on which it rests (the perfect functioning of the political market, the informed choices of voters, the complete control of politicians over their bureaucracies, etc.) are not always verified in practice. The savings on transaction costs implied by a shift from a more centralized to a more decentralized system might well be offset by losses of economies of scale, the weakening of strong national bureaucracies, and (particularly in low income countries) by increased fixed administrative costs. In addition, everybody, including the most extreme decentralists, recognize that some expenditures and some taxes (as will be discussed below) cannot or should not be decentralized.

Each of the three criteria mentioned so far suggests a different degree of decentralization. Figure 2 indicates, for each of these criteria the performance of the

system as a function of the degree of decentralization. For both equity and stability, the more centralized the system, the better. For efficiency (if one accepts the conventional view), the performance increase with decentralization, up to a certain point, then declines. The curves of Figure 2 must be considered as illustrative. They have no common units, and cannot readily be compared (how compare equity with stability, for instance?). Nevertheless, Figure 2 shows that there is no simple to determine desirable level of decentralization. Hard trade-offs have to be made, and have to be made by politicians.

Figure 2 - Achievements as a Function of Decentralization for Various Criteria

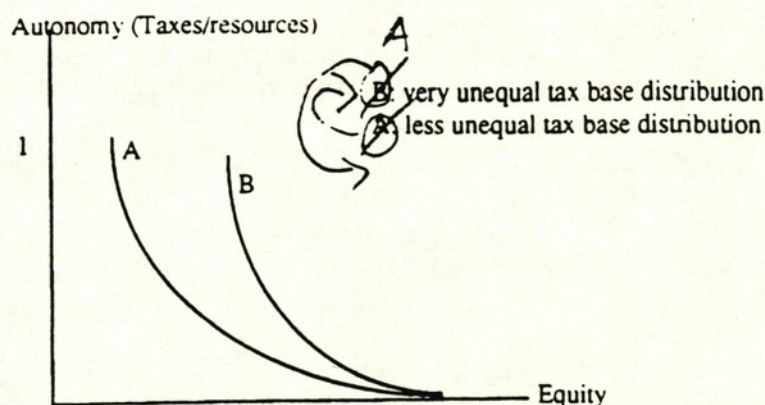


Autonomy

Another important criteria by which a system can be assessed is the autonomy of sub-national governments. The theory behind the efficiency benefits of decentralization assumes that sub national governments are autonomous, namely that they decide on the amount and the nature of the taxes they raise and the expenditures they make. If they do not, if their resources and their expenditures are decided by another, higher, level of government, the rationale for decentralization disappears.

This point is particularly relevant in relation to grants. As mentioned above, in many countries, expenditures decentralization is greater than tax decentralization and the difference is made up with grants. Grants, in addition are potentially a powerful instrument of equalization. Larger grants can be given to sub national governments with smaller tax bases. Grants equalize (or can contribute to) resources between sub national governments, but at the same time they decrease the autonomy of sub national governments, or at least of those that receive too much in grants and get too little in taxes. In other words, there is yet another trade-off between equity and autonomy. Complete equity (identical per capita resources per inhabitant between local governments) could be achieved by a system in which there would be only grants. Such a system would not leave any autonomy to local governments. At the opposite a system in which local governments resources would consist only of taxes would give them total autonomy. But such a system would imply large differences in resources pr capita and be very inequitable, particularly in a country like South Africa. Note that this trade-off is much steeper when the initial tax base distribution is more unequal. It is illustrated in Figure 3.

Figure 3 - Trade-off Between Autonomy and Equity



Simplicity

A final criteria or objective, particularly relevant for a country like South Africa, with relatively scarce administrative resources, is the simplicity of the system. A theoretically very good system that will be difficult to implement will not reveal its assumed qualities. Here too, there are trade-off to be made.

III - Assignment of taxes

Personal income tax

Income of individuals or of households is an important tax base. It can be, and usually is, taxed in a progressive fashion, by means of a multi-rate schedule. The personal income tax should better be a national tax, for several reasons.

First, it is a tax which is difficult to implement and to administer. Taxable income is hard to define, and the most complex and comprehensive definitions will always require interpretation. Verifying and collecting the tax for millions of people is a massive undertaking. Few, if any, sub national governments are equipped for such tasks.

There can be some debate over this point. The administration of a sub national tax may be done by a national administration, on behalf of the sub national governments. The central government decides on the tax base, sub national governments on the tax rates, the central government collects the tax proceeds and hands them over to the sub national governments. This can be done for any tax, not just the personal income tax. It is indeed done in a country like France, and in many other countries. This, however, requires a high degree of cooperation and of confidence between the various levels of government. It assumes that there is a strong, independent and dedicated central government tax administration. In many countries, particularly less developed countries, enforcement is not always a matter of fact. Enforcement rates cannot be assumed to be in the 97-100% range. They are a matter of policy. Tax yields are often as much a function of tax collection as of tax rates.

Second, the progressive personal income tax is the major instrument of interpersonal redistribution within a country; as discussed above, interpersonal

redistribution should primarily be the concern of central, not sub national, governments; this means that the personal income tax should primarily be in the hands of the central government.

Third, regional or local income taxes at different rates (or schedules) could induce households to move from high rates areas to low rates areas. The personal income tax is a very "visible" tax, of which taxpayers are very much aware. Inter jurisdictional rates would induce people to change residence, particularly if there were different rates in the same urban area and if people could change residence without changing job.

It is often argued at this point —and the argument is made for many other taxes, not merely for the personal income tax— that the imposition of uniform rates for all sub national governments would solve this problem. It would, indeed. But it would also kill the localness of the tax. A tax imposed at a nationally decided rate is a national tax, not a local tax. If its proceeds are allocated to sub national governments, it is a national tax coupled with a grants system. The total amount of the grant is equal to the total, national, yield of the tax. The allocation criteria of the grant is the amount of taxes collected in each sub national government. This is one of the worst allocation criteria that can be imagined.

Fourth, income is unequally —particularly in South Africa— distributed amongst sub national jurisdictions. A local or regional tax based on income will give local or regional governments very unequal tax resources.

A similar argument can —unfortunately— be made for most tax bases. Whether they are based on income, on property, on sales, on activity, they will be unequally distributed. Reliance upon local taxes will create inequities. Some tax bases, however, are more unequally distributed than other. And, more relevant to the case of the personal income tax, disparities will be *aggravated* by progressive tax schedules. Consider A and B, two homogeneous local governments of similar populations. In A, per capita income is 200; in B it is 100; this is a ratio of 2/1. Both local government have a similar income tax schedule: 10% for the 0-100 bracket, 20% for the 100-200 bracket. It is easy to figure out that the tax for A will be 30 and the tax for B will be 10; this is a ratio of 3/1.

A special reference must be made to *shared taxes*. Shared taxes, that is the allocation to each sub national government of a share of the proceeds of a national tax actually collected in this particular sub national government, can be applied to any tax. But shared taxes are particularly advocated with reference to income taxes. Indeed, the interim Constitution of the Republic of South Africa allocates to provinces "a percentage of income tax on individuals which is collected within the province" (§155 (2) a). Such a resource may be desirable for sub national governments, but it is not a sub national tax, because its rate is not decided by a sub national government.

It is a subsidy. Like all grants or subsidies, it is characterized by its amount and its allocation formula or criteria. The total amount of the subsidy is equal to a certain % of a national tax (in this case: the personal income tax), and will increase if the national tax rate is increased. There is nothing wrong with that, and it might give sub national governments at large a welcome guarantee about the total grant amount. The criteria used to allocate the grant between the various sub national governments is the amount of the national tax collected in each sub national government. This particular criteria is not a good one. It is inequitable, because per capita proceeds of the personal income tax are likely to differ greatly between sub national jurisdictions. Subsidies do restrict the autonomy of sub national governments. But they make it possible to equalize resources. Subsidies that do not equalize have the worst of both worlds.

Corporate income taxes

The income of businesses and corporations is a second tax base. It is also better suited for central government taxation than for sub national governments taxation. One reason is of course that this tax base is also unequally distributed between sub national governments. It can also be mentioned that the corporate income tax is difficult to assess and to administer. But the most compelling reason has to do with enterprises operating in several jurisdictions. It is difficult enough to assess the income of a given enterprise. But it is even much more difficult to allocate this income between the various jurisdictions. Consider an enterprise with headquarters located in region A, production facilities in region B, and sales in region C; how allocate its benefits between A, B and C? Any formula is bound to be arbitrary, difficult to implement, and inefficient, in the sense that enterprises will manage to make benefits appear in the region with the lowest tax rates (for instance through the manipulation of internal prices). A final reason to prefer corporate income tax at the national level is that differing rates between jurisdictions will induce enterprises to locate in the lower rates jurisdictions, which may not be the most desirable ones from an economic perspective.

Payroll taxes

Taxes assessed on wages paid are common in many countries. They are usually not too difficult and not too costly to administer, because much of the administrative burden falls on the employer. Note, however that enterprises that perform the functions of tax collectors do it at a cost, which is not visible, but is nevertheless very real. Note also that the burden of checking and auditing remains with the administration. A major drawback of payroll taxes is that they are a poor substitute of income taxes. They are assessed on wage income, not on other forms of income, and on declared wage income, which may be only a fraction of effective wage income. For that reason, payroll taxes tend to discriminate against labor and against the formal sector. The administrative convenience of payroll taxes has an economic cost.

Payroll taxes can be decentralized to local or regional governments. This is not desirable, because—as in the case of income taxes just discussed—it will favor certain jurisdictions more than others (those jurisdictions with a great deal of formal wages), and because different rates will induce uneconomic business locations.

The reason why sub national payroll taxes may not be as undesirable as some other types of sub national taxes is their administrative convenience. Payroll taxes can be assessed and collected relatively easily at a local or regional level. Note, however, that this is true of payroll taxes at the *place of work*, but not so true of payroll taxes at the *place of residence*. Yet, in many cases, at least for local taxes, it is the latter which is desirable. In multi-jurisdictional urban areas, many people work in a given local government and live in another. Public expenditures needs are more associated with residence than with work. Ideally, a payroll tax should be levied at the place where wage earners reside. If the tax is to be collected by enterprises, it means that each enterprise should know where all its workers live, and be equipped to send the payroll tax to all the local governments where its workers live. This is asking a great deal from businesses.

Turnover taxes

Turnover taxes are assessed on the sales of goods and services by enterprises to enterprises, usually at rather low rates. They are not considered as a desirable form of taxation, even at the national level, for two main reasons. One is that the amount of tax borne by a given product is a function of the number of times the product has been taxed, that is the number of stages in the production-distribution process. This encourages vertical integration: an enterprise will reduce the tax burden by merging with its suppliers

and its clients. This tax is therefore not neutral. The other is that a turnover tax is difficult to administer. Inter-enterprises transactions are many and hard to spot. The tax is therefore likely to be widely evaded.

These difficulties are magnified at a sub national level. If rates differ between jurisdictions, as one would expect with regional and local taxes, trade patterns and locational patterns will be affected, because enterprises will prefer to sell to enterprises located in low rate jurisdictions. Enforcement difficulties will be made more acute by the multiplicity of rates if the tax is administered nationally, and might be beyond administrative capabilities if the tax is administered sub nationally.

Retail sales tax

Retail sales taxes are, as their name indicates, taxes assessed on retail sales. Unlike turnover taxes, they hit products only once: at the time and place where products are sold, if not consumed. Retail sales taxes are difficult to administer, because the tax base consists of millions or billions of —often minute, and usually unrecorded— transactions. It is therefore widely evaded. It is slightly regressive, because consumption increases more slowly than income, although it can be made proportional or even progressive when different tax rates are applied (a low rate for basic necessities, a high rate for luxury items).

Retail sales taxes can be used as sub national taxes. They constitute an important source of sub national taxation in the USA, for instance. Their main advantage, as a sub national tax, is that they cannot affect much locational patterns. Tax rates are usually not very high, and differences in rates between jurisdictions are of necessity smaller. They are too small to induce people to shop in one place rather than in another. Only at the border between two jurisdictions can one see people crossing the border to benefit from lower rates. Implementation difficulties, however, are as serious at the sub national level as at the national level.

Value-added taxes

Value-added taxation (a relatively new form of taxation: it was first introduced in 1954 in France, by a man who is still alive, Maurice Lauré) is increasingly replacing turnover taxation and retail sales taxation. South Africa has decided to turn to value-added taxation. The tax base is the value added at each production or distribution stage, defined as sales of the product minus purchases of inputs. Enterprises, including retail enterprises, pay the tax on their sales minus the value-added tax which has already been paid on their inputs. As a national tax, value-added taxes have several major advantages, which account for the phenomenal success of the idea. First, they are neutral relative to the production process; they do not encourage vertical integration like turnover taxes, and do not favor one production factor more than another. Second, they provide a build-in mechanism for enforcement. The taxes paid by supplier A are deducted from the taxes paid by its client B; for this reason, A and B cannot collide and practice under invoicing: B wants A to pay its taxes and is therefore a natural ally of the tax administration. Value-added taxation is complicated to administer, but it is not widely evaded. Finally, value-added taxes fluctuate, nearly by definition (since GDP is the sum of value-added), very much like GDP. Value-added taxes rates can be made to vary with the type of products, so as to make them more progressive (if high rates products are disproportionately consumed by higher income households), although multiple rates complicate seriously tax administration.

Value-added taxes, unfortunately, are not suited as regional and *a fortiori* local taxes. A system with different jurisdictional rates, would be very difficult to administer. In a country, the value-added tax on exports is usually zero, and the taxes paid on inputs

purchased for the production of exports are refunded: imports pay the full value-added tax; this system is said to be based on the "destination principle". This taxation of imports and exemption of exports implies controls at the borders of the country. Such controls are usually already in place for other purposes. In addition, the share of international trade is usually relatively minor. Value-added taxation in an open economy is therefore feasible. It is another matter if different value-added taxes are imposed by the various regions of a country. For most of these regions, interregional trade will be more or much more important than intraregional trade; what was an exception in the case of a country will become the rule in the case of a region. More important, since there are no controls at the borders of the regions, it will be extremely difficult to know what is exported out of the region (and gives rise to refund) and what is imported into region (and must be taxed). This could conceivably be done on the basis of book accounts. But the built-in enforcement feature of value-added taxation, one of the main advantages of the tax, would disappear, and risks of tax evasion would be serious.

There is another way to handle the interregional trade dimension of regional value-added taxation, based on the so called "restricted origin principle". In this approach, imports from the rest of the world are taxed, but imports from other regions are not taxed, there are no refunds on value-added taxes paid on inputs to exports, and there are refunds for exports to the rest of the world. This is the solution adopted in principle by the European Common Market countries, but never implemented in practice. This is also a solution adopted in Brazil, which is a classical example of value-added taxation at a sub national level. It could perhaps work if the value-added tax rates were the same for the various European countries or Brazilian states. But this is not the case, and it should not be the case if the tax is to be a real sub national tax. The multiplicity of rates creates all sorts of administrative difficulties, and distorts locational patterns. The Brazilian example is widely recognized to be a failure.

Value added taxation, which is highly desirable at the national level is not to be recommended at the regional level and is hardly thinkable for the local level. Can it be used as the basis for a shared tax, as suggested in the Interim Constitution (§ 155 (2) b)? Not really. The points made above about the use of income tax as a basis for a shared tax can be made again here. The amount of value-added tax collected in a given province will differ greatly from province to province, and create serious inequities. Some of the points made about the use of the corporate income tax as a regional tax can also be made here. One knows how much value-added has been created by a given enterprise (or how much benefit it made), but it is much more difficult to allocate this value-added (or this benefit) between the different regions in which the enterprise operates. Arbitrariness will therefore be added to unfairness. A shared tax is a subsidy, and should be allocated to the different sub national governments according to meaningful allocation criteria serving well identified purposes, and particularly equalization objectives.

Excise taxes, including taxes on utilities

Excise taxes are a form of retail sales tax, that hit certain specific items, such as alcoholic beverages, tobacco, motor fuels. The justification for excise taxes in general is that they are relatively easy to collect (there is a limited number of beverage, tobacco and fuels producers and distributors) and that they hit products the consumption of which implies social costs.

Excise taxes can be utilized at the regional level relatively easily. As long as inter jurisdictional differences in rates are not too great (and they cannot be very great), trade patterns will not be distorted, except in border zones, because transportation costs to low rate zones would quickly eat up tax differential benefits. This point is much less true for the local level. In addition, excise taxes are visible taxes, and will therefore increase regional governments accountability.

Excess charges on utilities (particularly water and electricity) are a form of excise taxation, which appears to be common in South African cities. They are easy to collect. They are not likely to distort significantly locational patterns. On the other hand, they might exaggerate existing distortions in the structure of charges. It is not easy to decide on the structure of user fees. Ideally, for economic reasons, charges should be equal to marginal costs. But marginal costs are often in practice difficult to know and are only grossly approximated by charges. There are also cases in which charging at marginal costs would mean operating at a loss, so that charges are set above marginal costs. In reality therefore the structure of charges is often quite different from what would be economically optimal. Imposing a surcharge will increase the potential welfare losses caused by these departures from optimal prices. In addition, one should note that electricity and water (and motor fuels too) are not only consumed by households. These goods are also purchased by enterprises, and used as inputs in the production process. They are a tax on business, and more precisely on businesses that use water and electricity (and fuels); there is no reason why this particular types of businesses would be discriminated against.

As sub national taxes, excise taxes are far from perfect; but they are not as dangerous as many of the other taxes discussed.

Property taxes, including automobile taxes

Taxes on property, usually land and structures, but also automobiles, are good candidates as sub national taxes. In most anglo-saxon countries, they are the most important local taxes. As such, taxes on land only have a major advantage over all other types of taxes. They cannot distort locational choices. Because the land is where it is, and cannot be moved away, a pure land tax will not induce any undesirable locational choices. A tax on income will induce households to settle to lower rates areas, a tax on consumption to shop in lower rates areas, a tax on production to produce in lower rates areas, etc. High land tax rates will not change anything. They will only wipe out part of the land rent. Taxes on immovable properties are amongst the best regional and local taxes.

In practice, however, the picture is not so rosy. Most "properties" are built up structures (houses, flats, shops, warehouses, factories, office buildings). Their market (or rental) value includes an element of land rent, but reflects the value of the building. It is very difficult, not to say impossible, to tax the land element only. What is taxed is the value of the building where it is. A high tax rate will hit both. And if it cannot affect the land, nor existing buildings, a high tax rate can and will prevent the construction of more buildings, thereby affecting the spatial allocation of resources.

Like most other tax bases, property values are unevenly distributed over space and between jurisdictions. "Rich" areas will have higher tax bases and, for a given rate, higher tax yields. A system founded on property taxes will contribute to maintain and aggravate existing inter jurisdictional disparities.

In addition, taxes on immovable properties are particularly difficult to assess and to administer. All properties must be recorded, their owners must be identified, their value must be estimated (a particularly demanding task at times of inflation), all changes (demolitions, additions, improvements) must be recorded, tax bills must be sent to a very large number of taxpayers, and tax payments must be collected. This is cumbersome and costly. In low income neighborhoods, these tax costs may in certain cases exceed tax proceeds. But since one does not know in advance for which properties this will happen, the effort of identification, assessment, and collection must be done for all properties.

Taxes on immovable properties are therefore not a panacea. They nevertheless are one of the best (or least worst) forms of local and regional taxation. There is little doubt that they must be an important component of sub national taxation.

Motor vehicles taxation is a particular form of property taxation. Movable property in general is difficult to tax at a sub national level. A tax on jewels or on equity ownership, for instance, would be widely evaded; and differential rates would induce people to locate in low tax rate areas. The case of motor vehicles is different. Motor vehicles are already registered at a particular location and are easy to spot: they can be taxed locally. Annual ownership taxes on vehicles are not very difficult to administer. This can be done by means of the sale of a sticker affixed on the vehicle, for instance. Vehicles taxation is probably more appropriate for regional governments than for local governments. In the case of local governments, differential rates could induce some people to register their cars in low rate local governments. This danger is not great in the case of regional governments.

The taxation of *property sales* is yet another form of property taxation that can be (and is, in many countries) utilized at a sub national level. In general, a tax on property sales is not very desirable, because it impedes transactions and adjustments which are desirable and even necessary for economic development. But it is a tax that, unlike many other taxes discussed above, is not more harmful at the sub national level than at the national level. Inter jurisdictional differences in rates are unlikely to become large enough to impede transactions differentially. It can therefore be considered as an element of a sub national tax system.

Natural resources tax

Natural resources, such as mineral deposits, are an interesting tax base. To the extent there is an economic rent associated with, it can be considered a good tax base. The tax will take some of that rent, and will not distort resource allocation. Because natural resources cannot be moved away, sub national taxation can be appropriate. In practice, however, there are difficulties with local or regional taxes on natural resources. The most obvious one is that natural resources are usually very unevenly distributed, more so than any other conceivable tax base, and in a random fashion. Some areas will have an enormous tax base per capita, whereas other will have nothing. This will be both unfair and uneconomic (because it will attract people and enterprises to these privileged areas). A second problem is that it is difficult to effectively base a natural resource tax on the economic rent. This requires a good understanding of the world market, which is not likely to be available at a regional level. In practice, natural resources taxes are likely to be assessed on output or on profit, and to be a form of corporate income taxation rather than a form of property taxation. Finally, the proceeds of natural resource taxes are likely to be very volatile; these great ups and downs will more easily be absorbed by a national budget than by regional, not to mention local, budgets. On the whole, it seems difficult to recommend taxes on natural resources as sub national taxes

Internalizing taxes

Socially undesirable behavior can constitute very desirable tax bases. This is particularly the case with pollution, but also with congestion. When a citizen or an enterprise engages in (lawful) activities that implies for other parties damages and costs not accounted for by market prices —when it creates negative externalities— "natural" market solutions are sub optimal. Too much of these particular goods or activities will be produced, relative to what society really wants. The best way to improve matters is to impose a tax on such activities. Ideally the rate of the tax should be equal to the marginal cost inflicted by the activity. The main rationale of these internalizing taxes, also called Pigouvian taxes (after Pigou, a British economist who first advocated them), is not fiscal.

It is to improve the allocation of resources, not to produce revenues. The revenues produced, however, are good to take. In fact, internalizing taxes are ideal taxes. Most taxes, be they on income, on capital, on activities, etc., distort resource allocation in an undesired fashion and have an economic cost. Pigouvian taxes, on the contrary, change resource allocation in a desired fashion and bring therefore an economic benefit.

Internalizing taxes can make good regional and local taxes. The reason is that many, if not most of the damages that need to be internalized are local or regional in nature. This is true of many (not all) air pollution damages, of noise, of water pollution damages, of traffic congestion. The difficulties with internalizing taxes is that they are often difficult to implement. They are relatively new taxes, and experience with them is not large. But they are more and more utilized as an instrument of environmental policy. Technological progress is also making internalizing taxes easier every day. They should be seriously considered.

Table 4 summarizes the above discussion.

Table 4 - Desirability of Taxes for Various Levels of Government

	National	Regional	Local
Income tax	+++	-	-
Corporate income tax	++	-	-
Payroll tax	+	+	-
Turnover tax	-	-	-
Retail sales tax	+	-	-
Value-added tax	+++	-	-
Excise taxes	++	++	+
Property taxes			
on immovable properties	+	+	++
on motor vehicles	+	++	+
on property sales	-	+	+
Natural resources tax	+	-	-
Internalizing taxes	++	++	+++

Source: subjective assessment based on the discussion above.

Note: +++ = very good; ++ = good; + = rather good; - = rather bad; -- = bad; --- = very bad.

The assessment of table 4 is indeed subjective, and it is based, in a not very rigorous ad hoc fashion, on many different criteria: the administrative feasibility of each tax at the level considered, its allocation impacts, its interpersonal and inter jurisdictional impacts, etc. It should therefore be considered as indicative. The main message, of the table, however, is rather strong: there are not many taxes that are suitable for local and provincial governments. In addition to internalizing taxes (which cannot be expected to bring much revenue in the near future), there are various forms of property taxes, and excise taxes. Some other, not very desirable taxes, can also be utilized amongst the least dangerous ones. It is also important to note that the damage done by a given tax are a function of its rate and its weight. This function is exponential. Doubling the rate of a tax will multiply its damage by 3 or 4. This means that, for a given yield, several bad taxes will be less harmful than just one bad tax.

IV - Assignment of expenditures

With several levels of government, a basic question is: who should do what? Which public goods and services should be provided by each of the various tiers of government? Neither theory nor experience offer a simple answer to this simple question.

The theory of fiscal federalism offers a guiding principle: spending responsibilities should be allocated to the lowest level of government, *except* when it can be shown that the service will be better performed by a higher level of government. In other words, it puts the burden of the proof on the "centralists".

There are four types of "exceptions": (i) the presence of spillovers, (ii) the existence of economies of scale in production; (iii) the ease with which the public good or service can be charged; and (iv) the technical complexity of the good. The more important these characteristics in a given public good or service, the less easily it can be decentralized.

The first one, that can be called the "externability" of a service, refers to the quantity and types of external effects and geographical spillovers associated with the service. Many public goods, such as defense or diplomacy only make sense for the country as a whole. Some infrastructure services, like highways, or power production and transportation, matter very much outside the area in which the infrastructure is located or the service provided. This is the case with most "network" infrastructures, as opposed to "point" infrastructures, although a spatially small network (such as a water distribution network) is really more like a point infrastructure, with a reduced "externability". The smaller the externability of a service, the easier it is to decentralize it. By contrast, services with important network effects or spillovers are not easy targets for decentralization.

There are, by definition, economies of scale when the unit costs of providing a given good or service decline with the total number of units produced —at least up to a certain point. Economies of scale, which are very common in industry, can also be found in the provision of some public goods and services. In education, for instance, curriculum developments or textbooks purchases, or teachers' recruitment procedures are activities subject to economies of scale, and would not be cost-effective if they were done at a very decentralized level.

The "chargeability" of a service refers to the ease with which the service can be financed by charges, as opposed to taxes. Services which are excludable and subtractable can and should be sold (i.e. financed by fees), rather than given for free (i.e. financed by taxes). Services are more or less "chargeable". National defense is not at all chargeable. Water, or power can easily be charged; urban public transport is already a little more difficult to finance by fees only; it is extremely difficult to make people pay for the amount of garbage collection or of street usage they consume. It should be noted, however, that technological progress constantly extends the domain of chargeability. Forty years ago, it appeared difficult to charge for parking: the various types of parking meters have made it easy. To-day, it appears difficult to charge for street usage: electronic road pricing devices are about to make it possible. Chargeability also has a social dimension. Some services, like education, which could technically be financed by charges, are often financed, at least in part, by taxes, either because they are considered as merit goods or because there are externalities associated with the provision of the service. The greater the chargeability of a service, the easier it is to decentralize it.

The "technicity" of a service refers to the degree of technical and managerial expertise required to provide the service. It is easier to provide garbage collection than to provide bulk clean water. The lower the technicity of a service the easier it is to decentralize it. This is because the economies of scale and of scope associated with the provision of the service, which are difficult to reap in the case of decentralized provision, will be less important, and therefore that the (potential) production efficiency losses will be minimal.

The following table 5 is a crude attempt to give some flesh to these concepts. The externability, scale economies, chargeability, and technicity of a number of public goods and services have been estimated on a 1-5 scale, with 5 the value most favorable to decentralization. Then, the values of the four characteristics have been added, to yield a gross indicator of "decentralizability".

Table 5 - Decentralizability of Selected Public Goods and Services

	Externability ^a	Scale ^a	Chargeability ^b	Technicity ^b	Decentrability ^c
Defense and diplomacy	1	1	1	1	4
Research	1	2	2	1	5
Highways	1	3	1	2	7
Railroads	1	1	4	2	8
University education	2	3	3	1	9
Welfare	3	2	1	3	9
Sanitation	2	3	2	2	9
Power production & transmission	1	2	5	1	9
Health	3	2	3	2	10
Primary education	3	4	2	2	11
Rural roads	2	4	1	5	12
Telephone	1	2	5	2	10
Airports	3	4	4	2	13
Water production & storage	2	4	5	2	13
Ports	4	4	4	3	15
Garbage collection	5	5	1	5	16
Power distribution	4	5	5	3	17
Urban transport	4	5	4	4	17
Water distribution	4	5	5	4	18
Street cleaning	5	5	4	5	19

Notes: ^aHigh 1,2,3,4,5 Low; ^bLow 1,2,4,5; ^cLow 3,4...14,15 High

The concepts, the ratings, and the weighting formula can be discussed and improved. This simple exercise, however, indicates that some services are better adapted to decentralization than other and why. Street cleaning, water distribution, urban transport (in the form of provision or of regulation) or power distribution appear the most interesting candidates. At the other end of the spectrum are such services as defense or diplomacy, highways, sanitation, railroads, power production or primary education, for which decentralization is impossible or should be pursued with great caution and prudence, if at all.

The case for a different treatment of different functions

The provision of many public services is the outcome of a complex set of tasks or functions. Six different functions can be distinguished: the design of investment, the choice of investment, the construction of facilities, the operation or regulation of facilities, the maintenance of facilities, and the monitoring and auditing of service performance. Not all these functions are required for every type of services; and these tasks are often interdependent. For a given public service in a given geographical context, the desirable degree of decentralization is likely to differ from function to function.

The design of infrastructure investments or facilities will often be a difficult, highly technical task, and will be more and more so in a world of rapid technological progress. This function, which is often marked by important economies of scale, cannot easily be decentralized to local governments. It must either be contracted out to private firms or remain a central government function.

The choice of investments has both a technical dimension (what design retain?), a geographic dimension (where locate the investment?), an institutional dimension (what agency should be in charge of it?), and a social dimension (who should benefit from it?).

This is the function that can best be decentralized. If local decision making can improve allocative efficiency, it is through the exercise of this function. This is where the detailed, first-hand, knowledge of local realities (which will be higher at the decentralized level than at the central level) can best be applied. This is also where the election/reelection control mechanism can be expected to play a role.

The construction (of facilities) function is probably not for a government, be it local or central, to undertake directly, and should, in most cases, be contracted out to the private sector. There will nevertheless always be a role for government in this area, either to construct on force account, or to contract out the work and supervise it. This role would in many cases be better conducted by a central government than by a local government, and is not particularly suited for decentralization. In the case of road construction, for instance, the fragmentation of technical staff and construction teams can lead to serious production efficiency losses. In practice, unfortunately, it is not always easy to divorce the construction of investment function from the choice of investment function. But in theory, the decentralization of the former is more dangerous than the decentralization of the latter.

The operation and/or the regulation of the facility is often the most important function required for the provision of the service. It includes the setting of prices and fees. This function lends itself easily to decentralization. It cannot be very well performed by the central government, which does not have the appropriate information nor the appropriate incentive.

The maintenance of facilities can and should also be decentralized. In many cases, it should be privatized, that is contracted out to private enterprises under the control of a government. This government can be the central government, particularly when the central government is financing, but it can also be the local government which will again have a comparative advantage in terms of information and of incentives.

A last function is monitoring and auditing. It is a function best suited for the central government which has the expertise, the independence, and the elements of comparison that make monitoring useful.

The case for the joint provision of services

This paper has focused on the desirable allocation of different powers or services or functions to the different levels of government. The problem, however, is not to decide which level of government will be in charge of which local public service; it is not to draw up a matrix of level of government x type of service, and fill it in. For many, if not most, types of service two or three levels of government will have to be involved as different levels of government will have different, but equally legitimate, reasons to be involved.

Consider the case of primary education. One can argue that it should be decentralized to local governments, because the needs and the specifics of each local group of pupils are likely to differ from local community to local community, and could only be recognized and satisfied in a decentralized system. But one can also argue that primary education should be a regional responsibility, because of economies of scale (in the production of curricula, or in the recruitment of teachers, for instance) and because a purely local financing is going to create inequality in the quality of the service. Finally, one can also argue that primary education should be a central government responsibility or concern, because the central government has an interest in the education of all its citizens, and also because migrations will create externalities and spillovers that must be corrected by a higher level of government intervention. All three arguments are strong

and convincing. The conclusion they suggest is that all three levels of government must simultaneously be involved in the provision of the service.

The problem therefore is to determine how the different levels of government could and should cooperate. There are many instruments available to this effect: subsidies (of many types), mandates, constraints, guidelines, floors and ceilings, coordination mechanisms, contracts signed between various levels of governments, etc. These instruments should be studied and compared. Some mechanisms work, other don't. In the US, for instance, bridge maintenance is a State responsibility, but whenever a bridge quality goes below a certain threshold, the bridge becomes eligible for federal money; this form of central-regional relationship is especially perverse, and a sure recipe to lower the quality of bridges. Much more is known on certain instruments, such as grants, than on other, such as mandates. Coordination is the essence of polyphonic music. The part of every instrument must have its own horizontal coherence and its interest: this is melody. But at every moment, all instruments must be vertically coordinated and synchronized: this is harmony.

Cooperation between levels of government

It is important to emphasize the need for horizontal and for vertical cooperation between the various governments. Horizontal cooperation refers to cooperation between governments of the same levels, such as communes or regions. Whatever the design of sub-national government areas, and the allocation of responsibilities between tiers, there will be cases in which the existing governments are not geographically appropriate for the provision of certain services. This is most likely to happen in the —particularly important— case of cities. The geographic area needed for the efficient provision of water, transportation or planning will usually encompass the territory of several local governments. The choice is not between accepting the fragmentation and its inefficiencies, or deciding that a higher tier of government will provide these services. Procedures can and must be developed to make sub-national governments cooperate or create joint bodies to benefit from both economies of scale and decentralization.

Vertical cooperation refers to the cooperation between governments of different levels, such as central and local or regional governments. The division of labor between the various tiers should be as clear cut as possible. Every tier should know what it is responsible for; and citizens should know it too. However, it should be realized that an absolute division of labor is neither possible nor desirable. For many public services, the different tiers have different, but equally strong and legitimate, reasons to be involved in the provision of the service.

Consider primary education, for instance. It is quite obvious that local governments, which are close to the needs of the people and their children, and who can best handle school buildings location and maintenance, must play a key role in the provision of the service. But the central government also has a responsibility in the quality and content of the education which is provided to its future citizens, many of whom will not work and live in the local government where they have been educated. One could also argue that the regional government (where it exists) is an appropriate level for the financing of school buildings, the curricula, the recruitment of school teachers, etc.

In such cases, the solution is not to choose one level of government, but to design mechanisms by which the various levels will be involved. This is what happens in practice. In countries, such as France, where primary education is in principle the responsibility of the central government, local and regional government are also involved; whereas in countries, such as the USA, where primary education is in principle the

responsibility of local governments, regional governments (the States) and the central government also play a major role.

V - Conclusion

This brief discussion of expenditures and tax assignments has raised more questions than it has answered. This merely reflects the complexity of the issues considered. What is desirable for tax assignments is not what is desirable for expenditures; yet the two cannot be divorced, and compromises must be made, that also involve grants system and control system. What is desirable from an efficiency view point is not what is desirable from an equity view point, and may not be desirable from a stabilization view point. Last, not least, what is desirable from the various "economic" viewpoints adopted here may not be what is desirable from a political viewpoint. This is why in such matters, the conclusion must be left to elected politicians.

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INTERGOVERNMENTAL GRANTS AND BORROWING POWER

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This paper will first examine the theory of intergovernmental grants as it is described in the typical public finance textbook used by students of economics around the world. It will go on to briefly describe the grant systems found in the United States and Canada. I examine the United States and Canada solely because I am most familiar with those systems and not because I believe that they serve as the best models for South Africa. You might have been better served by an Australian or Indian expert. But while the analogy with the United States and Canada is not perfect, I believe that many aspects of their practical experience provides useful lessons to designers of new grant systems wherever they may be.

This discussion of grants as they appear, in practice, will emphasize practical problems in implementing an ideal grant system. It will argue that some departures from the ideal are so common and so predictable that they indicate a universal tendency among democratically elected politicians to

deviate systematically from the goals found in the textbooks. Given these theoretical considerations and a good deal of practical experience, the paper then focuses on the main issue before this conference. What, if anything, should be said about the intergovernmental grant structure in the new South African constitution?

In this paper, I take a very long view of the problem, as is appropriate when discussing constitutional issues. It is much more difficult to talk pragmatically about the short run when so much is unknown about how provinces, municipalities, and local governments will function in the beginning. However, this paper will discuss some of the short-run issues as well.

The second part of the paper will look at the borrowing powers that should be given to lower levels of government. Arguments will be made for the central government restricting such borrowing power. Implicit and explicit subsidies for borrowing by lower level governments will also be considered. The simultaneous existence of restrictions and subsidies is not quite as contradictory as may seem at first sight. Whatever policies are decided, it is then necessary to determine whether they should be implemented solely through legislation or whether some bounds on policy choices should also be built into the constitution.

A. The Grant Structure

The Theory

It is generally agreed that for a considerable period in the future, lower levels of government

in South Africa, especially the newly-established provinces, will be heavily dependent on grants from the central government to finance their expenditures on public goods and services. It will take considerable period of time for them to design and implement their own tax sources.

Textbook theory describes two arguments for providing grants from the central to lower level of government. The first argument suggests a role for grants that adjust for different capacities to raise revenues among different lower-level governments, and perhaps, for differences in the costs of providing the same level of public services. These transfers are generally known as equalization grants. They are especially appropriate in a country such as South Africa in which the lower-level governments have not yet evolved mature revenue systems of their own. The second argument relates to grants that encourage lower levels of government to finance particular projects and programs, some of whose benefits accrue to people residing outside the jurisdiction that finances the activity. In the United States such grants are called categorical, matching or cost-sharing grants, and in South Africa, they are commonly called conditional grants. In this paper, however, I shall call them specific grants, a term that I believe is more common internationally. I shall first discuss grants from the center to the provinces and later consider the possibility of grants from the center to local governments and from the provinces to local governments.

Equalization grants - The goal of equalization grants is to put each province in a more equal position to provide the public goods and services for which the provincial level of government is responsible. This is generally interpreted to imply that different provinces' fiscal capacity should be equalized.

However, the concept of fiscal capacity is not easily measured. In a decentralized multigovernment system, each province may have considerable freedom designing its own tax rate structure and choosing its tax rates. What do we mean by equating the "fiscal capacity" of two provinces, one of which, by its own choice, relies heavily on sales taxation and the other of which relies relatively heavily on personal income taxation?

Most authors, but not all, argue that the equalization grant should be independent of a province's choice of tax rates or tax structures. The issue of whether a central government wants to influence a province's choice of tax bases or tax rates can then be considered as a separate problem. I am, of course, assuming that in the longer run, the provinces of South Africa will have some degree of independence in raising revenue. Even a small degree of fiscal independence makes what follows relevant. If the central government totally and completely controlled provincial sources of revenue some time in the future, much of the following discussion would be inappropriate.

In one appealing approach to designing a system of equalization grants, the grant to a particular province depends inversely on the per capita revenue that it would receive if it instituted an average representative tax system and applied an average tax rate to the implied tax base. Canadians have created a remarkably sophisticated system of this type. They examine 37 revenue sources that can be found in different provinces. They then estimate the per capita revenues that would be generated by implementing these 37 revenue sources in each province and applying the national average tax rate to each. The highest result for Alberta is thrown out as are the results for the four poor Atlan

provinces. The results for the remaining five provinces are averaged and all provinces with below average, hypothetical tax yields per capita receive the per capita amount necessary to bring them up to the average. This grant is then reduced in every province by an equal per capita amount that reflects the budget duress recently being experienced by the central government.

For example, in fiscal 1989/90, the hypothetical average per capita revenue raised by applying the representative tax system in the five relevant provinces was \$4,503. The same tax system applied in Newfoundland, however, would have raised only \$2,808. Newfoundland, therefore, receives a per capita grant of \$1,695 ($\$4,503 - \$2,808$) minus an adjustment of \$128 that reflects overall budget constraints. Provinces in which the hypothetical tax system would yield an above-average per capita amount do not have to contribute anything to the central pool. That is to say, there are no negative grants. Such negative grants can, however, be found in the German system of equalization and in some other countries. Technically, I suppose the issue as to whether there should be negative grants should be considered to be an open issue, but as a practical matter, I would think that it would be extremely difficult to design such a system here. As in all countries, and especially in the United States and Canada, richer states and provinces will resist such a system strongly. Moreover, it would be particularly difficult to implement in a country like South Africa where no province has yet developed a mature tax system.

A most important feature of the Canadian system is that the equalization grant is completely independent of a province's choice of tax structure or tax rates. As noted above, attempts to influence

a province's choice can be considered as a separate matter. At one time, the United States had "revenue-sharing" grant that contained a much less sophisticated formula than found in the Canadian system, and it provided a much lesser degree of equalization. In one version, it did, however, contain some encouragement for tax effort generally and for states to rely more heavily on income taxes. Given today's anti-government and anti-tax climate in the United States, it is now hard to imagine getting much support for any formula that actually encourages tax increases.

Because the provinces of South Africa are so new and because demographic and economic data have only been recently estimated at the provincial level, it would be difficult to implement an equalization system based on a representative tax system. Besides, the tax systems of provincial governments have not evolved to the point that it is possible to define a particular tax system as being "representative". If a grant system based on equalization criteria is desired in South Africa, it will probably be necessary initially to design a formula that depends on recently-estimated variables such as population and per capita disposable income that indirectly, but incompletely, reflect tax capacity in the long run.

As will be described later, it will be surprising if such a formula can be devised without considerable political bargaining. The end result is likely to be a formula that is not as accurate an indicator of well-being as economists might like, but it is still important, in my view, to arrive at an explicit, transparent formula. That saves repeating the bargaining process every year and it increases the confidence with which provinces can forecast their grant receipts for budget planning purposes.

another way, a crude formula is better than no formula at all. Even the crudest possible formula -- on providing equal per capita grants -- provides considerable equalization because it amounts to a higher percentage of the per capita income of a poor province than it does of the income of a rich province.

It might be argued that a formula that only strives to compensate for differences in fiscal capacity does not provide sufficient equalization. Two provinces may have equal fiscal capacities, but face very different demands for public services or face different costs in providing the same level of public services. For example, they may differ in the relative sizes of their school age population or in the severity of certain health problems. Consequently, there may be a desire to introduce indices of need into the equalization formula. It is my understanding that the Department of Finance has been working on such indices for use in the short run while the Finance and Fiscal Commission has been working on more elaborate measures of the cost of a minimal level of services in different provinces.

While it should be relatively easy technically to design a system of equalization grants from the central government to the provinces in South Africa, it is more difficult to apply equalization concepts to grants from the center to local areas. Somewhat different systems of local government are likely to evolve in different provinces and they are likely to have differing expenditure patterns and tax sources. In every province, local governments will face very different problems depending on whether they are rural or urban. Added complexity stems from the fact that in many areas, there will really be four tiers of government -- central, provincial, municipal, and primary local authorities. Until the relative fiscal powers and responsibilities of the municipal and local authorities are carefully sorted out, it is difficult

to be very precise about the role of grants to local governments from either the central or the provincial levels of government.

Initially, two-thirds of revenue sharing grants in the United States went directly from the center to local governments. But this had some absurd results. For townships in New Jersey, which are very powerful organs of local government, the grants provided a modicum of equalization and served a useful purpose. Townships in some mid-Western states, however, exist only to construct and maintain roads. When revenue sharing payments were given to them, they were no longer equalization grants. They became highway grants.

Although the diversity of local government in South Africa may never match that of the United States, it is probable that local governments will be diverse enough to make it very difficult for the central government to design an equalization system for local governments that bypasses the provinces; and moreover, the interim constitution discourages this approach. Each province can be responsible first, for deciding whether it wants its own system of equalization or formula grants for its localities and second, for designing a system that is specific to its needs. This will not be easy in any province and provinces may wish to confine their grant system to providing assistance to local governments for specific goods and services. As will be shown later, such grants can also be designed to have a major equalization effect. If desired, it is also possible to allocate a portion of specific grants financed by the central government directly to local governments:

Specific grants - Many activities financed by lower-level governments provide some benefits to people residing outside the jurisdiction that initiates the activity. For example, the benefits of education provided by a province may be enjoyed in another province if the educated person moves. Sewage treatment facilities on a river will benefit residents living downstream of the facility regardless of their political jurisdiction. If left to its own devices, a lower-level government is unlikely to consider the value of benefits accruing to taxpayers in other jurisdictions and consequently, is not likely to spend sufficient amount on such activities.

The textbook solution to this problem is for the central government to share in the cost of such activities, thus encouraging local governments to produce more goods and services that have spillover effects. The size of the cost share financed by the central government is supposed to reflect the importance of the spillovers. It is important to emphasize that a specific grant system of this type will only work well, if the grant is open ended. That is to say, if a particular provincial activity is deemed important enough to the nation as a whole to warrant a grant from the central government equal to, say, 20 percent of the cost of the activity, that 20 percent matching share should be available to help finance the activity wherever it occurs. In other words, the grant should be run as an entitlement. It is only in this way that the decisions of local governments are sure to be influenced at the margin.

Most countries are only willing to allocate a portion of their specific grants as entitlements. It is common to also have closed-end grants. These are grants that are subjected to a strict budget constraint. It is then necessary for the limited budget to be allocated to qualified projects by

application process operated by the bureaucracy. I like to call this type of grant a rationed subsidy. Although it is theoretically possible for bureaucrats to focus the limited funds on projects and activities that have the highest beneficial spillovers, it will be argued in the next section that this is a very unlikely outcome.

It is quite possible to build an equalization element into specific grants that finance activities that are deemed to be in the national interest. For example, to the extent that the central government supports the social welfare activities of lower-level governments, a disproportionate share of the funds will go to the lower-level governments containing the largest poor populations even if the central government's matching share of the cost is the same for all lower-level governments. It is, however, possible to go further in the pursuit of equalization. In the United States, the central government pays 50 percent of the cost of Medicaid, a health program for the poor, in the typical state. In poorer states, however, the central government's cost share can exceed 50 percent depending on the results of applying complex rules. When equalization goals are mixed with economic efficiency goals related to spillovers, it must be admitted that the grant becomes a mongrel and it is no longer possible accurately to relate the central government's matching share to the importance of the spillover.

Practical problems

Equalization grants - Although equalization grants play a prominent role in textbook discussions of grant systems, they are not easy to implement explicitly. For understandable reasons, they are often strongly resisted by richer states or provinces. Indeed, in the United States, it is common for a state

like New York to estimate the total taxes that its residents pay to the central government and to compare that amount to grants received and the amount of central government procurement in the state. The implication is that New York has a moral right to the revenues that it produces for the central government. This same notion appears more explicitly in the shared tax systems common in Eastern Europe. The central government returns different portions of central government taxes collected within local jurisdictions.

The first draft of the South African interim constitution created an entitlement for the province for a share of the taxes collected within their boundaries. Fortunately, this proved impractical, because of the difficulty of accurately identifying the geographical source of many types of central government revenues. The nature of the entitlement was altered in the final version and provinces were instead entitled to a specified share of national tax revenues of different types.

Shared taxes, although they appear in many countries, do not have a great deal of intellectual appeal since they do little for economic efficiency and nothing for equalization. But note the very important difference between shared taxes, where the tax rate and base are determined by the central government, and piggyback taxes where provinces are allowed to set a rate that is applied to a centrally defined base. A piggyback tax is a useful technique for giving lower-level governments fiscal independence while using the resources of the central government to administer their tax systems.

Despite the lack of strong intellectual support for tax sharing, politicians from richer states w

strongly argue for it implicitly or explicitly. In the United States, this argument often affects the choice of variables for various formula grants. The arguments about formulae are typically vociferous and long lasting. I have a theory, which I cannot prove, that the political bargaining process in a democratic country has a tendency to push the entire grant system toward providing equal per capita grants to various states or provinces, although this tendency is disguised by adopting extraordinarily complex formulae and rules. However, as was pointed out above, even equal per capita grants imply a considerable amount of equalization.

It is also important to repeat another point made above. Even though a formula may reflect the political power of various parties to the bargaining process rather than the goals described in textbooks, it is very important to arrive at a formula that lasts several years rather than repeating the bargaining process every year with unpredictable results.

Specific grants - It is much more difficult to design efficient specific grants than is apparent in most textbooks. It was noted above that the grant must be an entitlement to have a high probability of affecting the marginal decisions of lower level governments. But few governments are willing to take the risk to the budget of making all grants entitlements. Many specific grants are, therefore, given a limited budget and it becomes necessary to decide how the limited funds should be allocated.

As noted above, they could be allocated according to a technician's estimate of the importance of the spillovers associated with individual projects. However, a bureaucrat's natural tendency is

want to finance the "best" projects. That means ranking them by the total rate of return and that can be very different than ranking them by the importance of spillovers. But the "best" projects are more likely to be financed by states out of their own revenues or equalization grants, regardless of the amount of central government assistance that they receive. In other words, I believe that there is a natural tendency for such rationed subsidies to go to projects that would be constructed anyway, and the central government's cost share becomes a pure windfall for lower-level governments.

In the United States, there is a tendency for the central government to promulgate that they will pay a very high cost share of certain types of projects. The central cost share often is far higher than anything that can be plausibly be associated with the spillovers provided by the activity. I can only speculate as to why this occurs. I suspect it is because the central government wants its share to be very visible, so that it gets a considerable portion of the political credit for the project. Of course, if a high cost share is combined with a limited budget, the number of projects that can be assisted must be rationed more severely and the probability of influencing marginal decisions falls further.

As the central governments of the United States and Canada have faced more and more severe budget constraints, some cost sharing grants have evolved to the point where there is absolutely no chance of affecting marginal decisions. In the United States, the total amount of highway assistance going to any one state is limited by a formula and by the requirement that states finance part of the cost of projects. But for a large number of states, the formula is the binding constraint and these states contribute a much greater share of costs than is required by the law. Marginal decisions are not

affected at all. The "highway" grant becomes a lump-sum transfer that might as well be totally unrestricted. Exactly the same thing has happened to the Canada Assistance Plan, a grant that used to pay 50 percent of the cost of unemployment assistance and other social welfare costs. The growth of the central government's budget for the program is now capped while actual costs facing the provinces have grown faster than the cap. Decisions are no longer affected at the margin, and as far as the provinces are concerned, the grant might as well be an unrestricted lump-sum payment.

Other tendencies are so common in grant systems that it must be concluded that they indicate universal propensities that designers of new grant systems must be particularly sensitive about, so that their undesirable characteristics can be avoided. There has been a strong tendency for specific project grants in the United States to support capital costs, but not operations and maintenance. Capital grants are easier to design and they do not imply a continuing administrative and financial burden on the central government. Moreover, they are more visible, providing politicians many photo opportunities to break ground initially and to open the facilities with ribbon-cutting ceremonies.

However, they can lead lower-level governments into huge distortions, especially if the central government's cost share is very high. Capital projects are often initiated with little hope of maintaining them. Despite administrative difficulties and long-term budget implications, it is probably desirable to continue to assist with operations and maintenance if the capital cost of a project is supported with a grant.

Apparently, this issue has become a matter of concern with regard to RDP grants in South Africa. RDP grants are designed to support only capital costs. Since the RDP is supposed to go on for a long period of existence in a few years, they could not provide continuing operating support even if they wanted to. I do not have a ready solution to this problem, but it is obviously a matter that the RDP and others have to be very careful about. U.S. experience suggests that it is much easier to seduce lower-level governments into initiating capital projects than it is to get them to maintain them without continuing assistance from the central government.

More generally, specific grants are extremely difficult to administer. If the central government money is used by lower-level governments, the central government has an obligation to try to insure that it is used for the intended purpose and that the activity is free from waste and corruption. It is not easy, however, for technicians sitting in Washington, Ottawa, or Pretoria to devise rules and regulations that will apply equally effectively in the varying conditions found in far flung states and provinces.

In the United States, each scandal tends to provoke the promulgation of more and more complicated rules. Supported activities tend to get defined more and more narrowly. Eventually, the rules and regulations become so oppressive that local decision makers have no freedom to adjust programs to local needs and conditions. Complex rules also put a premium on grantsmanship. Communities that are able to hire individuals who are very skilled at selling projects and writing applications tend to get a lion's share of the proceeds.

In a number of situations, the U.S. reaction has been to junk the whole approach and to combine narrowly defined activities into broader categories that are then financed by a block grant that is distributed by formula. Any pretense of influencing marginal decisions is essentially abandoned.

Once a block grant is substituted for a number of very specific grant programs, it becomes harder to associate central government assistance with specific local activities. It is then harder for central government politicians to take credit for their largesse and the "blocking up" of a number of grant programs is very often a precursor to cutting their budgets.

The administrative problems described above are probably most severe when the central government tries to deal with jurisdictions below the provincial or state level. It is easier to design a grant system suitable for nine provinces than for hundreds of different local governments. On the other hand, local governments will often engage in activities that are deemed to be in the national interest and there may be a strong desire on the part of the central government to try to influence them directly rather than going through one more layer of decision makers at the provincial level. The most administratively effective technique for achieving national goals -- going through the provinces or dealing directly with local governments --- is likely to vary from activity to activity. However, philosophical considerations may dominate administrative considerations in South Africa. The choice of whether grants go directly from the center to localities or always through provinces will have a profound influence on the power of provincial governments vis-a-vis the power of the central government and it will have an even greater influence on the power of provinces to influence localities.

level governments. As a general rule, a heavy dependence on grants makes the grantee obeisant to the grantor. The degree of obeisance will depend on the extent to which the use of the grant is restricted by rules and regulations. To the extent that the grantee has the freedom to make decisions regarding the use of the grant, some of his or her political influence is restored.

Clearly, the issue of how political power is distributed among different levels of government cannot be decided by technicians. It is a matter for politicians. The design of the grant structure will be an important component of the political decision process.

I have belabored the practical problems involved in designing grant systems for two reasons. First, although some of the less desirable tendencies that I describe are very powerful, they can be resisted to some degree and presumably, they will be resisted more effectively in South Africa if the designers of grants are forewarned. Second, the tendency for specific grants to evolve in ways that makes them remote from their original purpose often occurs one disjointed step at a time and is often not noticed. There is a need for some analyst in the central government to be responsible for tracking the evolution of the grant system as a whole. Otherwise, there will be a tendency for health grant changes only to be considered by health policy administrators and health budget examiners, an education grant changes by education specialists and so on. If a health grant is not working well and that sets in motion a series of reforms that effectively turn it into a lump-sum transfer, that may not be the worst thing in the world. But if this happens in a large number of areas -- and it has occurred in the United States -- the end result may be a number of lump-sum transfers whose aggregate impact

does not make a lot of sense. It might then be preferable to convert them all into one large equalization grant that is based on an explicit formula.

B. The Borrowing Powers of Lower Level Governments

It is generally agreed that there are circumstances in which all levels of government should be allowed to borrow. It is also apparent that there are times when borrowing is irresponsible. Using law or the constitution to differentiate the two cases is not an easy task.

At lower levels of government, borrowing is a convenient device for imposing the cost of capital projects on the taxpayers who will be enjoying the benefits. For example, if the construction of a water purification plant is entirely financed by raising current taxes, some taxpayers will bear an immediate burden for long-term benefits that they will not enjoy if they move out of the locality or die. By issuing debt that has its longest maturity equal to the life of the project and retiring it using a sinking fund approach, the tax burden necessary to service the debt can be spread over the life of the project and borne by the people who actually enjoy its benefits.

Note that this argument assumes that the capital expenditures of lower-level governments are lumpy and irregular. If they occur in a steady stream, then the time pattern of taxes is not much affected by whether the investments are financed by taxes or borrowing.

There is also a theoretical argument for borrowing when a lower-level government suffers an abrupt drop in revenue that is expected to be temporary because of a recession or some other emergency. That avoids having to raise and lower taxes frequently, a result that is inefficient because of the uncertainty that it creates and that can be destabilizing to the macro economy.

Given that borrowing by lower-level governments can be justified, the question arises as to whether it should be subsidized by the central government. It is difficult to think of any argument that warrants a subsidy. If the central government wishes to subsidize capital projects at the provincial or local level, grants can be used for this purpose in a much more targeted and efficient manner. A generalized subsidy for borrowing for capital investment will only increase the bias in favor of new construction and against repair and maintenance that was discussed earlier.

What about a subsidy to counter imperfections in the domestic capital market? Options include interest subsidies, guarantees, or the creation of a special facility that uses the full faith and credit of the central government to raise funds and direct them to lower-level governments. Imperfections in capital markets are likely to harm both private and government borrowers, although it is likely that the problems created for small private borrowers will be most severe. Giving special assistance to lower-level government borrowers will simply take credit away from the private sector, and the opportunity cost is likely to be very high indeed.

If, despite these remarks, a decision is made to subsidize borrowing by lower-level governments

the United States has clearly shown one way *not* to do it. That is by giving a tax exemption for the interest paid by lower-level governments. The U. S. market for such securities is not sufficient to bring their interest rate down to the point that the highest-bracket tax payer is indifferent between a taxable and tax-exempt bond. Hence, high-bracket taxpayers owning such bonds enjoy a windfall. Consequently, the reduction in tax revenues received by the U.S. Treasury is greater than the interest cost saving enjoyed by states and municipalities. Tax exemption provides an extremely inefficient subsidy.

Should the central government restrict borrowing by lower-level governments either in amount or in the type of activity that can be financed by such borrowing? If a lower-level government becomes financially irresponsible, that irresponsibility is likely to be quickly manifested by an increase in borrowing. Unfortunately, in a democratic system, the propensity to borrow irresponsibly is very high. It is a mechanism for shifting the current cost of government to future generations who are not yet voting and to future politicians who have not yet been elected.

To some degree the propensity toward irresponsibility will be constrained by private capital markets. A jurisdiction that is behaving irresponsibly will find it more and more expensive to borrow and to buy bond insurance and eventually, it will not be able to borrow at any price.

There are, however, two problems with relying on private market discipline to limit irresponsibility. First, lower-level governments often borrow by pledging revenue streams to service

the debt. The lender is much more interested in the security of the pledged revenue stream than in the quality of the projects being financed or in the overall fiscal behavior of the jurisdiction. By pledging one revenue stream after another a jurisdiction may be able to borrow a great deal at low interest rate when, by any overall, objective criteria, the borrowing is not warranted.

A second problem arises because lenders know that if a lower-level jurisdiction goes bankrupt tremendous political pressure will be imposed on the central government to bail them out regardless of whether there is any legal obligation to do so. This is especially true if the bankrupt jurisdiction is relatively large.¹ This implicit guarantee allows lower level governments to borrow more than they could otherwise and perhaps, more than is responsible.

Because private markets may not limit lower-level government borrowing as effectively as desired and because the central government is very likely to be held responsible in the event of bankruptcy, there is some justification for central government restrictions on provincial and local borrowing. The next section will consider whether such restrictions should be in the constitution or in legislation.

C. Constitutional Considerations

¹ In the late 1970s, after putting up strong resistance, the U.S. Federal Government was finally pressured into bailing out New York City when it was on the edge of bankruptcy. There is, however, today very little pressure to bail out Orange County, California, which has recently gone under because their Treasurer lost a great deal of the county's money trading in derivatives. There seems to be a political distinction between a bankruptcy caused by the malfeasance of one individual and one caused by a general pattern of irresponsibility.

Grants

The interim constitution of South Africa creates an entitlement to some type of grant for provinces by saying that "A province shall be entitled to an equitable share of revenue collected nationally to enable it to provide services and to exercise and perform its powers and functions." [Section 155(1)] It goes on to define "an equitable share" as a percentage of the income tax, value-added tax, and other unspecified revenues. Clearly, the explicit reference to income and value-added taxes is a residual of an earlier draft which envisioned sharing revenues from these taxes with the provinces in which they originated. The current language says that the percent of revenues conveyed to the provinces "shall be fixed reasonably after taking into account the national interest and recommendations of the Financial and Fiscal Commission". Subsection (4) implies that the grant should serve equalization purposes, but that its size can be varied depending on the budgetary circumstances facing the central government.

As a non-lawyer, I interpret this section to allow a wide variety of types of grants and to allow the budget allocated to them to vary greatly over time. But although the commitment to provide financial support is vague, it clearly gives the provinces a moral, if not a legal right to some type of grants.

The question is whether this commitment should be made more precise or whether it should be omitted from the final constitution altogether. The U.S. constitution is silent regarding the revenue powers of states and about financial arrangements between the states and the Federal government.

contrast, the Canadian constitution from its beginning in the British North America Act of 1867 has contained some sort of commitment to provide financial assistance to the provinces. As noted above the current version, written in 1982, describes a system of equalization grants closely resembling the description of ideal equalization grants found in public finance textbooks. It says that "Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." As with the language in the South African interim constitution, the quantitative implications of the Canadian commitment are very vague, but clearly there is a moral imperative to provide some sort of assistance to provincial governments.

Because the Canadian provision was added to the constitution so recently, I know of no cases that would more precisely define "reasonably comparable levels of public services" or "reasonably comparable levels of taxation". It would, however, seem unwise to attempt to be any more precise for constitutional purposes. The above description of actual experience in Canada and the United States showed that the grant system has evolved significantly over time in response to bad and good experiences and to the budget constraints faced by the central government.

In the United States, the evolution of the system has caused the amount of resources devoted to grants to vary enormously over relatively short time periods. In 1960, less than 1.5 percent of the GDP was devoted to the grant system and it amounted to less than 14 percent of state and local own-source revenues. By the late 1970s, grants had reached 3.5 percent of the GDP and 26 percent of own-source

revenues. There was then a major reaction and grants fell to 2.5 percent of the GDP and about 1.1 percent of own-source revenues by 1990. By 1994, grants were again absorbing 3.2 percent of the GDP, but primarily because of the growth of medicaid spurred on by soaring health costs.

It would be a mistake to design a constitution that either fixed the details of the grant system in concrete or committed the central government to provide a precisely defined quantity of financial resources to grants. The system has to be allowed to evolve and to learn from its mistakes. This is especially true in a young federation such as that which is being built in South Africa. Equally important, the central government has to be able to adjust the financial commitment to the grant system to its ever changing budget constraints.

The language in the Canadian and South African interim constitutions seems to this non-lawyer to allow a suitable degree of flexibility. The only danger is that court cases may eventually give phrases like "reasonably comparable" and "equitable share" a more precise meaning and so reduce flexibility.

Obviously, the safest solution is to follow the U.S. constitution and remain silent on the issue. South African provinces may not find that acceptable, however. If a constitutional commitment must be made to a grant system, the Canadian language has much to commend it. It more clearly makes commitment to the concept of equalization grants than does the current South African language. Yet it remains extremely flexible with regard to the design of the system and the budgetary resources that it might absorb.

The interim South African constitution does suggested that grants from the central to local governments be channelled through the provincial level except in special cases. As noted above, this seems somewhat more appropriate for equalization grants than specific grants. As also noted above, the choice of the channels through which grants flow is primarily a political matter, even though it has some implications for administrative efficiency. The interim constitution seems to allow an appropriate amount of flexibility in this regard, and it would seem unwise to make it any more precise or rigid.

Borrowing Power

Section 157 of the interim South African constitution clearly gives the provinces the power to borrow for capital investment purposes, but disallows borrowing to finance current expenditures. It also prohibits the provinces from issuing loan guarantees. The U.S. and Canadian constitutions are silent on such issues.

In the United States, however, all states but Vermont have provisions in their own constitutions or in legislative language that restrict their borrowing. These restrictions take a great variety of form. Some prohibit borrowing to finance operating deficits, some restrict all borrowing, some require that a balanced budget be planned, but not actually implemented, and some require referenda on borrowing or restrict it to a proportion of property values. State constitutions often similarly restrict the borrowing of local governments within the states.

The most common characteristic of all these restrictions is that they are often evaded. Of

budget independent agencies are frequently created to carry on some functions of government free of restrictions on borrowing, capital investment is often loosely defined to include activities that do not much resemble true investments and on and on. My own conclusion is that it is futile to try to draft constitutional language that restricts borrowing effectively. I even wonder if the various constitutional provisions reduce borrowing at all. But this is a minority view among U.S. experts. Most think borrowing is reduced, although perhaps not down to the limits described in various constitutions.

It was, however, argued above that there should be some restrictions on the borrowing of lower level governments, because the central government is very likely to get stuck with the bill if they default and one cannot entirely rely on market discipline to restrict borrowing to responsible amounts. I think that the restrictions should be imposed legislatively rather than constitutionally. Legislative language is much easier to correct when loopholes emerge than is constitutional language. Further, the restrictions should be based on the total amount of borrowing rather than the type of borrowing. Borrowing to finance capital investments can be as irresponsible as borrowing to finance current expenditures if the projects are wasteful. Moreover, it is very difficult to use legal language to differentiate capital and current expenditures. In any case, there are occasions, as described above, in which borrowing to cover current expenditures is quite legitimate.

A law could be drafted to require that provinces get permission from the Department of Finance for their own debt issues and for local government issues within their borders once debt servicing for on- and off-budget debt rises above some arbitrary proportion of total provincial and local revenues.

say 10 percent.

D. Conclusions

The United States and Canada provide interesting contrasts in the ways that their constitutions handle the financial arrangements among different levels of government. The U.S. constitution is remarkably silent about such matters while the Canadian constitution is more detailed about spending and taxing powers and grants. It is not readily apparent, however, that the difference in constitutional treatment of the financial characteristics of federalism has had a large effect on how financial arrangements have evolved in the two countries. Both have strong federal systems with powerful states and provinces. Both have elaborate grant systems. Both have seen major swings in the pendulum with regard to the power of states and provinces vis-a-vis the central government and both have seen major changes in the grant system.

It is true that Canada has a greater commitment than the United States to equalizing grants and that that may be because they are explicitly mentioned in the Canadian constitution. I suspect, however, that they are mentioned in the constitution, because a strong political commitment to such grants existed prior to the drafting of the constitution.

I believe that the key point is that the constitutions of the two countries have been written in a way that allows considerable latitude for the federal system to evolve to reflect changing conditions. Where the constitution has been very precise, e.g., prohibiting the U.S. government from levying direct

taxes, it has had to be amended.

To me, the lesson is clear. There is no problem in using the constitution to create a moral commitment to broadly defined financial policies, but it should not be used to try to force a specific detailed result.

A FRAMEWORK FOR FISCAL AND FINANCIAL RELATIONS AMONG THE NATIONAL AND SUBNATIONAL GOVERNMENTS

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Fiscal and financial relations among the national and subnational governments of any country largely follows from the relevant constitutional provisions. The unique period in the history of South Africa through which we are now living, offers the opportunity to make choices in this regard. The first major choice is the one between centralisation and decentralisation of expenditure and tax powers in the government sector.

1 THE INITIAL CHOICE

The initial choice between centralisation and decentralisation of government powers is not of the "either-or" type. It is a matter of degree. The question is not whether all government powers should be centralised in the hands of the national government, or whether they should **all** be decentralised to subnational governments. The issue is not even **which** of the powers should be centralised and which decentralised. It is more accurate to state that the appropriate **degree** of centralisation or decentralisation must be chosen for each expenditure and tax power of government.

The extent of centralisation or decentralisation of government powers is ~~closely related to the number of tiers or levels in the government sector, as~~ well as to the demarcation of the boundaries of the subnational governments.

A system consisting of three tiers - national, provincial and local - offers a greater choice regarding the degree of centralisation or decentralisation than a two-tier system, and a more limited choice than a system consisting of national, provincial, subregional, local and neighbourhood levels.

Regarding demarcation, a small number of large subnational areas of jurisdiction on a given level of government represents a greater degree of

centralisation than a large number of small ones. Overlapping areas of jurisdiction, such as one would find in a system of single-function governments, or "special districts", as they are called in the US, offer wider choices than a system of multi-function governments with coinciding boundaries.

The extent of centralisation or decentralisation of expenditure and tax powers, the hierarchical structure, and the demarcation of boundaries within the government sector have a profound influence on the efficiency of resource use in and the economic viability of governments on all levels - and therefore on fiscal and financial relations among them.

The use of resources outside the public sector must also be taken into account. The full costs of political interaction are not reflected in direct government expenditure and therefore in the accounting books of national and subnational governments. Political interaction costs also include the direct supply of economic resources by citizens in the form of money, time and effort spent in deciding which political party to support, in promoting the interests of political parties and in lobbying to secure particular decisions from politicians. Furthermore, in a broader economic context, all reductions in individual and social welfare are defined as costs. If an individual disagrees with the outcome of a political decision, and is forced to comply with it, by being taxed to pay for its implementation or by being compelled to obey the resultant laws and regulations, his/her welfare is reduced.

1.1 CENTRALISATION

In the past the RSA Government collected about 90% of all the tax revenue and about 80% of total revenue (taxes and user charges) of "general government", i.e. excluding public enterprises. The regional authorities (including the former-TBVC countries) themselves collected less than 5% of the total revenue, while local authorities collected 4 to 5% of the tax revenue, and 30 to 35% of the non-tax revenue. The central government made more than 90% of the transfers that took place among general government institutions. Regional authorities received almost 70% of the total intergovernmental transfers, and local authorities about 8% (Du Pisanié 1991:4). No figures are available yet, but the provisions of the interim constitution clearly continues this rather extreme degree of centralisation of tax powers. One of the questions that have to be addressed in this workshop is whether it must be continued still longer.

1.2 DECENTRALISATION

The term "decentralisation" is often used ambiguously. It can either mean "delegation", or "devolution" of powers. These two concepts are vastly different and should be carefully distinguished in all deliberations on constitutional matters.

1.2.1 Delegation

Delegation of a power takes place when a higher-level authority transfers the power to lower-level authorities, but retains the final responsibility for its execution. The higher-level authority would typically be responsible for the formulation of general rules and the lower-level authorities for their implementation, whether the majority of the residents in its own area of jurisdiction are in agreement with the rules or not. The lower-level authority in fact acts as an agent for the higher-level authority.

1.2.1 Devolution

Devolution of a power means that the higher-level government relinquishes the final responsibility for its execution and surrenders control over it to the lower-level governments. Of course, this does not mean that the lower-level governments are no longer subject to any control whatsoever. Apart from being subject to judicial rules which are enforceable by the courts of law, they are subject to voter control by the residents of their areas of jurisdiction. Devolution of a power obviously means that the general rules in respect of its execution are no longer made by higher-level governments, but by the lower-level governments.

When a power is devolved from the national government to a subnational government, the subnational government has every incentive to execute the power according to the wishes of its own constituency. By contrast, when a power is merely delegated, the subnational government remains sensitive to the wishes of the national government, particularly if the execution of the power is financed by transfers from the national government.

Several criteria can be applied to choose between centralisation, delegation and devolution of an expenditure or tax power.

2 DECISION CRITERIA

2.1 STABILISATION

One of the generally accepted goals of fiscal policy is macroeconomic stabilisation. It is generally agreed that furthering this goal should be a function of the national government (Döckel 1991:1).

The theory is that in recessionary periods, the national government must spend more than it receives in the form of taxes. This so-called deficit spending adds to total demand in the economy and increases the gross domestic product (GDP), directly and through a multiplier effect. Conversely, during upswings in the economy the national government should not spend all its tax revenue. The withholding of the surplus reduces the total demand and dampens the upswing.

This function cannot be left to subnational governments, because their deficits and surpluses might cancel out.

However, the argument does not require the national government's total expenditure and revenue to make up huge percentages of the total expenditure and revenue of the government sector. In other words, it does not require a strong degree of centralisation of expenditure powers and revenue sources within the government sector.

What it does require, is that the national government's spending and revenue must be **flexible and controllable**. It must be easy to vary spending, as well as revenue, over time and on short notice. Only then can **deficits and surpluses** that are adequately large relative to the economy (as for example measured by the GDP) be manipulated as required by the goal of macroeconomic stabilisation.

There is no evidence that the national government's growing share in the total revenue of the South African government sector over the last three decades has improved its ability to "tune", not to mention "fine tune", the economy.

2.2 REDISTRIBUTION

Another generally accepted goal of fiscal policy is to move society towards an "acceptable" distribution of income (Döckel 1991:1). Whatever "acceptable" means, this requires taking from the "rich" and giving to the "poor", or, which is not necessarily the same thing, taking from people with "high" taxable income and giving to people with "low" taxable income. If a subnational government attempts such redistribution, the "rich" tend to leave its area of jurisdiction - and the "poor" pour in from elsewhere. Therefore, it is widely agreed that redistribution should be a function of the national government (Döckel 1991:1). The national government can reach the "rich" wherever they go, as long as they do not leave the country!.

This argument does not require centralisation in the sense that the national government's total expenditure and revenue must represent large percentages of the total expenditure and revenue of the government sector, or of the GDP.

What it does require, is that national taxes should be progressive and that the national government should be responsible for transfers to deserving individuals, for example, determination and payment of civil pensions.

2.3 PREFERENCE VARIATION

Whenever a society consists of subgroups which have different preference patterns, the government system should provide for variations in the combination of public services and tax levels. There is ample evidence that members of different income and cultural groups have different expenditure patterns in respect of private goods, where they are fairly free to choose what to buy. This is a strong indication that they also have different preference patterns in respect of public services. If that is so, equity does not necessarily mean equality. ~~It means that different communities should have the freedom~~ to choose their own combinations of public service and tax levels.

Preference variation requires decentralisation - in the form of devolution, not mere delegation. We need a public service industry, comparable to private industries, where people can shop around for services of different quality at varying prices.

2.4 FISCAL EQUIVALENCE

Olson (1969:483) indicates that government systems are self-regulating when the principle of "fiscal equivalence" (not equality) holds, i.e. when those who benefit from a set of public services, those who pay for it and those who decide on its size and composition, are the same group of persons. Otherwise, the presence of spillovers of costs and benefits between areas of jurisdiction would lead to under- or over-provision of services. Not all costs and benefits of specific programmes fall within the confines of one government's area of jurisdiction, but might spill over to adjacent areas. If local or regional constituents must bear the cost of a service which also partly benefits other jurisdictions, they will probably provide a lower level of such a service than would be optimal from the point of view of the society as a whole. By contrast, if they do not have to bear the full cost of a service, but enjoy the benefits and can decide on its provision, they will opt for oversupply, relative to the social optimum.

Depending on the initial situation, this principle might require either centralisation or decentralisation.

2.5 ECONOMIES OF SCALE

It is often argued that decentralisation prevents the realisation of economies of scale, that is, savings associated with production of goods and services on a larger scale. This is not necessarily the case.

Firstly, in the production of many goods and services scale economies are exhausted at fairly low levels of output. In the USA it has been found that there are ~~no economies of scale for services such as police, fire, refuse collection, libraries, street maintenance,~~ and primary and secondary education for jurisdictions beyond relatively small size, perhaps as small as 15 000 to 25 000 and certainly no larger than 50 000 to 100 000" (Bish & Nourse 1975:133). In such cases, scale economies can only justify centralisation up to a point.

Secondly, diseconomies of scale may arise when governments become too big. The US Advisory Commission on Intergovernmental Relations has found that "in cities over 250 000 population ... there are significant diseconomies of scale" (Bish & Nourse 1975:133).

Thirdly, and perhaps more importantly, one should distinguish between demand articulation and technical provision. In private markets, individual consumers articulate, or express, their demand by purchasing goods and services from suppliers. This process is not possible in the case of public goods supplied to groups of people. Group demand for public services have to be expressed by means of political processes, as Bish and Nourse (1975:126-131) explain. Put differently, national and subnational governments articulate the demand of their constituents for public goods and services.

Whereas demand articulation is definitely a function of every government, the physical provision of goods and services need not be. Governments can purchase service delivery from other organisations, be they private or public. The well-known Lakewood Plan has sparked off a whole series of so-called contract cities. Lakewood was incorporated as a city in California in 1953. It had a population of 80 000, but began with only ten employees. The city council fixes tax rates and decides what services and what quality of service their citizens need. The employees then contract with other governments and private firms to supply the services, collect taxes and user fees, and pay the contractors (Bish & Nourse 1975:133).

Such contracts provide a solution to the problems of scale. If a government is too small to achieve scale economies by means of own production, it can purchase the relevant service from outside organisations. Alternatively, it can produce the service for itself and others. If a government is so big that own production will result in diseconomies of scale, it can contract with a number of other organisations to provide the relevant service. Combinations of own and outside production are also possible.

The conclusion is that problems of scale is not necessarily an argument for centralisation or decentralisation.

2.6 AVAILABILITY OF KNOW-HOW AND LEADERSHIP

It is sometimes argued that South Africa lacks sufficient numbers of people with the know-how and leadership qualities to staff a highly decentralised system of government.

This argument is an insult to the thousands of existing politicians and government employees on national, provincial and local level and they will obviously oppose it most bitterly.

There are also thousands of persons with managerial expertise in the private sector who can serve the public sector equally well as members and chairpersons of various councils.

Furthermore, a decentralised system of government affords unsurpassed opportunities for on-the-job training. New entrants to the system quickly take responsibility for decisions, but because the decisions are taken for relatively small constituencies, the potential harm of incorrect decisions are far less than in highly centralised systems.

2.7 EFFECTIVENESS, EFFICIENCY AND DEVELOPMENT

If a system of government is to function properly, it should provide incentives for politicians and officials on all levels to promote effectiveness, efficiency and development. The degree of centralisation or decentralisation of tax and expenditure powers have important effects on such incentives.

If all the major taxes are collected nationally, subnational governments have very little control over fiscal performance, that is, the efficiency with which taxes are collected. The bulk of their revenue will consist of transfers from the national government and superior performance in the collection of their own revenues will therefore make very little direct difference to their total revenue. Only if all or most of the transfers are made subject to the fiscal performance of a subnational government, the latter will have an incentive for superior performance in revenue collection.

Competition between subnational governments can be an important incentive to improve the quality of services, relative to tax rates. However, this will only be the case if the subnational governments have control over both service quality and tax rates. If the national government sets service standards and tax rates, no self-regulatory system for improving the service-tax ratio is built into the system. Such improvements will rest solely on the efficiency of the national government's policing system.

Efficiency is also affected by other considerations. Centralisation of government powers of necessity brings into being huge bureaucracies, which are burdened by the costs associated with the limited "span of control" of managers. A manager can only lead a limited number of subordinates, which

means that a large bureaucracy must inevitably consist of numerous hierarchical levels. Direct production of goods and services is typically limited to the lower levels, while large numbers of lower, middle and top managers are needed on the higher levels. The number of directly productive employees per manager is therefore lower in large bureaucracies than in small ones, which have fewer hierarchical levels. The direct financial cost per unit of production must therefore be higher in large, centralised bureaucracies. Such large bureaucracies also have other disadvantages, for example, long lines of communication, which lead to distortion of information and long lead times before decisions are taken and implemented.

By increasing the number of decision centres, devolution of a function increases the chances of innovation.

Concentration of power in the national government will doubtlessly lead to high costs of political interaction. According to Buchanan and Tullock (1962) the costs of political interaction with one's fellow-citizens consist of two categories, namely political negotiation cost and political external cost. Both categories of cost increase with increasing centralisation.

Political negotiation cost is the sacrifice of economic resources (including leisure time) in order to reach decisions by political organs on behalf of the citizenry. The larger the constituency, the more people have to be consulted and the more time it takes.

Political external cost is the negative effects of political decisions on the welfare of individuals, that is, the difference between what they want and what they get from government. If powers are centralised in the hands of the national government of a large heterogeneous society like South Africa, it will tend to render a uniform service package to all communities, while many or even most of them would prefer different packages. By contrast, individual preferences regarding tax and government service packages tend to be similar, in small, like-minded communities. If services are devolved to local governments of such communities, the divergence between preferences and service packages will be smaller.

3 IMPLICATIONS FOR FISCAL ARRANGEMENTS

3.1 CENTRALISATION AND DELEGATION

As stated at the outset, the first major choice in the design of a constitution is the one between centralisation and decentralisation of government powers. If the choice falls on a high level of centralisation, with or without delegation, all revenue sources might as well be centralised.

If powers are not devolved, but merely delegated to provincial governments with legislatures, executives and administrations, the disadvantages of centralisation is compounded. Taxpayers then have to shoulder the cost of these institutions without the benefit of truly autonomous subnational governments which are sensitive to their varying preferences. South Africa must either have a large centralised bureaucracy and no provincial governments, or a national government with limited powers and autonomous provincial governments with devolved functions.

3.2 DEVOLUTION

3.2.1 Exclusive taxes

If the choice falls on a large extent of devolution, a balance must be struck between the revenue sources and expenditure needs of governments on all levels.

A subnational government can only enjoy true autonomy if it has **exclusive tax** powers. When a particular form of tax is assigned to a level of government on an exclusive basis, it means that the relevant government units are allowed to set the rates of the tax in their areas of jurisdiction (possibly within limits determined in the constitution), to collect the tax and to use its proceeds, and that other levels of government are prohibited from utilising that form of tax.

Numerous allocations of exclusive taxes are possible and possibilities for adjustment over time should be built into each new constitution. The allocation of specific kinds of tax are to be discussed in other papers.

3.2.2 The tax base problem

In practice the tax base, not the tax power, poses the biggest problem. The tax base is the private income from which the tax must be paid. If the tax base is too low, the relevant government will have inadequate revenue to finance its expenditure, whatever its tax power. Seven of South Africa's nine provinces have inadequate tax bases to finance their functions. A number of solutions to this problem may be considered.

4 POSSIBLE SOLUTIONS TO THE TAX BASE PROBLEM

4.1 RE-DEMARCATIION OF BOUNDARIES

Part of the solution might be to redraw the boundaries of the provinces, so that each will include an acceptably large tax base. The facts are that most of South Africa's income is generated in three metropolitan areas, namely the PWV Metropole, the Cape Metropole and Durban-Pinetown-Pietermaritzburg. However, the latter is already part of a populous, poor province and cannot finance services for an even larger area. The Cape Metropole might be able to carry a portion of the present Northern Cape province, but not much more. That leaves the PWV Metropole, the core of the Gauteng province. It might be possible to subdivide it into two parts and include larger areas with each of them. The result would be fewer provinces of which three, instead of the present two, might be economically viable without transfers from elsewhere.

4.2 CENTRALISATION

An alternative option could be centralisation in the sense of doing away with provinces altogether. That would leave two tiers of government: national and ~~local. The cost of provincial legislatures would be saved. Each government~~ department would have branch offices where it suits them.

However, this option has several disadvantages, namely:

- lack of preference variation
- lack of fiscal equivalence in respect of some functions
- high costs of large, centralised bureaucracies

- absence of competition and limited innovation in the national government
- high costs of political interaction among the citizens

4.3 GUARANTEED SHARED TAXES

Guaranteed shared taxes are basically percentages of particular taxes collected nationally, determined by formulae. The formulae could include variables such as population, tax capacity, fiscal performance (also known as tax effort) and unit costs of services, where they differ among government units.

Guaranteed shared taxes are a form of intergovernmental transfer. The national government collects the tax and transfers predetermined shares to the relevant subnational governments. Each subnational government then decides how the revenue should be spent and the national government typically has no control over the decision or its implementation.

This situation is often justified by arguing that any form of control by the national government would reduce the autonomy of the subnational government and that the latter is subject to democratic control by its own electorate. However, fiscal equivalence is lacking in this situation. Furthermore, without control over the eventual application of the funds, the national government cannot account for the use of its constituents' tax money. A Transkei or Lebowa situation should never again be allowed to develop in South Africa.

4.4 CONDITIONAL AND UNCONDITIONAL GRANTS

Conditional grants are transfers of funds for specific purposes, e.g. education or health, designed to enable the attainment of minimum standards. Unconditional grants are grants for any purpose the recipient government sees fit. Neither are guaranteed, but depends upon the donor government's ability and willingness to make the transfers.

The principle of fiscal equivalence is met to a greater extent in the case of conditional grants than in the case of guaranteed shared taxes. The representatives of those who pay (the national taxpayers), namely the national

politicians, decide how the money should be spent, and those who receive the benefits are included in these groups. However, the recipient governments have less certainty whether and how much revenue they will receive than in the case of guaranteed shared taxes, complicating the budgeting process.

A system of unconditional grants lack fiscal equivalence, as well as budgetary certainty. Unconditional grants should not be used at all. All intergovernmental transfers should be made subject to satisfactory fiscal performance by recipient governments in respect of the collection of their own taxes.

4.5 MIXED SYSTEM

The final solution might be a mixed system in which not all subnational governments are treated in the same way.

5 CHARACTERISTICS OF A MIXED SYSTEM

5.1 EXCLUSIVE TAXES PLUS GUARANTEED CONDITIONAL GRANTS

A mixed system could entail the use of exclusive taxes, supplemented by guaranteed conditional grants to provinces that cannot meet minimum standards in respect of important functions like education and health.

As many exclusive taxes as possible could be devolved to provincial and local governments, in order to minimise the need for intergovernmental transfers and to maximise the autonomy of the subnational governments that possess adequate tax bases. However, adequate tax powers will have to be assigned to the national government to finance its own services, as well as the guaranteed conditional grants.

Guaranteed conditional grants combine characteristics of guaranteed shared taxes and conditional grants. The recipient government units may only use them for specific purposes and are accountable to the donor government units in that respect. However, they are guaranteed that should their other sources of revenue be inadequate to provide services of a minimum standard, based on predetermined norms and standards, their revenue shall be supplemented by the donor government units.

5.2 AUTONOMY CUM DEPENDENCY

The result will be that some subnational governments will have full autonomy, but not others. This might be regarded as inequitable. However, without adequate incentives to foster economic development in the areas of jurisdiction which lack adequate tax bases, the current situation will be perpetuated.

5.3 INCENTIVE FOR DEVELOPMENT

If subnational governments place a high premium on autonomy, they will want to encourage economic activity in their areas of jurisdiction. This will serve as an incentive for them to provide their services more efficiently, in order to attract prospective entrepreneurs.

The danger exists that exclusive tax rates might be set unrealistically low and the lack of revenue supplemented by demanding transfers from the national government "to enable the attainment of minimum standards". This problem must be overcome by making all transfers subject to satisfactory fiscal performance in respect of the collection of exclusive taxes.

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DEVELOPMENT BANK OF SOUTHERN AFRICA

SUBMISSION TO

THE CONSTITUTIONAL ASSEMBLY

THEME COMMITTEE 6

ON FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

1. INTRODUCTION

1.1 The past few years have been devoted to mega-constitutional change in South Africa, resulting in the introduction of an Interim Constitution in 1994. The introduction of a process of economic transformation of a society marked by deep diversity has coincided with the implementation of this Constitution. **The final Constitution presents the opportunity to move beyond the 'political' covenant reform of the Interim Constitution to a new foundation for a 'social' contract among all South Africans by recognizing the importance of socio-economic issues in the design of the political system**

1.2 The Interim Constitution *inter alia* defines a way of life and the people comprising the community which is so directed; a form of government; the regime, the public and citizenship; as well as establishing the basis for the authority of the regime and distributing political power. Furthermore, it contains a set of binding and juridically enforceable principles with which all future Constitutions have to comply.

1.3 The form of government is defined by providing a framework for three levels of governments and the basis for its behaviour; providing a framework for, and in some instances the shape, of political institutions and specialized structures of government, e.g. an independent Public Service Commission, Reserve Bank, Auditor-General and Public Protector; as well as formalizing intergovernmental fiscal arrangements both in mechanism, i.e. a Financial and Fiscal Commission, and in criteria to be taken into account for this purpose. This submission will comment on specialized financial structures of government and specifically on the Financial and Fiscal Commission.

2. POINT OF DEPARTURE

2.1 There is a need to recognize the importance of socio-economic issues in the design of the political system.

2.2 The disparate socio-economic situation, interpersonally, and intergeographically, the stage of economic development, and the design and implementation of a reconstruction and development programme, all suggest that South Africa will experience profound structural shifts in the social and economic spheres. In order to accommodate this dynamic socio-economic environment, it is believed that constitutional proposals, specifically on financial and fiscal mechanisms, should not be excessively detailed, but rather outline the broad parameters and principles within which mechanisms and arrangements have to be developed. Therefore, the nature of the Constitution will have to be enabling rather than prescriptive or restrictive.

2.2 It is recognized that the vision, strategies and mechanisms for implementation of a socio-economic reconstruction and development plan should be fully compatible with the Constitution and foster the envisaged development of the nation-state. However, in turn, accomplishing the long-term socio-economic visions of a country, is not only dependent on specific policies and strategies in this regard, but also on enabling political, fiscal and financial, as well as administrative arrangements. It would thus be relevant to identify and strengthen those features of the political, fiscal and financial system as well as administrative arrangements that would have a positive impact on the process and outcomes of reconstruction and development. The **people-centred development focus of the RDP** as reflected in its six basic principles, i.e. **an integrated and sustainable programme, that must be a people-driven process, that provides peace and security for all and builds and integrate the nations, links reconstruction and development and deepens democracy, provides a useful point of departure for shaping constitutional proposals in a way that will reinforce the socio-economic reconstruction and development of South Africa.**

3. AUDITOR-GENERAL

3.1 Sections 191-194 of the Constitution provides in considerable detail for the establishment, appointment, independence, impartiality, and effectiveness of a common Auditor-General for the public sector at large, including all levels of government. This section could be shortened and reordered without detracting from the content of the Constitutional provisions. For example, sections 191(3, 8 and 7) deals with the eligibility criteria for an Auditor-General; section 191(5) with a temporary substitute; and sections 191(4, 6, 9 and 11) with terms of office, remuneration and service conditions. Some of these

issues such as those on remuneration and service conditions could even be dealt with statutorily rather than in the constitution.

3.2 A well-functioning national system of financial accountability is essential, but represents only one aspect of accountability and strategic management measures that need to be promoted in South Africa in realizing our visions for reconstruction and development. In the past and irrespective of the level of government, public financial accountability and financial control systems have been artificially divorced from accountability for overall socio-economic performance. However, the systems and mechanisms to promote these as well as strategic management are interdependent. Although constitutionalisation of an elaborate system for financial and socio-economic performance accountability is not desirable, the linkages of the financial accounting system with accountability for socio-economic performance and strategic management need to be recognized in the Constitution. It is, therefore, proposed that section 193 be amended to incorporate the linkages of the financial accounting system with accountability for socio-economic performance and strategic management.

3.3 Furthermore, in view of these interdependencies, whether intergovernmental or on a particular level of government, as well as the need to encourage community participation through political and informal control mechanisms, it could be argued that accountability on the provincial level could be strengthened by the establishment of provincial Auditor-Generals as well. The functions of these could be extended to include overall socio-economic performance assessment of provincial and local authorities. It is proposed that the Constitution be amended to enable the establishment of provincial Auditor-Generals.

4. THE SOUTH AFRICAN RESERVE BANK

4.1 The independence of the Reserve Bank as enabled in the Constitution is supported.

4.2 A Constitutionally independent Reserve Bank, however, supposes strong cooperation and coordination with loci of responsibility for other macroeconomic policies, not only with *the Minister responsible for national financial matters*, section 196(2). The degree of cooperation and coordination between the monetary authorities and other macroeconomic policy decision makers would *inter alia* influence the choice and level of policy instruments for achieving price stability and the appropriate external balances.

4.3 This could be illustrated by the fact that in many other countries, money supply has lost some of its appeal as an anchor for monetary policy purposes, and, in some instances, has been abandoned and replaced by a different basis, e.g. the exchange rate. In a number of countries - for example in the United Kingdom, New Zealand and Canada - the authorities

are now pursuing inflation targets more directly, instead of through an intermediate target such as the money supply. This approach, however, requires a degree of cooperation between government, private businesses, trade unions and the central bank which, in the present phase of socio-political reforms in South Africa, is extremely difficult to obtain. Therefore, the Bank is of the opinion that money supply targeting remains, at least in the present South African context, the most sensible anchor for monetary policy and for guiding the authorities in their decisions in executing their monetary policy responsibilities.

5. THE FINANCIAL AND FISCAL COMMISSION (FFC)

5.1 It is recognized that it is rarely possible to design a multi-governmental constitution in a way that allow for the precise matching of autonomous revenue sources with expenditure responsibilities for each level of government. Even if it could be done initially, the relative shares of different taxes and expenditures are likely to shift over time, thereby creating imbalances and a source of intergovernmental controversy. In South Africa, such a perfect matching of revenue sources and expenditure responsibilities is particularly unfeasible, due to the imbalances in economic activity and the need for interjurisdictional and interpersonal equalization. This makes the constitutionally established FFC (section 198) an immensely important link in the overall operation of the constitutional structure and the relationship between the various tiers of government, particularly regarding advice on a rational, accountable and predictable structure of intergovernmental fiscal relations.

5.2 Sections 200 to 205 can be considerably shortened and refocused in the new Constitution. Except for the composition of the FFC, section 200(1), the focus of the Interim Constitution should shift from an emphasis on structures to ensuring the impartiality, integrity, objectivity and professional competence of the FFC. This could be done through establishing eligibility criteria for members, e.g. those in section 200(3 to 10) as well as through establishing principles for operation. The latter might include e.g. fostering transparency; providing for interaction with communities/parties/institutions, e.g. to present their views; undertaking professional technical analysis; having access to relevant information; fostering the exercise of sound and impartial judgment; ensuring that reporting is done fairly, comprehensively and clearly; and effectively managing its resources.

5.3 Current constitutional proposals regarding its meetings; establishment of committees; cooption of persons by committees; terms of office of members and officials; remuneration and conditions of service of members and other persons; appointment of staff; and other relevant matters, could be allowed for statutorily rather than constitutionally.

5.4 An important element in establishing sound intergovernmental relations is the existence of a framework and criteria for evaluating and deciding on the intergovernmental

allocation of functions. As DBSA subscribes to the principle that *finance should follow expenditure function*, it is proposed that section 199(1 or 2) be amended to include an in-principle statement on such functional criteria that should serve as a framework for the FFC's advice and recommendations regarding the financial and fiscal requirements of the different tiers of government. The details of such a framework and criteria should, however, be dealt with in separate legislation.

5.5 Furthermore, it is proposed that section 199 on objects and functions be extended to provide for the FFC to play a facilitating role regarding inter-governmental fiscal/financial relations. In particular, the FFC should seek to facilitate coordination and cooperation between the different levels of government (vertically) as well as between same-level governments (horizontally). Although the process for this facilitating role need not be constitutionalised, it is important to notice that, for this purpose, close coordination between the FFC, the Public Service Commission, the Commission for Provincial Government, and/or any other institutional mechanism that might impact on intergovernmental finances would be essential.

6. OTHER

DBSA is of the opinion that issues such as the national fund, budget, procurement, special provisions for pensions and income tax of elected representatives and political officers, and provisions on public enterprises should not be constitutionalised.

7. CONCLUSION

7.1 These comments depart from the viewpoint that a constitution should be designed as a foundation for a social contract among citizens, through recognizing the importance of socio-economic issues in the design of the political system. Furthermore, the dynamic South African socio-economic environment requires flexibility and appreciation of the fact that a constitutional text cannot and should not with certainty and precision control every detail of the future.

7.2 The socio-economic realities, the intergovernmental allocation of resources, functions and powers, and the design and implementation of a reconstruction and development plan all require great intergovernmental cooperation, coordination, joint planning and sharing of resources

7.3 While the fiscal relations are to a certain extent constitutionalised, other types of intergovernmental relations will probably be provided for either statutorily or through informal arrangements. As in other federal and regional-type systems, the success of the South

African political dispensation will to a large extent depend on the success of these intergovernmental relations.

7.4 Serious consideration should be given to constitutionalise an advisory commission on intergovernmental relations, in order to analyze, evaluate and improve intergovernmental relations in general. It could have a number of functions, ranging from investigative tasks regarding the functioning of the system to the formulation of policy inputs and arbitration of intergovernmental disputes. The Commission for Provincial Government may well be transformed into a permanent advisory commission focusing on intergovernmental relations in general.