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CONSTITUTIONAL ASSEMBLY

THEME COMMITTEE 3 RELATIONSHIP BETWEEN LEVELS OF GOVERNMENT

FINANCIAL & FISCAL RELATIONS WORKSHOP

5 JUNE 1995

DOCUMENTATION

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CONSTITUTIONAL ASSEMBLY

THEME COMMITTEE 3
RELATIONSHIP BETWEEN LEVELS OF GOVERNMENT

FINANCIAL AND FISCAL RELATIONS

WORKSHOP:
05 JUNE 1995, 14h00 - 17h30, E249 PARLIAMENT

PROGRAMME

14H00 — **Opening and Welcome**

Speaker : Mr Leon Wessels, Deputy Chairperson, Constitutional Assembly

SESSION ONE

14h15 — **A Framework for Financial and Fiscal Relations: Canadian experience**

Facilitator : Dr TJ King, Co-chairperson, Theme Committee 3

Speaker : Dr AW Johnson, Director of International Development Research Centre

14h45 — Questions and Clarifications

SESSION TWO

15h00 — **Expenditure Functions and Revenue Powers of a German Länder**

Facilitator : Prof DC du Toit, Co-chairperson, Theme Committee 3

Speaker : Mr G Mayer-Vorfelder, Minister of Finance, Baden-Wuerttemberg Länder, Germany

15h30 — Questions and Clarifications

SESSION THREE

15h45	**<u>Comparative Perspesctive of Financial and Fiscal Relations in Developing Countries with special reference to Nigeria</u>**
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SESSION FOUR

16h30	**<u>South African Perspective - current provisions, assingment of expenditure functions, revenue powers and mechanisms for inter-governmental transfers</u>**
	Facilitator : Dr TJ King
	Speaker : Prof L Liebloots and Mr M van Blerk
17h00	**<u>Summary of Proceedings</u>**
	Speaker : Prof D Davis, Technical Advisor, Theme Committee 3
17h20	**<u>Vote of thanks</u>**
	Speaker : Prof DC du Toit

NATIONAL-PROVINCIAL FISCAL ARRANGEMENTS

CANADA AND SOUTH AFRICA

A Presentation by A.W. Johnson

to Theme Committee 3 of the Constitutional Assembly

Cape Town, June 1995

South Africa/Canada Program on Governance
Sponsored by
the Canadian International Development Agency (CIDA)
and
the International Development Research Centre (IDRC)

Presentation to Theme Committee 3, Constitutional Assembly on National-Provincial Fiscal Arrangement: Canada and South Africa

I welcome and am honoured by this opportunity to review with you Canada's experience in the field of national-provincial fiscal arrangements, and to compare them with emerging fiscal arrangements in South Africa. I am fully convinced from my two years in South Africa that comparisons of Canadian and South African experience, in this area as in others in the field of governance, are of great benefit to both of our countries.

What I will try to do today is to describe Canada's experience in tax sharing between the national and provincial governments; in the equalization of provincial fiscal capacity; and in conditional and other unconditional grants to the provinces - and in doing so, to compare to our arrangements with those contemplated in Section 155 of South Africa's Interim Constitution.

Two Families of the Constitution in Two-Tier or Federal Governments

I distinguished, when I spoke to you two weeks ago, between two families of constitutions in two-tier or federal states: the divided responsibility model, under which legislative competencies and financial powers are divided up between the national and provincial governments, and the shared responsibility model under which legislative competencies and financial capacities are shared between the two orders of government.

I shall continue with this theme as I talk about national-provincial fiscal arrangements - showing in one column, so to speak, the arrangements to be found in Canada, where we have the divided responsibility model, and those to be found in the South African Interim Constitution, where you have the shared responsibility model.

The Division of Powers to Raise Revenue, and the Entitlement of Provinces to Receive Certain Revenues to Finance Their Responsibilities/Competencies

Divided Responsibility Model (Canada)	Shared Responsibility Model (South Africa)
1. The Division of Revenue from Major Tax Fields	
■ In Canada, the provinces are given the same access to personal income tax, corporate income tax, VAT, and excise taxes as the national government enjoys. The only exception: customs, duties, and other taxes that reach beyond province's boundaries. This approach is known as the "access to tax fields approach" as distinguished from "the sharing of taxes or revenues approach". In this system, the "tax shares" of the national and provincial governments are the product of the autonomous decisions of these governments concerning the level of their respective taxes. This "access" approach gives to the provinces a great deal of autonomy both in the levying of taxes and in the allocation of these revenues among competing expenditure programmes. But two major problems arise.	■ Under the Interim Constitution, the national government imposes all the major taxes, and then divides the revenues first between the national and provincial governments, and second, among the provincial governments - the latter to be done "equitably". This equitable share of revenue will consist of a percentage of each of the individual income tax, the VAT and other sales taxes, and the national fuel levy. It will also consist of an equitable division of any conditional or unconditional grants paid by the national government (see below).
■ Firstly, the per capita revenue tax yields vary widely as between the rich provinces and the poor ones. The question is how to achieve equity in the "division" of tax revenues under the "access to tax fields" approach. Canada has developed an <u>equalization formula</u> to achieve this goal: it is described below (under Equalization).	■ This Constitutional provision gives the national government very substantial powers, and results in less autonomy for provincial governments, relative to the divided responsibility model. However, the provinces are given protection in the Constitution, in a number of ways, against arbitrary action on the part of the national government.

Divided Responsibility(continued)

- The second problem that arises when every province has access to every tax field, is how to avoid the development of a veritable jungle of tax laws. Canada's approach to this problem has been to develop tax collection agreements, ~~under~~ which the national government will collect provincial taxes, at provincial tax rates, providing the provincial tax laws are substantially identical with the national laws. We have not been uniformly successful: 9 out of 10 provinces have tax collection agreements for personal income tax; 7 out of 10 have agreements for corporation income taxes; and only 1 province has entered a tax collection agreement in respect of the recently introduced VAT.

- The Canadian system might take on more meaning if I gave you a few numbers. On the question of the proportion of total revenues collected by the national and provincial governments, 45% of the total is collected by the national government, and 55% is collected by provinces and local governments.

  Taking only the personal income tax, plus VAT and sales taxes, plus fuel/gasoline taxes, the proportion of such taxes collected by the national government is 55.5% and the proportion collected by the provinces is 44.5%.

Shared Responsibility (continued)

- there is a Constitutional injunction that the tax shares and any conditional or unconditional grants will be equitable [Section 155(4)(b)]
- the national government must receive and listen to the advice of an independent Fiscal and Financial (grants) Commission;
- the tax shares shall be paid to the provinces "without any deduction therefrom";
- the Senate may veto any fiscal or financial legislation which affects the Provinces - thus giving the collectivity of the Provinces more power (the majority), but without increasing the power of individual Provinces.

- Clearly one of the major fiscal decisions to be taken in South Africa, pursuant to Section 155 of the Interim Constitution, is what share of the "big 3 taxes" (as I will call the PIT, VAT and fuel levy for short) should go to the provinces, and what should be retained by the national government. Obviously that decision has yet to be taken.

- To get some feel for the importance of this decision, however, it is useful to look at a couple of hypotheses. If the provincial share of the proceeds of the "big 3 taxes" were 40%, the provincial revenues from such

Divided Responsibility (continued)

It is interesting to know, too, what proportion of provincial revenues is made up of taxes and levies, and what proportion is made up of grants from the national government, including equalization payments ("federal fiscal transfers" as we call them). These percentages are about 80% from taxes and levies and 20% for fiscal transfers, if you include cash and tax transfers from the national to the provincial governments. If you count cash transfers only, the percentages are closer to 85% and 15%, respectively.

Shared Responsibility (continued)

taxes would amount to Rm 36,544, which is 52.58% of the total estimated provincial revenues for 1995-96 (Rm 66,000 from national government transfers, plus Rm3,500, approximately of "own revenues").

If the provincial share were 50%, the provincial revenues from the "big 3" would be Rm45,680, or 65.73% of total estimated provincial revenues for 1995-96.

The next major fiscal decision - how the provincial share of the "big 3" taxes should be divided up - is dealt with immediately below.

2. The Equalization of Provincial Revenues (The Major Unconditional Grant in Canada)

- The equalization system in Canada provides that the per capita tax yields in every province, from every revenue source (at national average provincial tax rates), will be brought up to the national average per capita tax yields (again at national average provincial tax rates). This is achieved through the payment of equalization grants to make up the difference between per capita tax yields in the poorer provinces and the national average per capita tax yields (in recent years the "national average" has given way to a "national standard". But it is convenient to speak in terms of national averages).

- After having decided on the aggregate provincial share of the revenues from PIT, VAT, and the fuel levy, the next major fiscal decision is the distribution of the provincial shares among provinces, taking into account the constitutional requirement that the sharing must be "equitable".

- Clearly this decision has not yet been taken, but to understand what is involved it is helpful to look at a couple of possible hypotheses.

- If the provincial share of the "big 3 taxes" were divided among the provinces on an equal per capita basis, then every province would

Divided Responsibility (continued)

The way in which the system works is this:

* the average provincial tax rates for each revenue source is calculated (let's think in terms of provincial sales taxes)

* that tax rate is then applied to the tax base for the whole of Canada (in the case of provincial sales taxes, the tax base would be total retail sales) and the national average per capita yield is calculated

* then the average provincial tax rate is applied to the tax base in individual provinces, and the per capita yield province by province is determined

* wherever this per capita yield is lower than the national average per capita yield, the province is entitled to the difference, in the form of an unconditional equalization payment

* when this exercise has been completed for every revenue source, in a particular province, the variances in respect of the several revenue sources are totalled and the aggregate equalization payment is determined.

■ The essence, then, is that every province is entitled to at least the

Shared Responsibility (continued)

automatically be receiving the national average per capita yield. This would be similar to the Canadian approach to equalization, except it would be limited to three tax fields.

■ So if this approach were to be used in SA, the revenue equalization, as we know it in Canada, would be <u>built into</u> the provincial shares of the revenues concerned.

It follows that the values of the provincial share of the "big 3 taxes", as shown above, in the section on the Division of Revenues, include revenue equalization.

■ The next question to be posed would be this one: would the provinces in which the per capita yield was greater than the national average per capita yield, notably in Gauteng and the Western Cape (and possibly the Northern Cape, marginally), be given this excess, per the Canadian model, or would it be retained by the national government to assist in the financing of other purposes (such, for example, as equalization payments based on expenditure need - see below)?

■ Another fiscal issue for South Africa, as it moves towards the Section 155 arrangements, is whether the equalization regime in the country should include some equalization of expenditure need as well as some equalization of fiscal capacity (I refer to the

Divided Responsibility (continued)

national average per capita revenues from provincial revenue sources. The principle of this equalizing of revenues has been enshrined in the Canadian constitution: "Parliament and 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".

- It is important to note that Canada is "equalizing" the fiscal capacity of the provinces, but not on the basis of "expenditure needs" (eg: the disproportionate costs of providing adequate services in the most severely disadvantaged provinces).

Shared Responsibility (continued)

"equity" that is called for in the Constitution). I will refer to this question again when discussing conditional and unconditional grants.

3. Provinces' Own Tax Fields

- The provinces are free to impose any taxes they want, and at whatever rates, so long as they don't levy duties between the provinces or between Canada and other countries

- The provincial legislature may raise taxes, levies, and duties, other than the major taxes above, where it is authorized to do so by an act of Parliament, passed after recommendations of the Financial and Fiscal Commission have been submitted to and considered by Parliament.
- A provincial legislature may impose surcharges on taxes, subject to the same provisions.
- Provinces have exclusive competency to impose taxes, levies, and duties (other than the

Divided Responsibility (continued)

Shared Responsibility (continued)

major taxes above) on casinos, lotteries,and betting.

- A provincial legislature may impose user charges after having received the advice of the Financial and Fiscal Commission regarding the criteria upon which such charges should be based.

- The provinces are entitled to receive any nationally collected duty on the sale or transfer of property situated within their respective boundaries.

- It is estimated that the total of the above revenue sources would around to some Rm 3,500 to Rm 4,000, out of total provincial revenues of Rm 69,500 (approximately 5%).

4. Unconditional Grants Beyond the Equalization of Revenues

- The Parliament of Canada may pay unconditional grants to the provinces - with the equalization payments being the outstanding example.

  Other examples include unconditional block grants that formerly were conditional grants - ie: were tied to one requirement or another.

- Under the South African Interim Constitution the national government of South Africa may also pay unconditional grants to the provinces. Beyond the equalization of revenues, which has been discussed above, the other possible unconditional (equalization) grant that comes to mind is equalization based on expenditure need (which, again, has been mentioned above).

Divided Responsibility (continued)

Shared Responsibility (continued)

5. Conditional Grants

- By Constitutional interpretation, Canada may pay conditional grants to the provinces - sharing the cost of provincial programmes where certain national standards or norms/principles have been set by the national government.

- It is worth mentioning that Canada does not have a Senate that represents provincial interests, which means there is no institution within the national government through which provincial influence or power may be brought to bear on the national government in respect of its use of conditional grants.

- South Africa's Interim Constitution explicitly provides for conditional grants - they must be equitable, based on certain criteria provided for in the Constitution ("fiscal performance, efficiency of utilisation of revenue, needs, and economic disparities within and between provinces, as well as the developmental needs, administrative responsibilities, and other legitimate interests of provinces and any other objective criteria identified by the Fiscal and Financial Commission").

- One of the important fiscal questions to be asked is whether conditional grants might be used to partially recompense the provinces for the higher costs of those programmes associated with the establishment by national government of national norms or standards (including minimum standards) under Section 126.

- A Senate veto is available to the representatives of the provinces in that body.

6. The Place of Conditional and Unconditional Grants in Provincial and National Budgets

- To lend a quality of reality to this discussion of conditional and unconditional grants - beyond revenue equalization - it is useful to look at some numbers again.

- One cannot predict what conditional or unconditional grants will come into existence in South Africa, but it is possible to predict the kinds that might be considered. This I did earlier, when I spoke of the possible

Divided Responsibility (continued)

- There are two major conditional grant programmes in Canada, now called "block grants", but still subject to national criteria. The first is a universal health insurance plan, legislated and administered by the provinces, but subject to five-nationally established criteria. The national government contributes a significant proportion of the total cost, amounting to some $15 billion dollars, or about 35% of the total federal fiscal transfers.

- The other major conditional grant is the Canada (social) Assistance Plan, which again involves provincially legislated and administered programmes, but which, after the 1995 budget, seems to be subject to only one national criterion or condition. The national contribution to this programme is in the neighbourhood of $8 billion dollars, which represents around 19% of the total federal fiscal transfers.

Shared Responsibility (continued)

consideration of equalization on the basis of expenditure need, and of the possibility of the national government partially recompensing the provinces for the extra programme costs they incur when national norms or standards are imposed on designated provincial programmes.

- To get some sense of the "fiscal room" for such conditional / unconditional grants, it is useful, again, to look at some numbers.

Provincial Revenues 1995-96 (est)
- under current arrangements:

From block grants by function - national govt.	Rm 66,000
From "own revenues"	<u>Rm 3,500</u>
TOTAL	<u>Rm 69,500</u>

Provincial Revenues 1995-96 (est)
- under potential Section 155 arrangements:

---Equalized share of taxes@ 40%	Rm 36,544
---"Own Revenues"	Rm 3,500
---Available for conditional grants or further unconditional grants	<u>Rm 29,456</u>
TOTAL	<u>Rm 69,500</u>

If the equalized share of taxes were to be larger than 40%, then the amount available for conditional or further unconditional grants would be lower.

- **These numbers are by no means meant to be indicative or prescriptive: they are meant simply to indicate the range and the scale of the fiscal issues to be considered.**

Divided Responsibility (continued) **Shared Responsibility (continued)**

7. The Range within which Provincial Governments may set their own priorities and allocate expenditures without constraint

- In Canada, the provinces are constrained in their expenditure allocation to the extent of roughly 12% - this representing the proportion of the conditional (tied) grants or fiscal transfers they receive in relation to their total revenues.

- In South Africa, when the Section 155 provisions are converted into operating fiscal arrangements, the provinces would be constrained in their allocation of expenditures by the proportion of those expenditures devoted to programmes that are affected by national norms or standards (or other elements of Section 126).

- Under the alternative hypotheses spelled out earlier (which is to say provincial shares of 40% or 50% of the "big 3 taxes"), the maximum amount of money available for conditional or unconditional grants would be:

At a 40% share	At a 50% share
* Rm 29,456	* Rm 20,320
* or, 42% of the provincial budget.	* or, 29% of the provincial budget.

It is important to note that the larger the provincial tax share is, and the larger the provinces' "own revenues" are, and the larger the unconditional grants are, the greater the discretion (some would say autonomy) the provincial governments and legislatures have in allocating funds in accordance with their own priorities and local needs.

To illustrate, if the provinces enjoyed a 40% share of the "big three taxes", equalized to the national average, plus "own taxes"

Divided Responsibility (continued)

Shared Responsibility (continued)

equalling 5% of their total revenues, and assuming the whole of the remaining Rm 29,456 (above) were transferred to them in the form of conditional grants, then the degree of provincial flexibility in allocating funds in accordance with provincial priorities would be 58% (i.e., the 40% tax share, equalized, plus the "own taxes"). The conditional grants of Rm 29,456 (above) represent the remaining 42% of the total budget.

If the provineial share of the "big three taxes" were 50%, the provinces' degree of flexibility would be 71%.

Conclusion

Well, this brings me to the end of my presentation. I'm afraid it has been pretty dense stuff. But that seems to be in the very nature of intergovernmental fiscal relations. My hope is that the central issues of such arrangements, as between national and provincial governments, have become clear our of all this murk! Simply stated, they are the following in my view - when one is talking of Section 155 of the Constitution, <u>or of any constitution in the "shared responsibility" family of Constitutions</u>:

- the decision as to the provincial shares of designated national taxes;
- the decision as to the revenue fields that will be assigned exclusively to the provinces;
- the decision as to how the provincial share of such taxes will be divided between the provinces, and whether that division of revenues will be equalized or not;
- the decision as to the scale of other fiscal transfers to the provinces - which is related to the first two decisions;
- the decision as to how these other fiscal transfers will be divided as between
    - unconditional grants, such as equalization on the basis of expenditure need as well as on the basis of fiscal capacity, and,
    - conditional grants, as a means of compensating the provinces for the costs they incur in meeting the national norms or standards (or other conditions) prescribed by the national government in respect of certain designated programmes.

I thank you again for the great privilege of meeting with you.

Contents

Paper given by the Finance Minister, Mr. Mayer-Vorfelder, MdL,
before Committee No. III
of the National Constitutional Assembly
of the Republic of South Africa
on 5 June 1995 in Cape Town on
"The public finance system as provided for
by the German Constitution"

A. Importance of a constitutional public finance system in a federative country

The German public finance system reflect the fact that under the terms of its Basic Law, the Constitution, Germany is a country with a federal structure. This means that the individual federal states have equal rights with the federal government - the central state - in implementing the powers and responsibilities granted to them by the Constitution for the fulfilment of public tasks

The central problem of any federal constitutional system is to achieve a clear demarcation of the duties and powers allocated to the central government and the federal states respectively.

In the first place, the Constitution distributes the public tasks between the central government and the federal states. As the fulfilment of such tasks necessarily also entails spending, the next question is to decide on how the burdens should be shared and how the available public resources should be distributed.

B. Distribution of powers between the central government and the federal states

1. Basic principle

The fulfilment of public duties is fundamentally a matter for the federal states, except where the Constitution provides otherwise.

2. Legislative powers

According to the principle enshrined in the Constitution, the federal states have the right of legislation except where the Constitution allocates such rights to the central state. In fact, most of the legislative work is done by the central state because the Constitution allocates extensive legislative powers to it. The parliaments of the federal states are therefore mostly left to legislate on those matters which are not included in the legislative catalogue reserved for the central state, and in particular local authority and police law as well as cultural affairs.

3. Administrative powers

While legislative competence is in fact largely vested in the Federal Parliament, the federal states have priority over the central state in the fulfilment of administrative duties. A major part of state administrative activity concerns the implementation of the law. Under the system of our Constitution, the federal states are responsible not only for implementing the state laws but also the federal laws, except where the Constitution provides otherwise, e.g. the Foreign Office or the Federal Armed Forces Administration. We therefore speak of the principle of executive by the states.

C. Financing responsibilities under the constitutional public finance system

In this respect, the Constitution answers the question as to which government level is required to bear the costs for fulfilling the various tasks.

1. Allocation of burdens between the central state and the federal states

The financial relations between the central state and the federal states are regulated by the so-called burden-allocation principle:

Fundamentally, the central state and the federal states are each separately responsible for bearing the expenditure arising in the fulfilment of their duties.

In other words, financing responsibility follows administrative responsibility. Whichever government level is responsible for performing the duty also bears the costs. Consequently, under the principle of executive by the states, the federal states have to bear a large part of the financial burden.

2. Exceptions to the burden-allocation principle

The Constitution allows exceptions to this principle of allocating burdens to administrative responsibility, the central state bearing all or part of the costs for the tasks allotted to the federal states:

- in cases of administration on behalf of the federal authorities
- in the implementation of laws involving the payment of cash benefits
- in the case of financial assistance by the central state
- in the case of joint tasks

a) Administration on behalf of the federal authorities

In this case, the federal states perform administrative tasks on behalf of the federal government. The central state pays for the material costs incurred. The administrative costs, on the other hand, have to be borne by the states.

Administration of this kind on behalf of the federal authorities is only permitted in the instances provided for in the Constitution, e.g. in the fields of nuclear energy use for peaceful purposes, air transport and the administration of the federal highways.

b) Laws involving the payment of cash benefits

These are federal laws which explicitly provide for the payment of money to third parties, e.g. the Housing Benefit Act for rent subsidies to the needy, the Educational Grants Act for student grants and the Child Benefit Act.

A number of cash benefit laws are indeed implemented by the federal states according to the principle of executive by the states, but the spending law itself provides for these payments to be financed wholly or partially by the federal government itself.

c) Financial assistance

Financial assistance by the central state involves payments which are made to promote particularly important investments by the federal states and local authorities designed to lessen the effects of economic recession with the help of economic recovery programmes or to assist projects in the field of urban renewal, improvement of local roads or expansion of publicly-financed housing.

d) Joint tasks

In certain activities which are of particular importance for the country as a whole, the central state may, if its financial assistance is necessary in order to fulfil the particular goal, assist a federal state in one of that state's own duties by contributing to the framework planning or to the costs.

Such joint tasks are an exception to the fundamental prohibition on mixed administration.

Examples of such activities are contributions by the central state to the building of universities or to the costs for improving the regional economic structure.

D. Aspects of tax law in the public finance system

The spending on the tasks which the central state and the federal states are required to perform is mainly covered by revenues from taxes. One of the core questions in a country with a federal organisation is, therefore, how the powers relating to tax legislation, tax yields and tax administration are allocated between the central state and the federal states.

1. Powers of tax legislation

The Constitution gives the central state extensive legislative powers in the field of tax law, although the approval of the Federal Council - the second chamber of parliament which represents the federal states - is required in those cases in which the federal states participate in the tax revenues. Consequently, all the major tax laws today are federal laws. This comprehensive right of legislation intended to prevent regional tax differences arising. The legislative powers of the federal states in tax matters are restricted to certain local taxes on consumption and spending, which do not yield any very high returns.

2. Powers relating to tax yields

These regulate which level of government is entitled to the tax revenues. Concerning the distribution of taxes, three main questions arise:

- Which taxes or share of taxes are allocated to the central state and the federal states respectively - so-called vertical tax distribution?

- How are the revenues to which the federal states are entitled to be divided among them - so-called horizontal distribution?

- Should the differences in financial strength between the individual states be adjusted, and if so, how - so-called horizontal financial equalization?

2.1 Vertical tax distribution

For each kind of tax, the Constitution regulates in detail the revenue sovereignty of the central state, the federal states and the local authorities. In this context, a distinction is made between four different groups of taxes:

- pure federal taxes
- pure state taxes
- joint taxes
- local authority taxes

a) Pure federal taxes

The central state has exclusive entitlement to the revenue from such taxes. They include, for instance, customs duties, excise duties (e.g. tax on fuel or tobacco), insurance tax, as well as the special solidarity levy introduced from 1995 to help finance German reunification.

b) <u>Pure state taxes</u>

The Constitution conclusively defines the taxes to which the federal states have sole entitlement.

They include, for example, general property tax, inheritance tax and motor vehicle tax, real estate acquisition tax and - of special importance for Germany - beer tax.

c) <u>Joint taxes</u>

The characteristic of these taxes is that the respective territorial authorities are each entitled to a certain percentage of the revenues.

The most important taxes, which account for about 3/4 of all tax income, are shared by the central state and the federal states, and to some extent also by the local authorities.

- Concerning taxes on wages and incomes, the central state and the federal states are each entitled to 42.5 per cent of the revenues and the local authorities to 15 per cent.

- In the case of corporation tax, the central state and the federal states each have a share of 50 per cent.

- The shares of the central state and the federal states in the income from value added tax are laid down by federal law, though because of the importance for the federal states this requires their assent in the Federal Council. In this case, then, the respective shares are not specified in the Constitution. In the federal public finance system, which allocates all other taxes constitutionally to the central state or the states, the revenue from value added tax represents the largest flexible item, which is needed to close any financing gaps in the budgets of the federal government and the states not covered from other sources. It should be noted in this context that both the central government and the federal states have a claim to their necessary expenditure being covered. The size of these shares, as they effectively determine the financial resources of the central state and the federal states, is therefore a decision of crucial fiscal importance.

The respective shares of the central state and the federal states have to be redefined if the relationship between the income and the expenditure of the central state and the federal states deviates substantially from what was originally prognosticated. This triggers an obligatory revision procedure, which is intended to restore a balance between the respective shares. Thus, from 1993 on, the federal share was 63 per cent, that of the states 37 per cent. Starting in 1995, the federal share will fall to 56 per cent and the states' share will rise correspondingly to 44 per cent. The primary reason for this were the heavy demands placed on the federal states of the old West Germany by the inclusion of the financially weak states of the former East Germany in the finance equalization arrangement of the German federal states. This situation had not been allowed for in the former quotas.

d) Local authority taxes

German constitutional law in fact only recognizes two government levels: the central state and the federal states. Nevertheless, the local authorities, as parts of the federal states, claim the constitutionally protected and historically based guarantee of local self-administration. Within this framework, they enjoy financial autonomy and for this reason are also taken into account in the national tax-sharing process.

Besides their share of wage and income tax, the local authorities are primarily entitled to the revenue from tax on land and buildings and local business tax.

2.2 Horizontal tax distribution and financial equalization between the federal states

a) Distribution of tax among the states

The allocation of tax revenue between the central state on the one hand and all the federal states together on the other does not say anything about how the taxes to which the latter are entitled should be distributed among them. The Constitution regulates the horizontal tax distribution essentially according to the principal of local yield.

The yield from state taxes and the states' share of income tax is due to that federal state in which the taxes are collected.

A different arrangement applies to corporation tax and wage tax. A direct link to the place of collection would lead to intolerable divergencies between the states. It would, for instance, surely be unacceptable if all the corporation tax or wage tax from a company operating throughout the country were received only by the state in which the company had its head office. Because of the importance of taxes of these types, a redistribution of very considerable complexity has to be made in order to meet criteria of fairness.

Consequently, corporation tax goes to those federal states in which a company has operating locations, and wage tax to the state in which the employee has his or her place of residence.

b) Distribution of value added tax

A special arrangement applies to the allocation of value added tax among the federal states, because it aims at the same time to bring about a financial equalization between states which are financially strong and those which are financially weak.

75 per cent of the states' share of value added tax revenue is allocated according to the number of inhabitants. This has an equalizing effect between financially strong and financially weak states because the revenue from value added tax is significantly greater in some states than others due to the concentration of business enterprises there.

c) Equalization of value added tax

The remaining 25 per cent of the states' share of value added tax serves to strengthen the financial resources of the weaker states. The aim is to eliminate extreme differences in tax strength between the states. An equalization arrangement of this kind has become highly topical again in the relationship between the old federal states and the new, financially weak ones of the former East Germany.

d) Financial equalization among the federal states

In order to at least partially even out the differences in financial strength of the federal states which still remain after the horizontal tax distribution as described above, the Constitution requires that financial equalization be made.

This is done by requiring federal states with above-average financial strength to make equalization payments to those with below-average strength.

It is important to note here that this financial equalization is based not on the concrete financial requirements of a state, but on its financial strength. An equalization is only made on the revenue side. As far as its spending conduct is concerned, each state is responsible for itself. It cannot be the point of federal financial equalization to burden thrifty states to the benefit of high-spending ones.

e) Supplementary federal grants

In addition to the equalization payments made between the states, financially weak ones also receive grants from the central state as an additional contribution to their general financial needs. These payments are of crucial importance in particular for the new federal states in the former East Germany.

3) Tax administration

The system of administrative powers in the field of tax law distinguishes between federal revenue authorities and state revenue authorities. The federal revenue authorities administer customs and excise duties, the state revenue authorities all the other taxes. With the administration of the joint taxes, the main responsibility therefore rests with the state revenue authorities.

E. Budget management of the central state and the federal states

The central state and the federal states are each responsible for their own budgetary management, and are completely separate from and independent of each other.

This means that within the given framework of powers and responsibilities, they each have the right to prepare and implement their own budgets. Any joint budget for the central state and the federal states is therefore ruled out.

F. Concluding remarks

As already underlined at the beginning, the tensions which exist in a federally organized country between unitaristic and federative tendencies are reflected particularly strongly in the question of financial powers and the yield from taxation. The financial resources available to any polity are one of the determining factors in its freedom and scope for action.

I believe that our Constitution has resolved these tensions in an exemplary manner. Since the major public finance reform of the late 1960s, our financial system has proved itself outstandingly in practice.

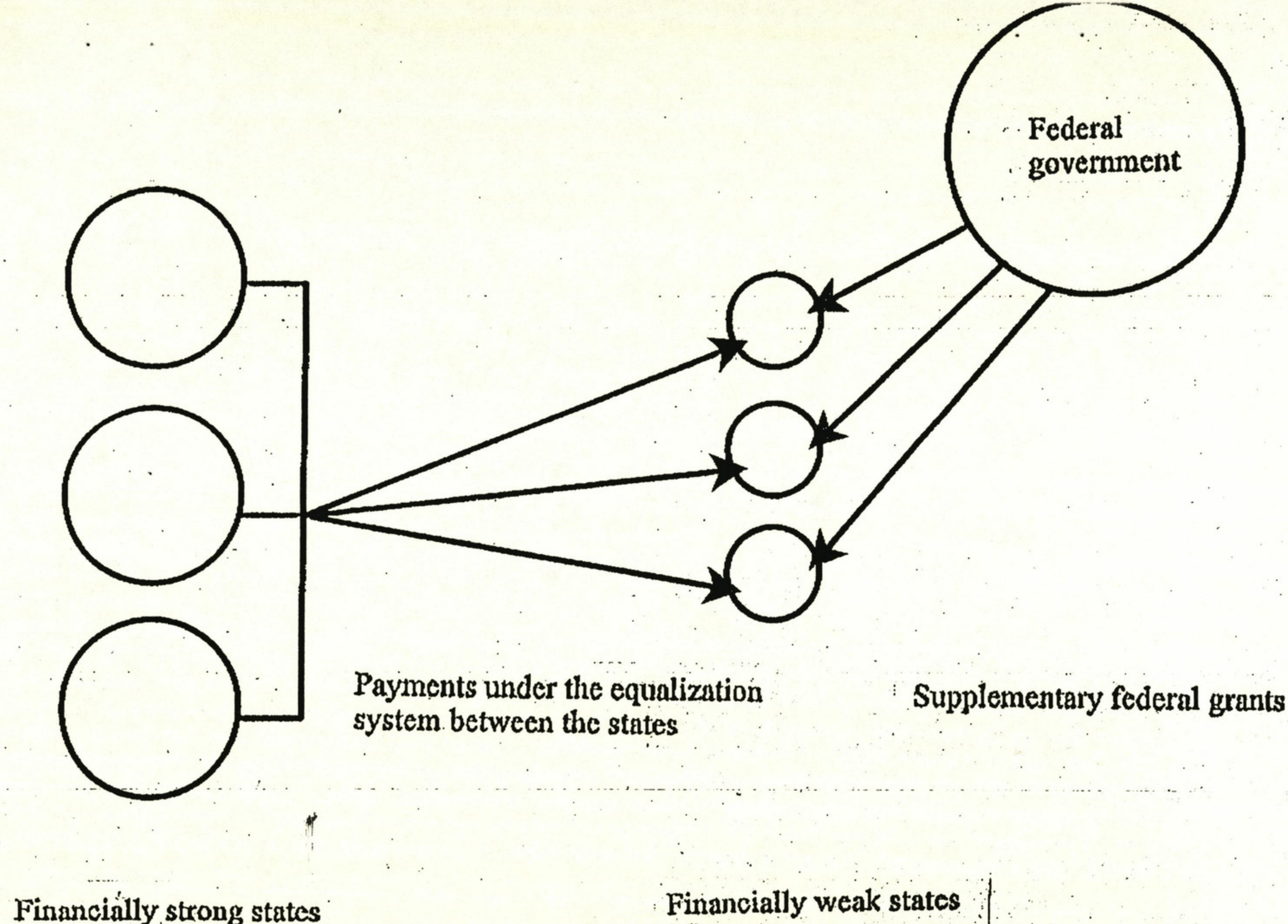
I would wish to give any constitutional assembly two important pieces of advice:

- In organizing a country on a federal structure, it is essential to ensure that each element has comparable financial strength. In this respect, we have considerable problems in Germany, with financially powerful states side by side with extremely weak ones. And for a wide variety of reasons, subsequent territorial restructuring is virtually impossible, as German experience has shown.

- The fundamental allocation of powers, particularly in respect of tax distribution, should be laid down in the constitution clearly and in detail. Obviously, while the constitution is still being drawn up, this leads to considerable fighting over who should get what. But it subsequently avoids annually recurring negotiations on this subject, often on the basis of inadequate financial planning certainty. Furthermore, such squabbling over the allocation of taxes can give rise to considerable tensions within a federal country and have a potentially destabilizing effect.

Naturally, as the finance minister of a German federal state, I would recommend you to follow our example when drawing up your constitution. It has proved itself in practice for many decades as an element of stability.

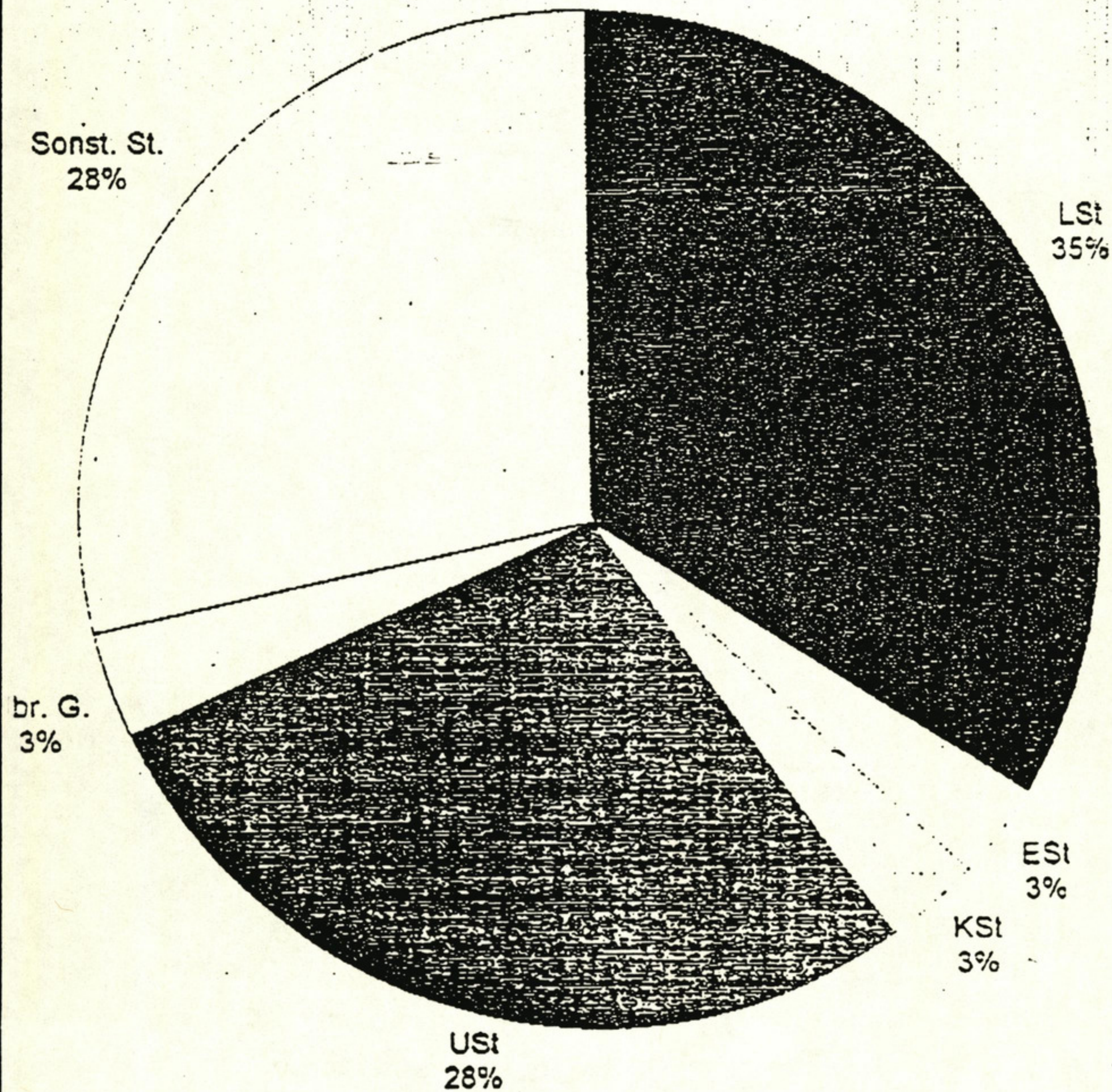
I hope very much that the new constitution of your country will help you to continue successfully on the path to reconciliation between the people of South Africa which has begun so promisingly. I therefore wish you good luck, every success and God's blessing in your most important work!


Federal government
Payments under the equalization system between the states
Supplementary federal grants
Financially strong states
Financially weak states

Entitlement to the national tax revenue is - highly simplified - as follows:

Federal government as the central state	Individual states	Local authorities as the bodies responsible for local self-administration
- pure federal taxes	- pure state taxes	- local authority taxes
- federal share of joint taxes	- states' share of joint taxes	

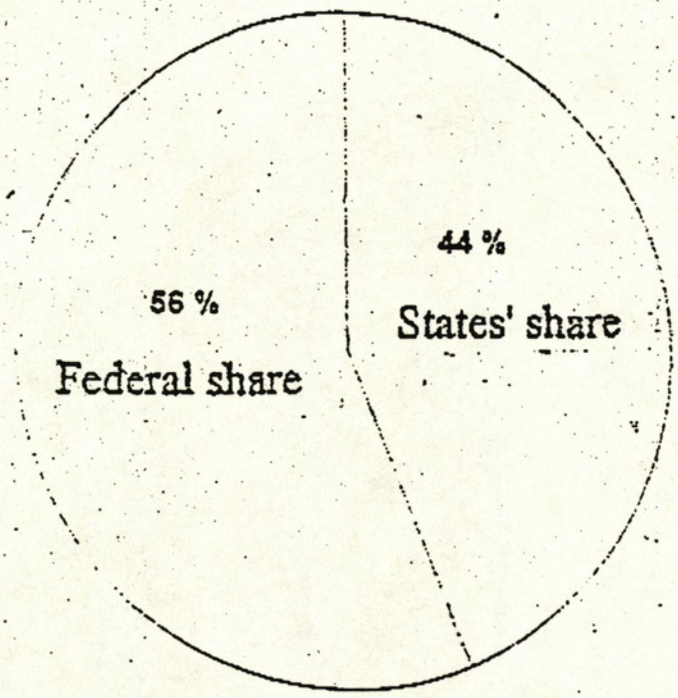
Joint taxes in relation to total taxes in the Federal Republic of Germany



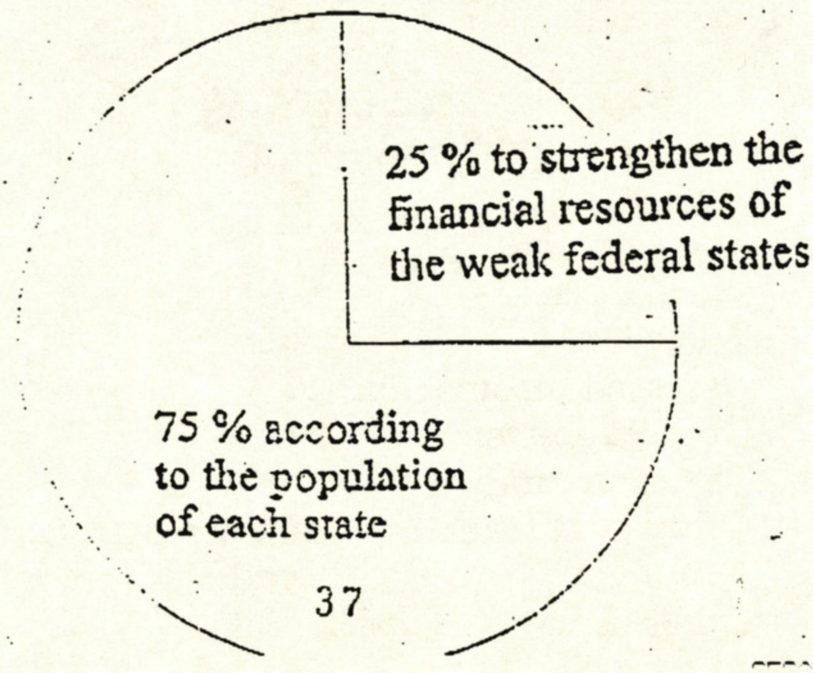
LSt	=	Wage tax		
ESt	=	Assessed income tax		
KSt	=	Corporation tax		
USt	=	Taxes on turnover		
Übr. G	=	Other joint taxes	=	non-assessed taxes on yields and those withheld from interest
Sonst. St.	=	Other taxes		

Distribution of value added tax revenue in 1995

a) As a joint tax to the central state and the federal states



b) Allocation of states' share to the individual states



Public finance

In view of the negative experience of the 70s, when the government became overinvolved in the country's management, the present government aims to have a "leaner" state, in other words to cut back on public spending. By dint of budget savings, a consistent privatization policy and deregulation, it was possible in the 80s to reduce the public share of GNP from 50% in 1982 to 45% in 1989.

The purpose of privatization is to enable the state to concentrate on its central role. The proceeds from privatization are not considered a major contribution to the solution of budgetary problems, however. When, for instance, the Salzgitter corporation was sold in 1990 the money was used to establish the German Environment Foundation, one of the largest endowments in Europe, with initial capital of DM 2.5 billion.

But the country's reunification suddenly confronted the government with a host of new responsibilities. The volume and the importance of public finance have increased again accordingly. In 1992 the federal and state governments as well as the local authorities together spent DM 1,051 billion. This was the first time in the country's history that public spending had exceeded the trillion mark. If we add the cost of national insurance, the total came to DM 1,367 billion or 49.3% of GNP. Thus the public share of the national income is back to where it was in the early 80s. Every second mark earned in Germany at present comes from the public authorities. The government plans to reduce this high proportion.

■ ■ **Distribution of responsibilities.** The Federal Republic of Germany has three levels of government, federal, state and local. Their responsibilities in their respective areas are governed by the Basic Law. Generally speaking, they have to meet the necessary expenditure themselves. Hence public revenue does not flow into a joint account but is distributed among the federal, state and local governments.

The lowest level of public administration is that of the municipality, which is concerned with all matters that directly concern the local community and individual citizens. It is thus responsible for water, gas and electricity supply, refuse disposal, the maintenance of local roads, welfare and health services. Together with the state authorities it is also responsible for schools and cultural establishments.

The states have jurisdiction for all aspects of government, unless the Basic Law specifically provides otherwise or leaves open the possibility of a different arrangement. Its main responsibilities fall into the category of cultural affairs and primarily concern schools and education. But the administration of justice, the police and public health services also fall within the states' purview.

Most of the responsibility, and thus the largest financial burden, is borne by the Federal Government. According to the Basic Law, its sphere of competence embraces all matters that directly secure the existence of the state as a whole, viz social security, defence, foreign affairs, national security, the construction of autobahns and national highways, telecommunications, science and research. It is also responsible for energy and the promotion of industry, agriculture, housing and urban development, public health, the environment and overseas development.

There are other various tasks which the federal and state governments plan, implement and finance jointly. They include university building, improvement of regional economic structures, agricultural structure and coastal preservation, as well as cooperation on educational planning and the promotion of science. A fourth level of administration is also assuming increasing importance: the European Community.

■ ■ **Financial planning.** A 1967 Law for the Promotion of Economic Stability and Growth requires the federal and state governments to draw up their budgets in the light of the principal economic policy objectives. These are price stability, a high level of employment, balanced foreign trade and steady economic growth (the "magic square"). The Federal Government and the states must draw up financial plans for their areas of responsibility in which incomes and expenditure are projected for a period of five years. The purpose of this pluri-annual financial planning is to ensure that public revenue and expenditure are commensurate with national economic resources and requirements.

The municipalities, too, must draw up medium-term financial plans. The great importance of the public budgets requires close coordination through all levels of administration. The main body in this process of voluntary cooperation is the Financial Planning Council set up in 1968 and representing the Federal Government, the states and municipalities and the Bundesbank. There is also an Economic Policy Council with a coordinating and advisory function.

■ ■ **Distribution of revenues.** In order to meet their responsibilities the federal, state and local governments must have the necessary funds. Wide-ranging as public responsibilities are, the sources of revenue are equally varied. The main source is taxation. Total tax revenue in 1992 was DM 729.1 billion. The Federal Government's share was 48.1%, that of the states 34.2% and that of the local authorities 12.6%.

Tax revenue has to be distributed according to the size of the responsibilities of the three levels of government. Income, corporation and value-added tax are the „share taxes", that is to say, they are distributed between the federal and state governments according to specific formulas (the value-added tax being renegotiated from time to time). Part of the income tax goes to the local authorities. In exchange they have to surrender to the federal and state governments part of the trade tax they raise, which used to be a purely local government tax. Another part of this VAT goes to the European Community.

Tax revenues 1992
(in millions of DM estimated)

Federal Government	356,849
States	247,363
Municipalities	93,417
EC funds	34,202
Total	731,831
Important taxes:	
Wage tax	247,322
Assessed income tax	41,531
Turnover tax, import turnover tax	197,711
Oil tax	55,166
Tobacco tax	19,253

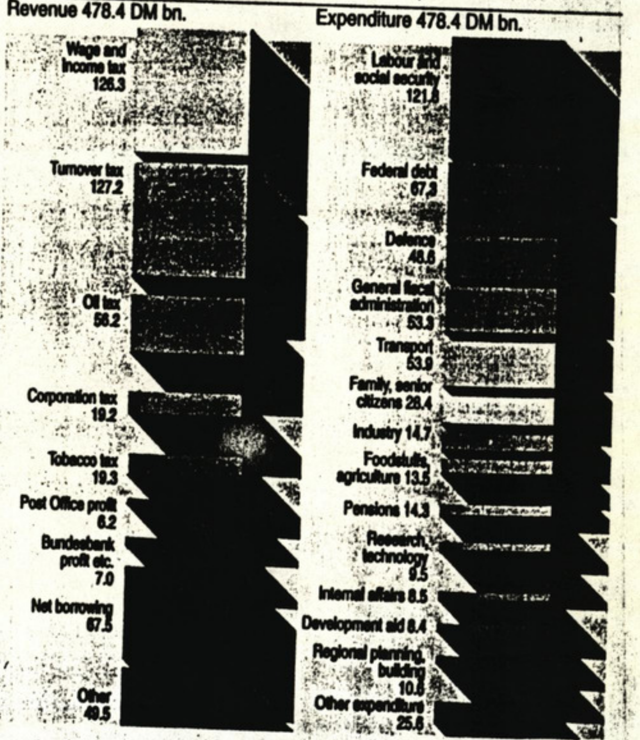
Other taxes apply to only one level of government. The Federal Government obtains revenue from monopolies (e.g. on spirits) and various consumer and transaction taxes (e.g. mineral oil, tobacco and capital transfer taxes).

The states receive the motor vehicle, property, inheritance and beer taxes as well as a number of smaller taxes.

The municipalities obtain revenue from trade tax, less the proportion taken by the federal and state governments, real estate and local excise duties.

There are more than two dozen different taxes. Nearly half of all revenue comes from income tax and corporation tax. Income tax is the one which affects the average person most of all. Employers deduct it from wages and

Federal Budget 1994 (draft)



salaries and remit it to the tax office (the „pay-as-you-earn" principle). The rate of taxation rises with the individual's income. After deduction of certain non-taxable amounts it comprises (until the end of 1993) at least 19% and at most 53%. The new Investment Promotion Act („Standortsicherungsgesetz") will reduce the top rate to 47% as from 1994.

The second largest source of revenue is turnover tax (value-added tax and turnover tax on imports). It accounts for a quarter of all tax revenue. Mineral oil and municipal trade tax each provide between six and seven per cent.

■■ **Financial equalization.** The tax-raising capacity of the states varies considerably because their situation and economic structures are also very different. Thus some states, such as Baden-Württemberg, Hamburg and Hesse, have substantial financial resources while others like Lower Saxony, Saarland, Schleswig-Holstein and Bremen do not. These differences in tax-raising potential are largely balanced out through a sys-

The Nuclear Research Centre, Karlsruhe tem of „horizontal financial equalization". On the one hand the turnover tax accruing to the states is shared proportionately, on the other the wealthier states make equalization payments to the poorer regions.

A „vertical financial equalization" takes place between states and local authorities. The tax and other revenues of the municipalities are inadequate for their tasks. They therefore depend on subsidies from the states. Some of them are tied to specific purposes but others are freely disposable. The aim of equalization is to reduce the disparity between local authorities with high and those with low tax revenues.

■■ **Public debt.** Apart from levying taxes to finance public expenditure the government can also borrow money. In the 70s and especially since reunification the federal and state finance ministers have been drawing increasingly on the capital markets. In 1992 the country's total budget debt came to a record DM 1.21 billion or almost DM 15,000 per head of the population. To this sum must be added the debts of the Federal Railways (1993: DM 48 billion), the Post Office (DM 102 billion) and the Treuhand (about DM 300 billion).

■■ **Financial problems in connection with German unity.** When the wall dividing Germany was opened in November 1989 the overall public debt stood at DM 929 billion. Five years later, at the end of 1994; this sum will have almost doubled. This in itself indicates the size of the financial problems relating to Germany's reunification.

Funds which up to 1990 were available to the 11 western states for such things as social security, infrastructure, education and research, individual branches of the economy and the labour market, now have to be spread among 16 states. Public expenditure has naturally increased all round as a result of reunification but the necessary revenue base is only gradually taking shape.

Investment in German unity is therefore correspondingly high. In 1992 public spending on social insurance for the new states exceeded DM 110 billion after deduction of their structural and administrative revenue. The amount in 1993 was almost DM 140 billion, nearly 5% of western Germany's gross domestic product. There are in addition united Germany's considerable international liabilities.

The Unification Treaty provided that the new federal states should from the very beginning be incorporated as far as possible in the financial system established by the Basic Law. Thus since 1991 the new states have been subject to basically the same regulations with regard to budgetary management and tax distribution as the western states. A „German Unity Fund" was set up to provide financial support for the new states and their municipalities. It is fed jointly by the Federal Government and the western states, most of the money being raised in the capital market. This fund will be a substitute until the end of 1994 for a nationwide financial equalization arrangement among the federal states. As from 1995, the financial relations between the Federal Government and all sixteen states are to be completely readjusted. In addition to untied assistance via the German Unity Fund, the states and local authorities in the former GDR receive tied aid from the central government.

In mid-1991 the Federal Government launched a further joint programme known as „Recovery East". In both 1991 and 1992 it provided DM 12 billion for local authority investment, job creation or promotion of regional industry. In order to finance structural reform in the new federal states it was necessary to considerably increase public borrowing, especially that of the Federal Government. A consolidation process over the next few years is intended to reduce the government's public sector borrowing requirement substantially.

REVENUE ALLOCATION IN NIGERIA

Being Text of Paper Presented

To Internal Workshop

on Financial and Fiscal Relations

Organised by Theme Committee 3

of the Constitutional Assembly

BY Mr **M.U. OFFOR**

ACTING HIGH COMMISSIONER OF NIGERIA

I should like to begin by thanking the organisers of this workshop for inviting me to participate in this afternoon's session. I am particularly delighted that the members of Theme Committee 3 have, through this invitation, acknowledged the utility of the experiences of other African countries in the subject under discussion.

2. The Federal Republic of Nigeria, the country which I have the honour to represent in this beautiful land, has had a rich and varied experience in the management of fiscal relations between various tiers of government. It is my wish, therefore, that this modest contribution will prove useful to the members of the Constitutional Assembly in their onerous task of drawing-up a final constitution for South Africa.

3. Nigeria is a three-tiered federation, with a Federal Government at the centre, thirty States and 589 local government areas. The maps contained in Annex I show Nigeria in relation to South Africa as well as the thirty states of the federation. Quite naturally, such a political arrangement necessitates a fiscal system that allows each unit to carry out constitutionally assigned responsibilities.

4. In this paper, I intend to discuss fiscal and revenue allocation in Nigeria, from the following perspectives :

(i) Mechanisms for Revenue Allocation

(ii) Autonomous Sources of Revenue

(iii) Principles and Formulae for Revenue Allocation

(iv) Present System of Revenue Allocation

(v) Lessons from the Nigerian Experience.

MECHANISMS FOR REVENUE ALLOCATION

5. Until 1989, revenue allocation in Nigeria was determined on the basis of reports rendered by ad hoc Commissions established for that purpose. Between 1946, when such exercises began, and 1989 there were eight such Commissions. The appointment of these ad hoc Commissions was usually made by the Federal Government and prompted by changing political circumstances such as the adoption of a new constitution or political arrangement.

6. These ad hoc Commissions were able to establish a number of practices which have endured over time. For instance, these exercises have helped to settle parameters such as :

- independent revenue bases for each tier of government
- development of principles used in revenue allocation
- establishment of a distributable pool account which has consequently been incorporated into the constitution as the Federation Account.

7. There were, however, a number of drawbacks associated with these ad hoc Commissions. Usually, their work was highly publicised and tended to attract a lot of attention especially as each unit (centre and states alike) wanted to use the opportunity to improve its share of revenues. This also led to an over-emphasis on the division of existing revenue at the expense of revenue generation. In any case, such temporary Commissions meant there was no means of obtaining a flexible response to changing circumstances.

8. The inadequacies of ad hoc revenue allocation Commissions caused the Federal Government of Nigeria to establish, in 1989, a National Revenue Mobilization, Allocation and Fiscal Commission as a permanent mechanism for revenue allocation.
Its responsibilities include :

- the design and mobilization of all sources of public sector revenue
- periodic review of revenue allocation principles and formula to minimise short-term political pressure
- prescription of formula for sharing revenue between Federal, State and Local Governments
- commissioning studies on the federal fiscal system and on inter-governmental financial relations.

9. It is probably too early to pass judgement on the work of the permanent Commission. However, in the short time of its existence it contributed to the introduction of Value Added Tax (VAT) in 1994 which significantly boosted revenues at all tiers of government. It has also helped to reduce politicisation of revenue allocation issues, as the temperate debate on the subject in recent sessions of Nigeria's Constitutional Conference would tend to indicate.

AUTONOMOUS REVENUE SOURCES

10. A very pertinent issue in the fiscal relationship between the three tiers of government in Nigeria has been determining "who gets to keep what ". Put differently, what are the independent sources of revenue available to each unit of government to enable it execute constitutionally assigned responsibilities ?

11. To insist, for instance, on the central pooling of all revenue may create a quasi-unitary state. On the other hand, granting states jurisdiction over all revenues raised in their territories may result in a confederal arrangement. Given the importance of finance in determining the relative strength of the centre vis-a-vis the states and amongst individual states, it was imperative to find a balance between these two extremes.

12. In finding a balance, the following factors were taken into consideration :

- the need to retain revenues arising from constitutional powers
- the need to retain revenues related to the provision of public services, eg local roads, sewerage and sanitation, and land registration, inter alia
- the need to retain revenues derived from innovative or internally generated activities. These include, for example, state government investments in business concerns, levies or

fines accruing from the contravention of social codes of behaviour.

13. As a direct consequence of the afore-mentioned factors, we have in Nigeria, four types of revenue accounts.

(i) The Federation Account is the constitutionally prescribed distributable pool account. Each unit of government in all three tiers receives an allocation from the Federation Account on the basis of a revenue allocation formula described later on in this paper. The revenues paid into the Federation Account include :

- Company Income Tax
- Import Duties
- Export Duties
- Excise Duties
- Petroleum Profits Tax
- Mining Rents and Royalties
- Nigerian National Petroleum Corporation Earnings from Direct Sales
- Oil and Gas Pipelines Licenses and Fees
- Surpluses from the sale of Natural Gas

(ii) Federal Government Independent Revenue which includes the personal income tax of Armed Forces and Foreign Affairs personnel as well as of residents of the Federal Capital Territory. Also included are revenues and profits from Federal Government owned agencies, parastatals and companies.

(iii) State Government Independent Revenue include gains made from the provision of services or profits from state owned enterprises. In addition, however, the following taxes accrue into the coffers of the state in which they are generated :

- personal income tax
- sales taxes
- property taxes
- motor vehicle licensing fees
- land registration and survey fees

(iv) Local Government Independent Revenue is not as well developed as the revenue arrangements of other tiers of government, but includes profits made from investment in business concerns, donations and communal levies.

14. The autonomous sources of revenue to the states and local government are, at present, not very substantial. This is because the major source of total government revenue is from petroleum and natural gas related taxes which are paid into the Federation Account. In addition, the taxes which the states are allowed to collect depend to a large extent on economic development. For instance, a state would need to have a large number of houses that fall into the category required to pay property taxes, or of citizens that own motor vehicles if it is to collect substantial independent revenue. These weaknesses are further compounded by the problems of tax collection and administration at such levels.

15. The excessive reliance on the Federation Account has resulted in a lot of attention being focussed on the principles and formula for its allocation amongst the various tiers of the federation and its component units.

PRINCIPLES AND FORMULA FOR REVENUE ALLOCATION

16. As stated in earlier parts of this paper, the use of ad hoc Commissions and the preponderance of revenues payable into the Federation Account tended to generate excessive interest in the rules used for allocating centrally collected resources.

17. For instance, up until 1990, the Federation Account relied on oil related revenues for at least 75 % of its total. At the same time, states relied on the Federation Account for between seventy to ninety percent of their recurrent budget. The local governments have an even greater level of dependence.

18. Allocation from the Federation Account takes place on a vertical and horizontal basis. Vertical allocation refers to the distribution of total revenue between the three tiers of government. Horizontal allocation, on other hand, concerns the sharing of the total allocation for states and local government between each individual unit.

(i) ***Vertical Allocation***.

Vertical allocation from the Federation Account has usually been determined by constitutionally prescribed responsibilities. Thus, apart from resources to maintain governmental structures, allocations are also made to cover the provision of services. Recently, for example, local governments were assigned the responsibility for primary school education, and as a result their total share of the Federation Account was increased from 15 % to 20 %.

Apart from the vertical allocation made to the Federal Government, State Governments and Local Governments, part of the Federation Account has also been allocated to special problems and projects of a national character. These Special Funds include allocations for :

(i) The Federal Capital Territory. Being a national project, funds are allocated from the Federation Account for the development of the new federal capital city of Abuja.

(ii) Stabilisation. A specific amount of the Federation Account is set aside annually to establish a Stabilisation Fund. As the name indicates, the resources in the fund are to create a financial buffer when major reversals in government revenue occur. Conversely, should there be excess revenues accruing to government over and above budgetary estimates, these are also paid into the stabilisation account.

(iii) Ecological Problems. Part of the Federation Account is allocated annually to enable the three tiers of government to cope with natural and man-made disasters such as earthquakes, soil erosion, desertification and oil pollution.

(iv) Development of Oil Mineral Producting Areas. As distinct from the fund for ecological problems, special emphasis is placed on the development of oil mineral producing areas. This is because of the amount of damage done to the habitat in such areas coupled with the huge expense of undertaking construction in the Niger delta from which most of the oil is derived. Such resources are meant for the particular areas which produce crude oil and not for the entire state in which the crude oil is located.

(ii) *Horizontal Allocation*

Over the years a number of principles have been developed to determine the weighting of allocation between States.

(i) Derivation is the principle which recognises the contribution of individual states to the Federation Account. Derivation was given greater emphasis as a horizontal principle when taxes on agricultural exports were the main source of government revenue. It has tended to be given less emphasis now that taxes and royalties on mineral resources such as oil and gas are predominant sources of revenue and derivation is now a vertical principle.

Population is a self-explanatory principle and takes into account the number of citizens each state has.

Equality as a principle takes into account the fact that there are certain things a state must have irrespective of size. Apart from constitutional equality, other examples are a civil service, judiciary, legislators etc.

Land Mass and Terrain refers to the geographical size of a state while taking into account the type of terrain. For instance, it should cost more to build a road network in a geographically vast state, yet road construction may be more expensive per mile in the Niger Delta than in the Sahel Savannah because of the nature of the sub soil.

The Social Development principle refers to the need for all state governments to play a role in promoting socio-economic development within their territories. This principle has been upheld and defined over the years in various ways including : need, minimum national standards, equality of access to development, even development, minimum responsibility, national interest. The social development principle is calculated using proxies such as primary and secondary school enrolment, number of hospital beds and availability of rainfall and water. The principle is calculated in a manner to give states with heavy responsibilities in these areas the resources to carry out such duties. At the same time states which are underdeveloped in these respects are also given the resources to enable them to make progress.

Internal Revenue Effort. This principle links allocation from the Federation Account to the efforts made by states to generate independent revenue from within their boundaries. This is not easy to measure as the use of actual revenue generated will penalise smaller, underdeveloped states. The approach adopted, therefore has been to measure the percentage increase in state revenues over a given period.

PRESENT PRINCIPLES AND FORMULA FOR REVENUE ALLOCATION

19. The present vertical allocation of the Federation Account is shown in Table I below, while horizontal allocation is contained in Table II.

TABLE I

VERTICAL REVENUE ALLOCATION OF FEDERATION ACCOUNT AS OF JUNE 1994

Beneficiary	Percentage share
Federal Government	48.5
State Government	24
Local Government	20
* Special Funds	7.5
TOTAL	100

* Special Funds (7.5 %) is broken down as follows :

(i)	Federal Capital Territory	1.0
(ii)	Stabilisation	0.5
(iii)	Derivation	1.0
(iv)	Development of Oil Mineral Producing Areas	3.0
(v)	Ecological Problems	2.0
	TOTAL	7.5

TABLE II

HORIZONTAL ALLOCATION OF FEDERAL ACCOUNT AS OFJUNE 1994

Principle	Percentage Share
Equality of States	40 %
Population	30 %
* Social Development	10 %
Land Mass & Terrain	10 %
Internal Revenue Effort	10 %
TOTAL	100 %

* Social Development allocation (10 %) is broken down as follows :

-	Education	4 %
-	Health	3 %
-	Water	3 %
	TOTAL	10 %

LESSONS FROM THE NIGERIAN EXPERIENCE

20. The experience of revenue allocation in Nigeria offers some insights that may be useful in the South African context. For instance, using ad hoc arrangements to determine the vertical and horizontal allocation of revenue may lead to over-politicisation of the process. To be quite frank, in Nigeria the use of the principles of population and equality of states, while unavoidable, led to disputes over census figures and demands for the creation of new states.

21. Ad hoc arrangements also suffer from the fact that they do not offer a prompt and flexible response to changing financial or political circumstances. In such a situation, relations between the various tiers of government or the component units may be strained by delays in addressing misgivings about the revenue allocation system.

22. Another lesson that can be gleaned from the Nigerian experience is the imperative of placing an equal emphasis on revenue generation as on revenue allocation. States and local governments must have an incentive to exploit revenue generating opportunities within their territories, otherwise much effort will be dissipated in fighting for a bigger share of an existing 'cake'.

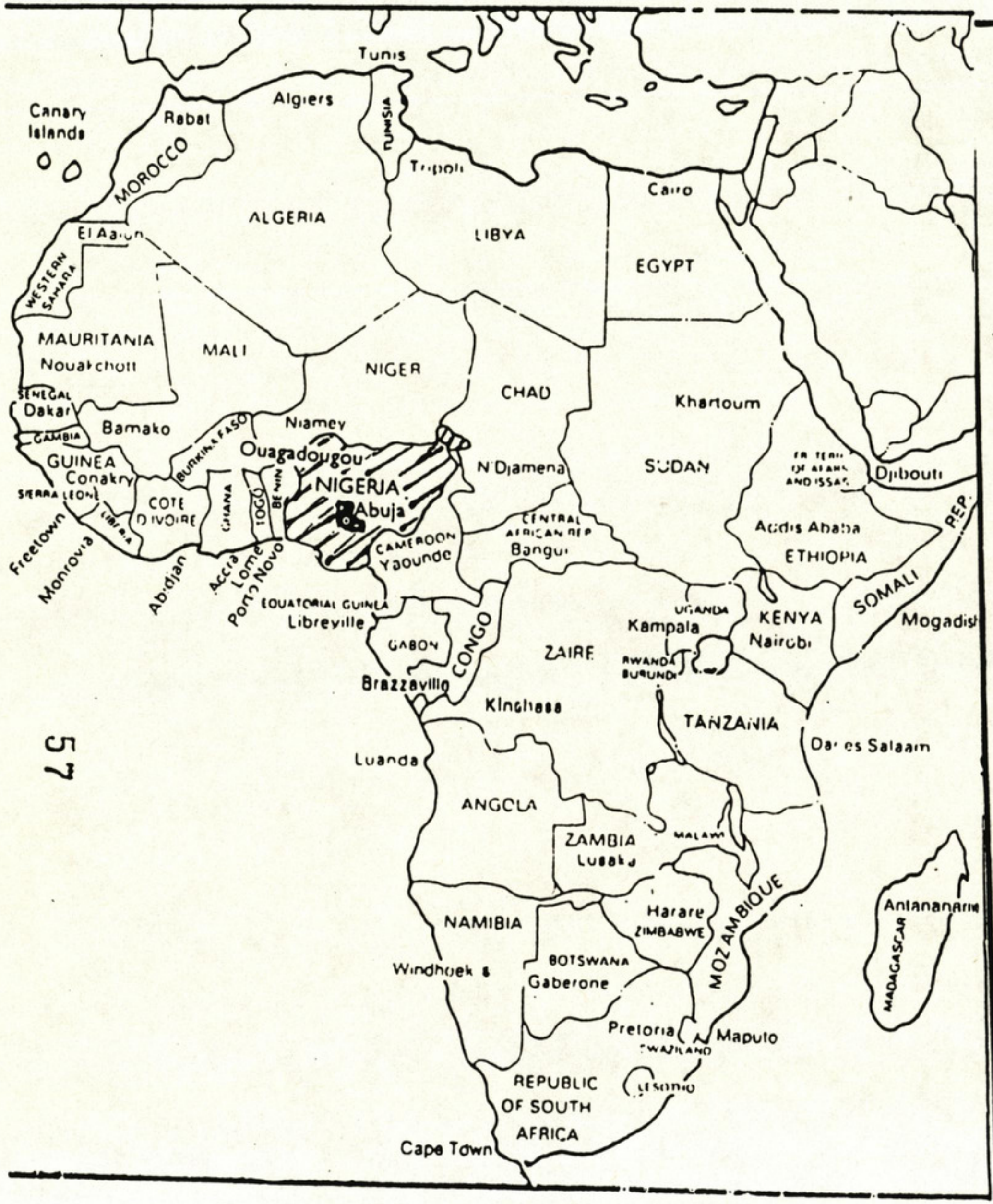
23. Closely related to this is the difficulty of finding a balance between equity in the provision of funds and efficiency in its utilisation. It is important to provide resources to enable each tier of government to meet basic obligations and promote socio-economic development. At the same time, however, the allocation of resources has to take into account the ability to put such funds to proper use.

24. The international community acknowledges the existence of developing countries and provides aid and technical assistance to them. Similarly, in Nigeria, there is a recognition that some areas are less developed than others and an attempt is made to provide resources to enable such states to 'catch-up'. This principle is also extended to providing additional resources to areas that suffer environmental damage in the process of contributing to national well-being. This is particularly true of mining areas.

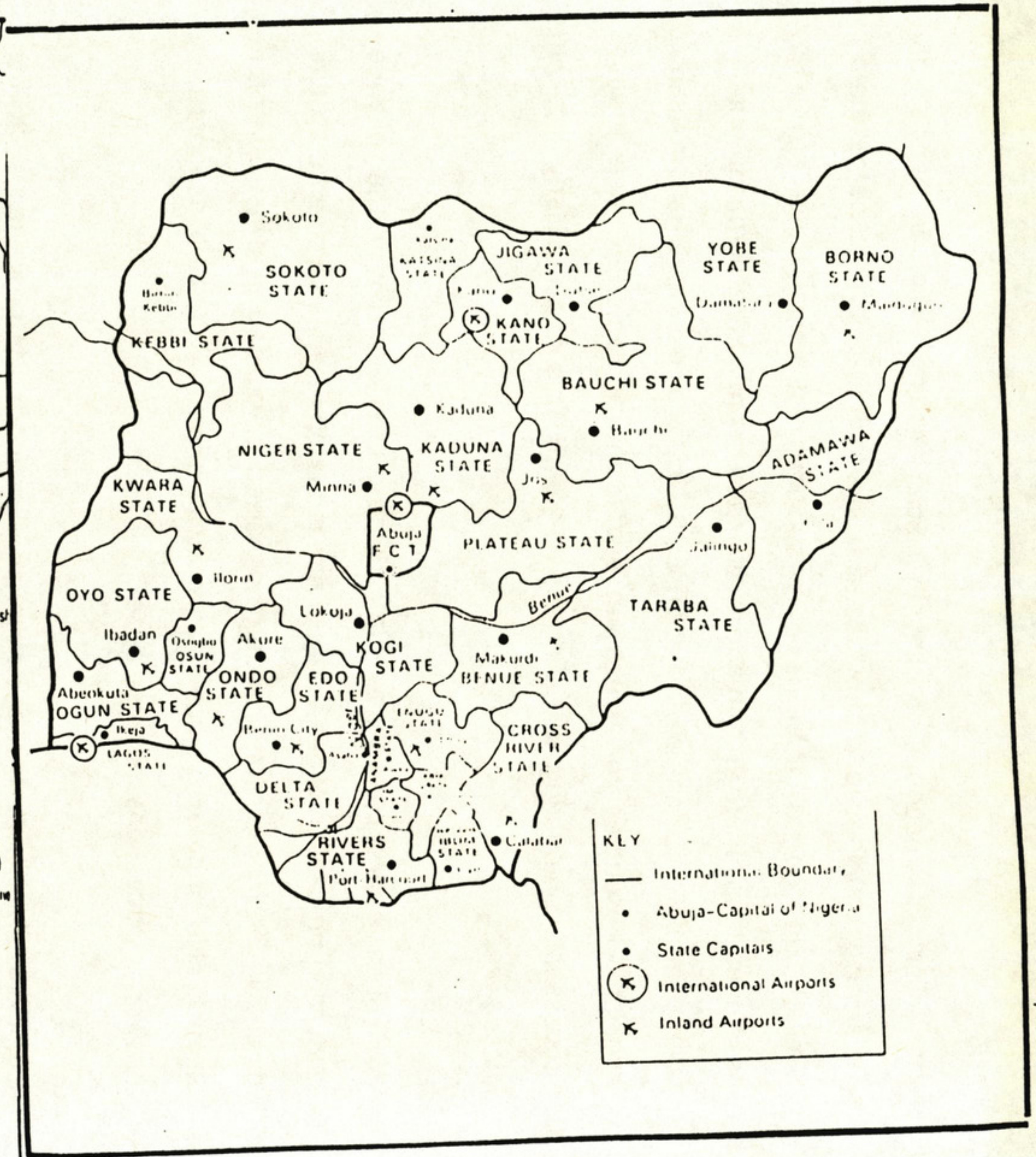
25. I have tried in this paper to provide a brief overview of the revenue allocation process in Nigeria. I must stress that the issues involved are quite extensive and I may have underemphasised or omitted to dwell on some aspects. Nevertheless, since this is a workshop. I would be delighted to answer any questions that may arise.

26. Finally, I hope that the Nigerian experience will prove of use to the work of the Constitutional Assembly. I thank you for your kind attention.

MAP OF AFRICA



MAP OF NIGERIA



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CONSTITUTIONAL ISSUES: THE FINANCIAL AND FISCAL COMMISSION

WORKSHOP, CONSTITUTIONAL ASSEMBLY, 5 JUNE 1995

by
Lieb J Loots
Member, Financial and Fiscal Commission

1 INTRODUCTION

The Financial and Fiscal Commission (FFC) is firmly committed to playing a non-political, advisory role with respect to financial and fiscal matters. The constitutional issues raised below, must therefore be seen as a response to the legislature's request for comments on relevant constitutional matters.

2 GENERAL

2.1 TOO MUCH DETAIL

It can be argued that, in general, the Interim Constitution contains too much details about the FFC' composition and functioning, especially in Sections 199 to 206, and deals with matters that should rather be dealt with in enabling legislation. The new constitution will be more elegant if it only stipulates the method of appointment and impeachment (thus giving effect to the requirement for independence and objectivity) and the Commission's brief in very broad terms with a reference to the enabling legislation, perhaps something along the lines of Section 199 (1).

A sunset clause may be inserted enabling the FFC to continue to function in terms of the Interim Constitution until the said legislation has been promulgated.

2.2 TASKS DISPERSED IN CONSTITUTION

The various tasks of the FFC are spread among Sections 155, 156, 157, 178, 199 and 239 of the Interim Constitution. If possible these should be consolidated in one section, or one chapter, with references in other sections to it.

3 CLAUSES IN NEED OF GREATER CLARITY OR DEFINITION

3.1 EQUITABLE FINANCIAL AND FISCAL ALLOCATIONS

Section 199 (1) (b) refers to "equitable financial and fiscal allocations" lacks clarity in the following respects:

> "equitable" can refer to vertical equity, ie each of the three tiers of government must receive in total a fair share of revenue collected at the national level; or to horisontal equity, ie within each level there should be a fair allocation (eg all local authorities should be treated in an equitable manner); or some combination of both, ie each jurisdiction at each level of government.

"allocations" can refer to national tax revenues only (appropriately defined); or national tax revenue and borrowing by national government; or national tax revenue plus borrowing by national government plus borrowing by some or all of public sector institutions (eg the DBSA and IDC).

The Interim Constitution may have intended the latter in both cases, but it is unclear and needs to be formulated with greater clarity. It is possible, for example, that Constitutional Principle XXVI is concerned with vertical balance - the "level" question - and not horisontal balance or equalisation - the "jurisdiction" question.

3.2 REVENUE COLLECTED AT THE NATIONAL LEVEL

Section 199 (1) (b) refers to "revenue collected at national level". This is not clear as it can refer to any of the following:

"revenues collected in the nation as a whole, ie by all levels of government", or
"revenues collected by the national government, whether for its own account or as an agent on behalf of the other levels of government"; or
"revenues collected at the national level, including the shares of the taxes specified in Section 155, but excluding revenues collected on an agency basis on behalf of other jurisdictions which go directly to those jurisdictions (eg transfer duties)"; or
"revenues collected at the national level, but excluding the specified shares of Income Tax, VAT and the Fuel Levy that has to go to the provinces, and excluding revenues collected on an agency basis on behalf of other jurisdictions".

Section 155 which refers to "revenue collected nationally", suggests that the third definition above is the appropriate one.

3.3 TAXES, LEVIES IMPOSTS AND SURCHARGES

Section 199 (1)(c) refers to "taxes, levies, imposts and surcharges". The distinction between these terms is not clear. Strictly speaking, there is no conceptual difference as they all refer to taxes of one kind or another. It also raises the question whether a tax that is given another name, eg an "excise", is now automatically excluded because it wasn't specifically mentioned. It would be more clear if it was formulated generally by referring to "any form of a tax, regardless of the name given to it".

3.4 THE RAISING OF LOANS

Section 199 (1) (d) refers to "the raising of loans by provincial or local government". It may be necessary to make sure that "loans" cover any form of credit or advance to a provincial or local government <u>or any agency owned or controlled by such a government, regardless of the source of such a credit or advance</u>. If not, "raising" could be interpreted as only referring to loans actively sought by the said government, or "loans" could be interpreted as referring to only a class of credit, or the reference to provincial or local "government" could allow these authorities to create parastatals, eg a provincial development corporation, to borrow on its behalf.

3.5 ASYMMETRY IN TAXING POWERS

Section 178 (2) state that local governments are "competent to levy and recover such property taxes, levies, fees, taxes and tariffs as may be necessary". Apart from the fact that it is not really possible to draw a clear conceptual distinction between them ("taxes", "levies" and "tariffs" are in fact all taxes), it also seems to imply that any tax can be raised, as long as it is referred to as a "tax", a "levy", or a "tariff". This appears to suggest that local governments are not subject to the same constitutional constraints as provinces are in terms of Section 156. This anomaly may be overcome by a consolidation of these clauses into one coherent and consistent section with a formulation similar to that suggested in point 3.3 above. Alternatively, there should be a reference to the section dealing with provinces, stating that those conditions will also apply to local governments. In principle, local governments should be subjected to at least the same constraints on their taxing powers as provincial governments.

3.6 ASYMMETRY IN BORROWING POWERS

Section 178 does not make any reference to the borrowing powers of local governments. This may suggest that local governments are not subject to the same constraints as provincial governments are in terms of Section 157. This anomaly, if it is not intended, may be overcome by a consolidation of these sections. Alternatively, there should be a reference to the section dealing with provinces, stating that those conditions will also apply to local governments.

3.7 PROVINCIAL TAXES, LEVIES AND DUTIES

Section 156 (1) stipulates that a "provincial legislature shall be competent to raise taxes, levies and duties, other than income tax or value-added or other sales tax". The mention of specific taxes, which are not clearly distinguishable, may again result in a lack of clarity. It may also impose unforeseen prohibitions on provinces where they may not be desirable. For example, a tax on hotel occupancy, which will, strictly speaking, be a sales tax and thus prohibited by the Interim Constitution, may very well be a good tax for provinces to raise. It may thus be better to have a broad forumulation such as: "A provincial legislature shall be competent to raise taxes provided that ...", followed by Section 156 (1) (a) and (b).

3.8 SURCHAGES ON TAXES

Section 156 (1) gives provinces the compentency "to impose surchages on taxes". If it is regarded as necessary to mention "surcharges" explicitly, it may not be clear what is meant by referring to "surchages on taxes". Does it exclude surchages on levies, duties, etc.? A more serious shortcoming is that it could be interpreted as only referring to a surcharge on the tax paid to the exclusion of a surcharge on a national tax <u>base</u>. For example, it is better for technical, equity, revenue certainty, accountability, transparancy and economic reasons if a surcharge on personal income tax takes on the form of a percentage of the nationally defined base (ie personal income) rather than a percentage added on to the tax paid. It may thus be better simply to state that "A province shall be competent to raise taxes and surchages on national taxes provided that ..." followed by Section 156 (1) (a) and (b).

The reason for including "on national" above is that it is most indesirable for a higher level authority to impose a surcharge on a tax levied by a lower level authority. For example, it is undesirable for a number of reasons for a provincial government to impose a surcharge on property taxes collected by local authorities.

4 CLAUSES THAT MAY HAVE NEGATIVE CONSEQUENCES

4.1 PERCENTAGE OF TAXES COLLECTED NATIONALLY

Section 155 (2) stipulates that a province shall be intitled to a percentage of "income tax on individuals", a percentage of "value-added tax or other sales tax", and a percentage of "any national levy on the sale of fuel". The mention of these specific taxes does not make sense and only adds to administrative costs and complexities. The same or better outcome can be obtained by referring to "a percentage, as fixed by an Act of Parliament, of all taxes collected by the national government, but excluding those taxes collected as an agent on behalf of provincial or local governments". That will be much simpler, and more certain from the provinces point of view, as national government will then not be able to introduce other taxes and cut back on the taxes mentioned in the constitution in order to reduce the revenue share of provinces.

In any case, to allocate VAT to provincial jurisdictions in terms where it originated, is simply not a sensible exercise. In countries that have tried to do this, eg Brazil, the VAT system is a mess. In other countries where the constitution makes VAT a provincial tax, eg the USA, it has not been introduced because of the complexities of doing so. Moreover, some two decades ago VAT did not exist as a separate tax. Now it is a major one. New technology and international economic developments may likewise result in major shifts in relative tax shares. It is therefore not desirable to mention specific taxes in the constitution.

4.2 RAISING OF LOANS BY PROVINCES

Section 157 may suffer from the same shortcoming as Section 199, as discussed in point 3.4 above. It may, moreover, be necessary to include in the definition of a province, for the purposes of borrowing, any agency that is owned or controlled by a province. Otherwise it could provide provinces with an escape from the conditions imposed in this section.

5 COMPOSITION AND FUNCTIONING OF THE FFC

5.1 COMPOSITION OF THE FFC

Sections 200 to 206, apart from containing too much detail about the composition of the FFC that should preferably contained in enabling legislation, envisages a Commission that is too large to function effectively. A much smaller commission, with perhaps more full time members, may be more able to perform all the functions given to the Commission.

5.2 TERM OF OFFICE

Section 200 stipulates that ordinary members of the FFC will serve for a term of two years. This may be too short, especially if the Commission were to be much smaller with more full-time members. The work of the FFC is complex and it takes a long time for a commissioner to develop the necessary understanding of the issues and their interrelationships and two years may not allow for much time for the benefits of this learning process to be felt.