Fiscal decentralisation in South Africa's North West Province

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Abstract

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South Africa faces significant economic development challenges in poverty, inequality and unemployment. The development profile of North West Province is representative of South Africa in general and reflects the typical challenges that policy makers face. It may be argued that the creation of provinces may provide opportunities for addressing the economic development challenges by bringing economic decision making closer to the people and their needs.

Fiscal decentralisation in South Africa may be supported if the development challenges facing the provinces are due to market and central government failure to allocate resources efficiently and equitably. The absence of property rights, information costs, indeterminancy of bargaining and social and public choice problems may be mitigated by the efficiency of catering for decentralised differential preferences, based on the spatial characteristics of public goods and services. Fiscal decentralisation may, however, not always lead to the efficient and equitable resource allocation outcomes suggested in theory. Fiscal decentralisation may result in inefficient spillovers and interjurisdictional competition, and may obstruct national redistributive equity objectives. In practice it may thus be necessary to combine decentralised and centralised functions to realise the benefits of fiscal decentralisation, while compensating for possible inefficiencies and inequalities.

In South Africa such a balanced system may exist, since expenditure in major functional areas are the responsibility of both national and provincial governments. However, there is only limited decentralisation of taxation, minimum standards for expenditure are attached to conditional revenue allocation, and there is an aim to ensure fiscal fairness in the provision of public goods and services. It is argued in this dissertation that this system's ability to address the development challenges facing North West Province may depend on its ability to realise the benefits of fiscal decentralisation. In this regard the indications are that North West may experience difficulty in catering for decentralised differential preferences. It has limited access to own revenue, limited discretion over allocated revenue, the composition of expenditure limits the ability to reprioritise and the

province may lack institutional capacity. It is therefore concluded in this study that a fiscally decentralised system may not in itself contribute to development and to overcoming the economic development challenges facing not only North West Province specifically, but also all provinces in South Africa generally.

Opsomming

Fiskale desentralisasie in Suid-Afrika se Noord-Wes Provinsie

Suid-Afrika staar beduidende ekonomiese uitdagings, in die vorm van armoede, ongelykheid en werkloosheid, in die gesig. Die Noord-Wes Provinsie se ontwikkelingsprofiel is verteenwoordigend van dié van Suid-Afrika in die algemeen en reflekteer die tipiese uitdagings wat aan beleidmakers gestel word. Daar kan egter geredeneer word dat die daarstel van provinsies geleenthede kan skep om die ekonomiese ontwikkelingsuitdagings aan te spreek, deur ekonomiese besluitneming nader aan die mense en hul behoeftes te bring.

In Suid-Afrika kan fiskale desentralisasie gesteun word indien die provinsies se ontwikkelingsuitdagings die gevolg is van mark- en sentrale owerheidsmislukking om hulpbronne doeltreffend en gelykmatig te allokeer. Die afwesigheid van eiendomsreg, die koste van inligting, onbepaaldhede in bedinging en die probleme van sosiale en openbare keuse kan moontlik oorkom word deur die doeltreffendheid wat geassosieer word met voorsiening in verskillende gedesentraliseerde voorkeure, en hierdie fiskale desentralisasie, op die ruimtelike kenmerke van openbare goedere en dienste gebaseer is. Fiskale desentralisasie mag egter nie altyd, soos wat die teorie stel, tot doeltreffende en gelykmatige hulpbronallokasie lei nie. Dit kan ondoeltreffende oorspoel-effekte en mededinging tussen sub-nasionale owerhede tot gevolg hê en kan nasionale gelykheids- en herverdelingsdoelwitte dwarsboom. In die praktyk mag dit dus nodig wees om gedesentraliseerde en gesentraliseerde funksies te kombineer om die voordele van fiskale desentralisasie te kry, terwyl daar terselfdertyd gekompenseer word vir moontlike ondoeltreffendheid en ongelykheid.

So 'n gebalanseerde stelsel kan in Suid-Afrika bestaan omdat die besteding in die belangrikste funksionele areas die gesamentlike verantwoordelikheid van nasionale en provinsiale owerhede is. Aan die anderkant is daar slegs beperkte desentralisasie van belastingheffingsmagte, minimum bestedingstandaarde word aan voorwaardelike

toekennings van inkomste gekoppel en daar is die doel om fiskale regverdigheid in die voorsiening van openbare goedere en dienste te verseker. In hierdie verhandeling word geredeneer dat dié stelsel se vermoë om die ontwikkelingsuitdagings in Noord-Wes Provinsie aan te spreek, afhang van die vermoë om die voordele van fiskale desentralisasie te realiseer. In hierdie verband is die aanduidings dat Noord-Wes probleme kan ondervind om in verskillende gedesentraliseerde voorkeure te voorsien. Die provinsie het beperkte toegang tot eie inkomste en beperkte diskresie oor toegekende inkomste. Die samestelling van besteding beperk die vermoë om te herprioretiseer en daar is ’n gebrek aan institusionele kapasiteit. In hierdie verband word die gevolgtrekking gemaak dat ’n fiskaal gedesentraliseerde stelsel opsigself moontlik nie sal bydra tot ontwikkeling nie - nie net in die Noord-Wes Provinsie spesifiek nie, maar ook nie in die algemeen in Suid-Afrika se ander provinsies nie.

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Chapter 1: Introduction

1.1 Objective

The objective of the study is to evaluate the potential contribution of fiscal decentralisation to economic development in South Africa, by analysing the experiences of North West Province between 1994 and 1997 (fiscal years 1994/95 to 1997/98).

1.2 Problem statement

South Africa faces significant economic challenges in poverty, inequality and unemployment (May, 1998). The new Constitution outlines a unitary, albeit decentralised system. Functions and finance are assigned to national, provincial and local governments, some of which are exclusive, concurrent and shared (South Africa, 1996). The creation of provinces in terms of the new constitutional dispensation may create opportunities for addressing the economic development challenges by moving government decision making closer to citizens and their needs. The theory of fiscal federalism needs to be examined in order to identify the benefits, shortcomings and constraints to the contribution that a fiscally decentralised system can make to development. In this study this will be done by investigating whether the new fiscal system will be able to address to the development challenges facing a typical developing province, the North West Province.

1.3 Motivation

In South Africa the challenges that need to be faced, in order to ensure economic development, are significant (May, 1998). The North West Province's development profile is representative of the plight of South Africa's people and reflects some of the most serious development challenges that the country's policy makers face.

Between 1984 and 1993 the North West Province experienced negative economic growth per capita, and is currently still under-performing. Economic activity in the province is concentrated on mining, agriculture and the manufacturing of metal and mineral products. These sectors are shedding jobs and may not benefit from current international trends or national policies (Naudé *et al.*, 1998). The extent and severeness of unemployment in the province are reflected in the size of the informal and subsistence farming sectors (Naudé, 1997). The labour force is characterised by low levels of education. North West Province ranks seventh out of the nine provinces in the Human Development Index (HDI). Inequality and poverty are further exacerbated by a lack of infrastructure and limited health and welfare capacity (SPDU, 1997b).

The South African government's Growth, Employment and Redistribution (GEAR) macroeconomic strategy recognises the problems of economic under-performance, unemployment and development, and places a significant responsibility on government to contribute to growth and job creation. In terms of the constitution certain functions have been delegated to the provinces. The provincial government should reprioritise delivery of these functions to reflect the mandate given to it by the electorate in terms of their basic needs, and to reflect and facilitate the GEAR strategy's quest for job creation and growth.

The notion that a fiscally decentralised system may create opportunities for addressing economic development challenges closer to the people and their needs is not only limited to South Africa. In many countries the trend is in the direction of a growing role for state, provincial and/or local governments (Oates, 1990:1). Tanzi (1995:295) confirms this trend and states that interest in the issues of fiscal decentralisation started to increase in the 1980s, and the topics attracted much attention in the 1990s. The high level of interest was reflected in the International Institute of Public Finance's 46th Congress in 1990 (*In* Prud'homme, R., *ed.* Public finance with several levels of government. Papers and proceedings of the 46th Congress of the International Institute of Public Finance. Brussels. Foundation Journal Public Finance: The Hague/ Koenigstein.), and the Annual World Bank Conference on Development Economics in 1995 (*In* Bruno, M. & Pleskovic, B., *eds.* Annual Word Bank Conference on Development Economics. Washington DC.: The World Bank.).

In South Africa, the role of the provinces in addressing the development challenges facing them may be based on the view that the challenges represent instances of market and government failure to allocate resources efficiently and equitably. It may be argued that a fiscally decentralised system, based on the spatial characteristics of public goods and services, could overcome these failures (Tanzi, 1995). Where government can be shown failing to determine individual preferences for public goods and services, decentralised allocation may be efficient. When the costs and benefits of public goods and services are limited to a particular region or locality it is possible that residents of different localities may have different preferences for those public goods and services (Boadway *et al.*, 1994a). In smaller, decentralised groups individuals are more likely to reveal their preferences for public goods and services, because misrepresentation could mean that they are not provided at all. With reference to the Tiebout model it may be argued that individuals will also reveal their preferences through their mobility between jurisdictions (Oates, 1990). The consumer-voter will move to and settle in a jurisdiction that best satisfies his or her preferences for public goods and services (Oates & Schwab, 1988). In addition to the advantages of demand revelation, smaller decentralised groups may be more homogeneous and the difference in the intensity of preferences less (Döckel & Somers, 1992). As a consequence, majority voting may be more stable and that may reduce the possibility of government failure due to the nature of the system of social choice. Decentralisation may also be argued to address the public choice sources of government failure. Citizens are closer to the government, which may reduce agency and monitoring costs, and they can also move in response to vote or budget maximising behaviour (Kritzinger, 1988). Decentralised stabilisation and redistribution may also be argued to be efficient and equitable when it reflects the diverse attitudes and preferences of residents in different jurisdictions (Sewell, 1996, Pauly, 1973, Ladd & Doolittle, 1982 and Brown & Oates, 1987).

Fiscal decentralisation may, however, not always solve government failure and not always lead to the efficient and equitable resource allocation outcomes which the theory suggests. Arguments against decentralised allocation can be based on the possible inefficiency of spillovers and interjusrisdictional competition (Boadway *et al.*, 1994a, Tanzi, 1995, Shah, 1990, Shah, 1991, Hewitt, 1991 and Zodrow & Mieszkowski, 1986). Decentralised stabilisation may realise only partial benefits and even exacerbate macroeconomic instability (Tanzi, 1995 and Prud'homme, 1995b). Arguments concerning the mobility of the poor and redistribution as national public good favours national redistributive equity objectives to decentralised redistribution (Ladd & Doolittle, 1982 and Brown & Oates, 1987).

Against the background of the economic development challenges and basic arguments for and against fiscal decentralisation, this study will examine the possible contribution of fiscal decentralisation to economic development in the North West Province of South Africa.

1.4 Method

This study will rely on a literature survey and analysis. As a case study, the focus will be on North West Province, where the development challenges are representative of that of most of South Africa's poorer provinces. Furthermore, the province is fairly average as far as institutional structure and government financial resources are concerned. The method will include the relevant documentation, much thereof unpublished, as well as structured interviews with provincial decision makers and participation in IDASA's Budget Project Workshops and workshops held by the Financial and Fiscal Commission (FFC). Due to the relatively recent introduction of South Africa's decentralised fiscal system in 1994, a lack of sufficient time series data precludes econometric analysis.

1.5 Description of the study

A description of the development profile of and development challenges facing North West Province follows in chapter two. Chapter three examines possible market and government failure to allocate resources efficiently and equitably, and introduces fiscal decentralisation as a possible solution. In chapter four the case for and against fiscal decentralisation is presented. The South African system of fiscal decentralisation is examined in chapter five. Chapter six investigates fiscal decentralisation aimed at contributing to the development challenges facing North West Province and outlines the prerequisites for the

South African fiscal system to realise the advantages of fiscal decentralisation. Chapter seven contains a summary, conclusions and a number of recommendations.

Chapter 2: Economic development challenges in North West Province

2.1 Introduction

South Africa's most significant economic development challenges are the alleviation of poverty, inequality and unemployment. The development profile and challenges of North West Province are in many respects typical of that of all of South Africa's nine provinces. The creation of the provinces, with constitutionally determined functions and obligations, may contribute to elucidate these challenges.

The purpose of this chapter is to examine the economic development profile of North West Province and in so doing, identify the economic development challenges facing the province.

The structure of the chapter is as follows: In section 2.2 the current development profile is presented with reference to economic activity, human capital and labour, and infrastructure and services. In section 2.3 the development challenges facing North West Province are described, with emphasis on the six strategic focus areas identified in the provincial government's development strategy, known as North West 2001. The chapter concludes in section 2.4 with a summary.

2.2 North West development profile

Current levels of development in the province can be described with reference to the economic activity, human potential and labour as well as the infrastructure and services.

2.2.1 Economic activity

In terms of Gross Domestic Product (GDP), the total value of output produced in South Africa in 1995 amounted to R430 424 million. Of this, the North West province contributed 5 percent, or approximately R21 521 million (Naudé, 1998a:48). The economy of the North West is roughly twice the size of that of Botswana, five times as big as that of Mozambique and Swaziland and bigger than the economy of Kenya (Naudé *et al.*, 1998b:31). Relative to the other South African provinces, however, North West is the third lowest contributor to national GDP. Table 2.1 below gives an indication of the relative size of North West's contribution to GDP in South Africa:

Table 2.1: Provincial contributions to GDP in South Africa, 1995 (%)

Province	R millions	% of total GDP
1. Gauteng	139455	38%
2. KwaZulu Natal	55013	15%
3. Western Cape	52842	14%
4. Mpumalanga	31964	8%
5. Eastern Cape	25383	8%
6. Free State	21940	6%
7. North West	20191	5%
8. Northern Province	10280	4%
9. Northern Cape	7014	2%
Total	R364082	100%

(Source: Naudé, 1998a)

Considering its rank of 7th out of 9 in terms of output it may be taken that the province is under-performing, as it has almost 10 percent of the surface area of South Africa, about 8.4 percent of the people and 8.3 percent of budget transfers (Naudé, 1998a:49 and SPDU, 1997b:2).

In terms of economic growth, North West's GGP increased on average by 3.2 percent per annum from 1984 to 1988. Thereafter it declined to an average -1.3 percent per annum until 1993. During this period the population growth rate in North West was 3.1 percent, which implies negative economic growth per capita (SPDU, 1997a: 11).

The analysing of the contributions to North West's GGP shows that its economy is significantly dependent on mining and agriculture. Table 2.2 provides a summary of the contributions of the various sectors to the North West's economy in 1995.

Table 2.2: Contributions to North West's GGP, 1995

SIC-code	Sector	Output R millions	% of total	Employment numbers	% of total	Average annual growth in output: 1985 - 1995
1	Agriculture	2625	13%	78 822	18%	9.4%
2	Mining	8480	42%	165 064	39%	-1.2%
3	Manufacturing	2424	12%	57 345	13%	-1.1%
4	Electricity	202	1%	3 437	1%	4.0%
5	Construction	808	4%	26 498	6%	-0.2%
6	Trade	2423	12%	61 097	14%	1.2%
7	Transport	606	3%	12 750	3%	2.7%
8	Finance	2623	13%	20 442	6%	2.3%
	Total	R20191	100%	425 455	100%	0.5%

(Source: Naudé *et al.*, 1998b)

Table 2.2 shows that mining contributes 42 percent to GGP and 39 percent to employment. Agriculture is second in this regard with 13 percent of GGP and 18 percent of employment. Table 2.2 also suggests that without the high growth rate in agriculture (9.4 percent) over the period, the aggregate GGP growth rate (of 0.5 percent) for the province would have been negative. Trade and accommodation, which includes tourism, contributes 12 percent of GGP and 14 percent of employment. It is noticeable that financial services contributes 13 percent of GGP, but only 6 percent of employment (Naudé *et al.*, 1998b:33).

Identification of underlying problems and potential in the North West economy warrants a more detailed sectoral and spatial analysis of the composition of GGP in North West. In the following sub-sections mining, agriculture and manufacturing will be discussed, along with the informal sector, small, medium and micro-size enterprises, and competitiveness and foreign direct investment in the province.

2.2.1.1 Mining

Significant mineral deposits in North West include the platinum group of metals as well as chrome, gold, diamonds, slate, limestone, dimension stone, nickel, silica, manganese, vanadium, coal, phosphate, sand stone and dolomite (Naudé *et al.*, 1998:43-46). The economic importance of mining was indicated in table 2.2. Given that mining contributes 42 percent to GGP and 39 percent to employment in North West Province, its performance is of concern to the province, considering that for most of the period 1970-

1995 mining output declined (Naudé, 1998a: 50). As a result, the number of jobs in mining declined by 25 percent, or from 202 000 to 165 000 jobs, between 1987 and 1995 (SPDU, 1997b:40).

2.2.1.2 Agriculture

From table 2.2 it may be concluded that without the high growth rate in agriculture over the period 1985 to 1995, the aggregate provincial GGP growth rate (of 0.5 percent) would have been negative. Agriculture was shown to have contributed 13 percent to GGP and had a 18 percent share of employment in 1995. Despite the positive performance there are problems underlying the growth performance and employment potential in this sector. The first is that agriculture is dependent on the weather and showed an unequal and unpredictable output growth rate over the last three decades. For example, the drought of 1982-83 lead to a national contraction in agricultural output of over 20 percent. The average annual agricultural output growth in North West over the decade 1980-1990 was -1.1 percent (Naudé, 1998a:50). The second problem underlying the growth performance and employment potential of the agricultural sector is the distribution of land in the province. At present land ownership is not equal between commercial and subsistence farmers. Commercial farming is technologically advanced and capital intensive with high yields but low profit margins and significant debt (Jansen van Rensburg & Naudé, 1998:2). Capital intensity is reflected in the fact that output had grown with 9.4 percent per annum between 1985 and 1995, but employment declined from 104 133 workers in 1985, to about 78 822 in 1995 (Jansen van Rensburg & Naudé, 1998:11). Subsistence farmers are engaged in basic farming practices, which provides a livelihood for approximately 2 million people in rural areas (57 percent of the total population). At present, most people in rural areas own some cattle, but do not use it in active farming and it yields only 16 percent of the estimated potential. At the same time it leads to overgrazing (Naudé, 1996:18).

As a result of the dominance of the mining and agricultural sectors, the North West economy is the least diversified of all provincial economies, with a tress index of 54.2 (SPDU, 1997a:10).

2.2.1.3 Manufacturing

Manufacturing contributed 12 percent to provincial GGP and had a 13 percent share of employment in 1995 (table 2.2). That can be compared with Gauteng manufacturing's 32 percent contribution to its GGP (Naudé *et al.*, 1998b:34). In North West Province the total real value of manufacturing output today is lower than it was in 1981, and the whole manufacturing sector is almost exclusively dependent on the performance of three sectors. Fabricated metals (51 percent), non-metallic mineral products (21 percent) and food and beverages (18 percent) are responsible for 90 percent of the province's manufacturing output (SPDU, 1997b: 18). This is illustrated in table 2.3 below.

Table 2.3: Composition of manufacturing output in North West, 1995

Sector	Output (R millions)	% of total
Food & beverages	429	18%
Wood & wp	48	2%
Chemicals, rubber and plastic	119	5%
Fabricated metals	1214	51%
Non-metallics	499	21%
Basic metals	48	2%
Paper and paper products	23	1%
Total	R2380	100%

(Source: Naudé, 1998a)

The three dominating manufacturing industries in North West produce low technology, medium wage (with the exception of food) and resource-intensive products. Low technology means that only 60 percent of the manufacturing firms can be classified as high value added industries, while it is 76 percent in bordering Gauteng (Naudé, 1998a: 53).

Value added per employee in North West Province is one of the three lowest of the nine provinces. Even in the dominating sectors the ranking is food, 9th position, non-metallic mineral products, 6th and fabricated metals, 7th position of the nine provinces (SPDU, 1997a:10). Low technology, resource intensive products with little value added, may not benefit from trade liberalisation and the national government's macroeconomic Growth, Employment and Redistribution (GEAR) strategy and may not attract foreign direct investment (Naudé *et al.*, 1998b:35).

Furthermore, approximately 94 percent of all manufacturing firms in North West Province are low capital-labour ratio industries. Labour productivity increased by 0.2 percent per annum from 1970 to 1993. Multi-factor productivity dropped by -1.4 percent per annum (SPDU, 1997a: 11). Between 1990 and 1995, manufacturing in North West shed approximately 10 000 jobs.

Finally, the manufacturing sector in North West Province is spatially concentrated. Of the number of manufacturing firms in 1995, 46 percent were located in the Potchefstroom and Klerksdorp magisterial districts. The greatest number of job opportunities in manufacturing are provided in the eastern and far eastern regions of Brits and Rustenburg (54 percent of all jobs) where furniture and food processing are the dominant industries (Naudé, 1998a:54).

2.2.1.4 Informal sector, small, medium and micro-size enterprises

With mining, agriculture and manufacturing shedding jobs, 14 percent of North West's labour force had to make a living in the informal sector in 1994. The size of this "survival" sector may imply significant levels of poverty in the province. In the informal sector, the most significant number of employment opportunities is in the services sector, with 34 percent of all employment in this sector (Naudé, 1997:16).

2.2.1.5 Competitiveness and foreign direct investment

Sanctions and inward industrialisation policies in South Africa have resulted in an inward-orientated economy and low degree of internationalisation. When compared with other provinces, North West has a particularly low degree of internationalisation. It is land-locked and has, as yet, no operational international airports (Naudé *et al.*, 1998b:41). The province receives fewer international tourists than other provinces such as the Western Cape, Mpumalanga, Gauteng, KwaZulu-Natal or even the Eastern Cape (Naudé, 1998a: 57). Furthermore, in 1985, only 8.4 percent of North West's manufacturing production was exported (Naudé *et al.*, 1998b:42).

Foreign direct investment (FDI) is important for any country or region, but only 3 percent of all global flows of FDI is destined for Africa. In North West, current FDI levels are relatively low, though some foreign involvement exists in a variety of manufacturing concerns and a few joint ventures with multinational corporations (Naudé *et al.*, 1998:42).

From the above discussion the North West Province's economy appears underdeveloped and fragile. Economic growth has not kept up with population growth and is dependent on a few sectors. Mining is a non-renewable resource and is subject to adverse international price fluctuations. Agriculture is subject to adverse weather. Both mining and agriculture have been shedding jobs in recent years. The low technology, resource and labour intensive products that dominates the manufacturing sector's output contributes little to value added. Those industries may not benefit from South Africa's current trade liberalisation and are as such not likely to attract investors (see Coetzee *et al.*, 1997).

2.2.2 Human capital

The human capital of a country or region refers to the embodiment of health and education in the population and/or labour force. Table 2.4 compares the development levels and human resource base in the nine provinces. North West is a largely rural province, with more than 60 percent of the population classified as rural (Naudé, 1998a:28). Table 2.4 shows that in South Africa, only Northern Province has a higher rural/urban ratio. The rural nature of North West is also reflected in the less than average population density of approximately 28.8 persons per square kilometre, which is one of the lowest in the country after Northern Cape and the Free State. The population growth of 3.1 percent per annum between 1985 and 1993, is above the national average and second to Northern Province only.

Approximately 57 percent of the province's population can be regarded as poor. This is 9 percent of the poor people in South Africa. Of the 57 percent, 43.5 percent are regarded as ultra poor, with a monthly income of less than R178.00 per month (SPDU, 1997b: 2). Furthermore, unemployment increased from 34 percent in 1994 to an estimated 36.6 percent in 1996. This reflects the job losses in mining, agriculture and manufacturing which was alluded to in section 2.2.1. Unemployment is estimated to be highest among the rural communities. The non-urban unemployment rate is calculated to be 40.3 percent

Table 2.4: Development and human resource comparisons

	Western Cape	Northern Cape	Free State	Eastern Cape	KwaZulu Natal	Mpuma-langa	Northern Province	Gauteng	North West	Total
Development level										
Gini Coefficient	0.58	0.57	0.67	0.65	0.64	0.67	0.66	0.61	0.6	0.61
Population growth rate p/a '85-93	1.7	0.79	1.5	2.6	2.79	3.03	3.95	1.29	3.1	2.44
Life expectancy 1991	64.8	64	63.3	59.6	53.6	63.5	62.7	65.6	59.7	63.4
Density (persons per km^2)	28	2.1	21.7	39.1	93.5	34.7	42.8	365	28.8	33.3
Human development index	0.76	0.73	0.66	0.48	0.58	0.61	0.4	0.71	0.57	0.69
Infant mortality rate	26.8	31.5	45.4	58.2	44.7	14.2	57	35.2	43.3	41.8
Fixed treatment points/1000 pop.	0.2	0.4	0.2	0.1	0.1	0.1	0.2	0.2	0.1	0.1
Hospital beds/1000 population	5.6	5.5	4.1	4.6	5.8	2.4	4.7	6.5	4.5	5.1
Medical officials/1000 population	1.5	0.4	0.5	0.3	0.5	0.3	0.2	1.3	0.2	0.6
Nurses/1000 population	7	4.4	3.9	3.3	4.4	2.8	3	6.4	2.7	4.3
% access to save drinking water	99.5	99.7	93.7	77.0	86.2	76.2	70.0	93.9	90.2	86.9
% access to toilet facilities	99.1	91.5	90.3	76.2	93.4	86.1	86.7	98.4	88.8	91.1
Health funding per capita '95/96 (R)	513	366	383	301	334	203	271	458	271	
Human resource base										
Education attainment index	0.81	0.67	0.71	0.63	0.71	0.62	0.59	0.81	0.59	0.7
Primary pupils/1000 population	145	174	170	53	176	181	194	117	53	135
Secondary pupils/1000 population	64	67	82	265	69	78	148	66	193	135
Pupil/Teacher ratio	25.45	26.81	32.16	41.31	37.96	35.24	37.21	28.63	29.33	34.34
Non-school attendance (%) 1991	6.4	7.3	9.7	9.4	11.3	8.5	8.6	8.7	13.7	9.6
Std 10 pass rate 1995 (%)	85	75	50	46	78	42	39	63	68	
Education funding per pupil '95/96	3128	3346	2562	2019	1883	2101	1854	2360	1789	

by the CSS (1995), and there are indications that it may be as high as 53 percent (SPDU, 1997b: 2).

Table 2.4 shows that the quality of life of the province's people, as reflected in the Human Development Index (HDI), is lower than the national average. North West ranks 7th out of the nine provinces. The infant mortality rate is higher than the national average, but North West ranks 5th, above KwaZulu-Natal, the Free State, the Northern Province and Eastern Cape.

Adult life expectancy in North West Province is 59.7 years and does not compare well with the national average of 62.8 years (CSS, 1995). Health indicators suggests that North West has a very limited capacity in the area of health care and the province is below the national average on all counts. For instance, it has 4.5 hospital beds available per thousand of the population, which is third lowest of the provinces. North West has the fewest medical officials (0.2) and nurses (2.7) per thousand of the population. The health funding per capita in 1995/96 was the second lowest of the provinces, along with Northern Province, while only Mpumalanga budgeted less. In North West, 90.2 percent of the population had access to safe drinking water and 88.8 percent had access to toilet facilities in 1997.

Table 2.4 shows that North West lags behind the South African average in the Educational Attainment Index. In terms of non-school attendance, North West has the worst / highest percentage: 13.7 percent of its children of school-going age are not in school. However, in terms of the pupil / teacher ratio, only the Western and Northern Cape and Gauteng, have lower ratios than North West. Naudé *et al.* (1998b:56) provide additional information on the education levels in North West (1991). The estimates are that 2.2 percent of the population have no education, 34.5 percent have primary education and 36.5 percent secondary education. Diplomas were earned by 2.8 percent of the population and 4 percent have tertiary education.

The inadequate levels of human development and education in North West impact on the quality and cost of labour in the province.

Regarding the quality of labour, an example of the limited skills available is provided in table 2.5. It shows the occupational distribution of the labour force in the Platinum Spatial Development Initiative (SDI) area, the most populous and relatively developed area of the province.

Table 2.5: Occupational distribution of labour force in the Platinum SDI, 1991

Occupation	Total no.	% of total	% of North West
Professional & Technical	33 330	4.5%	57%
Managerial	5 423	0.7%	47%
Clerical	39 829	5.4%	60.1%
Sales	25 180	3.4%	61%
Services	94 113	12.8%	52%
Farming	50 487	6.9%	35%
Production	221 606	30.2%	58%
Other (unspecified)	263 239	36%	83%
Total	733 207	100%	

(Source: Naudé, 1998a)

Table 2.5 shows that over 66 percent of labourers in the Platinum SDI area are production workers and unspecified (manual) workers. Many of the workers in the unspecified category are in the informal or small, medium or micro enterprise sector. Just over 12 percent are in the services sector and 10 percent are professionals, managers and clerks. It was mentioned in section 2.2.1.3 that industries which produce low technology and labour- and resource-intensive products may find it difficult to remain viable in the face of the international trends in manufacturing and in the light of the South African trade liberalisation programme.

Concerning the cost of labour, the first aspect to keep in mind is that national labour legislation applies in the province. There is no statutory minimum wage, and wage determination is left to bargaining between employers and employees in the industrial councils. Labour in the North West is relatively cheap by international comparisons. The average monthly salary rate is estimated as equivalent to US $200. This is lower than in the neighbouring province, Gauteng (US $360). The average work week in North West *is 46* hours, which is higher than that in Botswana and Zimbabwe and second only to Kenya (48 hours) on the continent (Naudé *et al.*, 1998b:55).

In summary, the human potential and labour profile characterises North West as poor and rural. The health and education indicators describe significant backlogs and are in many cases below the South African average. Limited human potential spills over into the labour market where two thirds of the labourers are production workers and unspecified (manual) workers in industries which show limited potential.

2.2.3 Infrastructure and social services

Infrastructure and social services may be regarded as crucial for building the economy and improving the quality of life in the province. South Africa's provinces are under-provided and need infrastructure to remain competitive and meet the needs of the poor. In many cases existing infrastructure is outdated and deteriorating. Thus, aside from expansion into previously neglected areas, maintenance, replacement and upgrading of existing services are important (SPDU, 1997b:13).

North West has about 1785 km of national roads. One third of the province's roads are paved (Naudé *et al.*, 1998a:12). About 5 percent of the country's total vehicle fleet is registered in the province. Most of these are privately owned light passenger vehicles (Naudé *et al.*, 1998a:28). North West Transport Investments Pty. Ltd. runs a fleet of almost 2000 buses throughout the province on a daily basis (Naudé *et al.*, 1998b:54). At national level the construction of the Pretoria, Rustenburg toll road is seen as an important project. Development Bank of Southern Africa (DBSA) funding for roads in the province is also reaching completion. All other roads are in the domain of provincial government (SPDU, 1997b:8). However, budget constraints faced by the provincial government means that few roads can be built to address the infrastructure backlog in the province, or as a means of employment creation (Naudé & Krugell, 1997:2). Limited possibilities for new transport infrastructure also means less "crowding-in" of private sector investment to promote growth (Naudé *et al.*, 1998a:2).

Rail transport in the province is provided by Transnet and the network in North West has critical linkages in the national and regional networks. It comprises the North-South line (Harare-Johannesburg-Cape Town), the East-West line (Maputo-Rustenburg-Gaborone-Windhoek-Walvis Bay) and also the central corridor (Botswana-Zimbabwe-Zambia) (Naudé, 1998b:62). Rail transport is important in moving freight between South Africa and other SADC countries. It is also essential for transporting the primary sector's products in the province (Naudé, 1998b:5).

The North West Province has airports at Pilansberg and Mafikeng. The Pilansberg airport is especially important for tourism (Naudé, 1998a:63). The North West 2001 development strategy envisages that the upgrading of Pilansberg and full utilisation of Mafikeng airport (and its surroundings as an industrial development zone (IDZ)) may be important to help unlock the economic potential of the province (SPDU, 1997b:8).

Aside from transport infrastructure, most areas outside the main nodal centres are without access to clean drinking water, energy, telephones or postal services (SPDU, 1997b:13). It is estimated that 54 percent of all villages in North West currently do not have access to clean drinking water at the RDP level. This is affecting 1 800 000 people or 51.4 percent of the total population of North West (SPDU, 1997b:15). Adequate sanitation is necessary to prevent contamination of the underground water that is a primary source of water supply in a large portion of the province. It is estimated that 75 percent of villages in North West are below the RDP level in the provision of sanitation services. The provision of electricity, postal and telephone services remain critical needs (SPDU, 1997b:16).

In addition to physical infrastructure, social services also describe the province's development profile. Health, Social Welfare and Local Government and Housing are regarded as the key role players in delivering social services. Table 2.4 indicated that North West has the lowest number of medical officials (0.2) and nurses (2.7) per thousand of the population, of all the provinces. The health funding per capita in 1995/96 was the second lowest of the provinces, along with Northern Province, while only Mpumalanga budgeted less. In 1997/98, 17.5 percent of the total budget was earmarked for the provision of health services and 16 percent for social welfare services. This represents an increase of 90.6 percent over four years and the highest priority after education and training (Naudé & Krugell, 1997).

As far as welfare services are concerned, the public sector sees its role as primarily providing safety nets, in the form of social grants and pensions to the disabled, mentally retarded, unemployed, elderly poor and homes for children and women. The public sector also subsidises private sector welfare programmes. The abovementioned 16 percent share that social welfare services have in the North West budget may be regarded as inadequate to extend the safety net to all the disadvantaged at a level that still makes it a viable proposition for private sector welfare associations to continue their support of institutions that are currently in operation (SPDU, 1997b:21).

In summary, the importance of the transport infrastructure illustrates North West Province's needs to remain competitive. Budget constraints limit the possibilities of assistance from provincial government's side. The infrastructure necessary to meet the needs of the poor is inadequate, with access to clean drinking water and sanitation regarded as priority.

2.3 Economic development challenges in North West Province

The economic development challenges facing North West Province are partly the results of the material, socio-economic and political history and experiences of South Africa. In 1996 the provincial government embarked on a strategic planning process to outline a development profile and formulate a development strategy. It culminated in the *North West 2001 development strategy* that was accepted at a stakeholders' workshop on the 27th of November 1997. Subsequently, a provincial growth and development forum, "A re Ageng" ("We build together") was established to promote the strategy. As part of an integrated planning and delivery process, North West Province draws on international trends and experiences as well as the Growth, Employment and Redistribution (GEAR) macroeconomic strategy (SPDU, 1997b:1).

North West 2001 (SPDU, 1997b:3) states that the problems outlined in the development profile are interdependent and jointly offer the threat of a "vicious circle of in-competitiveness" in the province. It is argued that to try and solve the problems with only increased government spending, may lead to increased tax and debt and less investment. A decrease in investment may lead to lower economic growth and increased unemployment. Unemployment perpetuates more inequality and greater poverty. This may contribute to low productivity and more crime, which can start the circle over again. The strategy states that the challenge is to reverse the negative trend into a "virtuous cycle of growth and development", composed by people who are empowered in terms of rights, opportunities and means (SPDU, 1997b:4).

To meet the challenge, North West Province's 2001 strategy emphasises the six strategic focus areas (or pillars) identified in the national strategic vision. The strategic focus areas are the following: building the economy, physical services delivery, social services delivery, human resource development, safety and security and optimal governance. The following sections discuss the contents of each strategic focus area.

2.3.1 Building the economy

North West 2001 (SPDU, 1997b:9) emphasises that a minimum level of economic growth has to be achieved and maintained to create jobs, to be able to recruit investments and support the other five strategic pillars. Section 2.2.1, however, described the North West economy as under-developed and fragile. To achieve a minimum level of growth, the SPDU (1997a:9) states that appropriate government spending patterns and FDI are necessary. Before examining the North West 2001 document's projections of growth based on scenarios of the status quo, the national government's GEAR policy, and North West's need to address unemployment, the challenges in specific sectors are outlined.

2.3.1.1 Mining

Section 2.2.1.1 outlined the mining sector in North West. It was shown that mining contributed 42 percent to GGP and 39 percent to employment in North West in 1995. Declining commodity prices and rising production costs have, however, resulted in declining output and a loss of jobs in the mining sector between 1985 and 1995 (Naudé, 1998a: 50-51). North West 2001 (SPDU, 1997b:41) identifies the importance of mining not so much in the contribution it could make to the other strategic pillars, but rather in the negative implications if mining is not performing.

To build the economy the North West 2001 development strategy targets a growth rate of 3.5 percent per annum in the mining sector for the next five years. The aim is to achieve 5 percent GGP growth by 2001. To reach the target, expenditure in mining needs to increase. Private consumption expenditure has been estimated to have to increase from R91 million in 1996 to R101 million in 2001. Capital investment, which made up 5 percent of mining's contribution to GGP in 1993, has been estimated to have to increase by 11 percent, from R455 million in 1996 to R506 million in 2001. The net exports of the mining sector need to increase from R8 547 million in 1996 to R9 508 million in 2001. The strategy estimates the impact of such growth to result in an increase in employment growth in the mining sector of 0.6 percent in 1997, 1.3 percent and 1.9 percent in 1998 and 1999 respectively, 3.7 percent in 2000 and 3.5 percent in 2001 (SPDU, 1997b: table 3).

North West 2001 (SPDU, 1997b:41) sees successful negotiations concerning output, productivity and remuneration between labour, management, and government as the challenge to secure the increases in consumption expenditure, capital investment and exports which are needed to build the economy. The decentralised provincial government's ability to address the growth and employment challenges in the mining sector will be evaluated in chapter six.

2.3.1.2 Agriculture

In section 2.2.1.2, it was shown that that the agricultural sector is a significant employer in the province, with an 18 percent share of employment in North West. In addition, section 2.2.1.2 mentioned that commercial farming has been experiencing jobless growth, while subsistence farming provides a livelihood for 57 percent of the total population in the province. North West 2001 (SPDU, 1997b:42) considers agriculture to be an area where impact can be made in terms of benefiting a wide constituency, creating low cost employment opportunities and offering opportunities to historically disadvantaged women and farm labourers.

To build the economy North West 2001 states that to achieve a 5 percent average growth target in North West over the planned 5 years will require an increase of private consumption spending on agricultural output from R983 million to R1 328 million in 2001. Provincial government spending in the agricultural sector needs to increase by 35 percent from R287 million in 1996 to R388 million in 2001. Capital investment in the sector is estimated to have to increase by 35 percent and net exports also by approximately 35 percent. The impact of such growth is expected to increase employment growth in the agricultural sector by 4.8 percent in 1997, 5.9 percent and 6.2 percent in 1998 and 1999 respectively, by 7 percent in 2000 and 7.6 percent in 2001 (SPDU, 1997b: table 4).

In North West Province the provincial government identified the need to develop a farming support structure that focuses on small farmer entrepreneurial development. In this context it is regarded as important to facilitate ploughing services that may enable small farmers to start affordable crop production programmes. Feasibility studies have also been proposed for products in which the province can gain a competitive and export advantage, for example, citrus production, meat processing, frozen potatoes, vegetable and flower production, exports of pigs and small scale cigar manufacturing (SPDU, 1997b:17). The decentralised provincial government's ability to achieve its economic and employment growth targets by addressing the challenge of small farmer entrepreneurial development will be evaluated in chapter six.

2.3.1.3 Manufacturing

In section 2.2.1.3 manufacturing in North West was shown to be slow-growing, without creating jobs, while it is dependent on only a few sectors such as fabricated metals, non-mineral metal production and food processing (Naudé, 1998a:76). Those are low technology, resource intensive products, with little value added. The manufacturing sector is spatially concentrated as well. The problem facing the North West government which was identified in section 2.2.1.3, is that trade liberalisation and globalisation of manufacturing may impact negatively on these types of industries. Rising labour and distribution costs may further hamper the expansion of these industries (Naudé, 1998a:77).

To build the economy and achieve the 5 percent average growth target for the province, North West 2001 (SPDU, 1997b:44) sets a growth target of 10.9 percent by 2001 for the manufacturing sector[1]. This would require an almost 42 percent increase in private consumption expenditure on manufacturing output, from R1 313 million in 1996 to R1 864 million in 2001. It is estimated that a similar increase is needed in the form of government spending, from R109 million in 1996 to R155 million in 2001. An identical increase is

[1] It is argued by Kleynhans and Naudé (1998) that should all the potential projects along the Platinum SDI be successfully implemented, this growth rate of 10.9 percent could be achieved.

needed in net exports, while capital investments will have to increase by nearly 42 percent. The impact of such growth is expected to lead to an increase in employment growth in the manufacturing sector of 3.8 percent in 1997, 5 percent and 6 percent in 1998 and 1999 respectively, 11.2 percent in 2000 and 11.1 percent in 2001 (SPDU, 1997b: table 3).

Any approach to deal with the challenges in the manufacturing sector and achieve the growth targets will have to be integrated with all the other strategic focus areas. The North West Trade and Industrial Strategy (Naudé, 1998a:78) identified some of the key challenges:

- Industries where there is a possibility that the province has existing comparative advantages have to be stimulated.
- The establishment and growth of manufacturers along the Platinum SDI area have to be supported. The area is strategically positioned in terms of the expansion of trade and transport services, manufacturing is currently dominant in the area and it is where the best qualified labour force is found.
- Competition in the province may be raised by applying the national competition policy and investigating the possibilities of privatisation.
- Promoting SMME development.
- Human resource development also have to play an important role in the form of encouraging scientific and technical education and training as well as in developing an entrepreneurial spirit amongst the youth.
- Labour productivity could be increased through (a) adding more capital to labour, (b) increasing the stock and quality of the labour force, (c) technological progress, (d) changes in the products mix, (e) better infrastructure, (f) better industrial relations and (g) capitalising on economies of scale.
- The level of research and development (R&D) and innovation may be improved through linkages between universities in the province and firms.

Although the challenges outline an approach that may be both sound and promising, North West 2001 (SPDU, 1997b:44) states that provincial government will find it hard and even impossible to generate funding from own sources for purposes of making the province more attractive and competitive for investments and jobs, other than:

- direct allocations for SMME development,
- the establishment of investment promotion agencies and investment corporations,
- utilising indirect means of improving service delivery and human resource development, and
- negotiating incentives for cluster development from national government.

Even in the development strategy these actions are expected to be inadequate in view of the attention that the manufacturing sector deserves (SPDU, 1997b:44)[2]. The decentralised provincial government's ability to stimulate growth and employment by resolving the challenges in the manufacturing sector will be evaluated in chapter six.

2.3.1.4 Small, medium and micro-size enterprises

Section 2.2.1.4 showed that 14 percent of the North West's labour force was employed in the informal sector in 1994. North West 2001 (SPDU, 1997b:18) states that when government wants to promote SMME development to help create jobs, net value is added when the SMME funds are directed at small manufacturing, small contractor and small production units. The support measures for SMME development overlap with some of those mentioned in the previous section, such as low interest rate schemes offered by the Industrial Development Corporation (IDC). SMME funding is also available form Khula Enterprise Finance limited (Naudé, 1998a:61). However, North West 2001 states that SMME development consists of more than providing funding. Government should also ensure equal commercial opportunities to all and provide support through its public goods. That could include information, research and training that support SMME's (SPDU, 1997b: 18). The challenge in North West is to focus on support training, technology acquisition,

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[2] Some national industrial support measures exist. The Manufacturing Development Programme (MDP) flows directly from the GEAR-strategy. The programme includes an accelerated depreciation allowance for the establishment of small, medium and large enterprises. There is also the small-medium manufacturing development programme (SMMDP). SMMDP is for new enterprises with assets of R3 million or less. In addition there is a tax holiday possible for up to six years for new enterprises with assets *of more* than three million. The tax holiday is determined by the type of industry (2 years), the location (2 years) and the share of labour remuneration in value added (2 years for 55 percent or more). A large number of North West manufacturing firms are already located in areas that qualify for the two year tax holiday, for example, Brits, Klerksdorp, Potchefstroom, Rosslyn, Rustenburg, Babelegi, Ga-Rankuwa and Mabopane (Naudé, 1998a:61). Supporting the Platinum SDI has already been mentioned. There are also some supply side measures being used such as low interest rate schemes offered by the IDC, the Sectoral Partnership Fund (SPF), the Support Programme for Industrial Innovation (SPII), and the Technology and Human Resources of Industry Programme (TRIP).

partnership and institution building (Naudé, 1998a:61). It is argued that provincial government involvement should be complemented by private sector efforts to render commercial, financial and marketing services. Public-private partnerships may be essential in funding, training, research and technology. North West 2001 (SPDU, 1997b:18) stresses the importance of promotional partnerships to ensure that information on ideas, opportunities and support services are gathered and spread to the entrepreneurs willing to take risks.

When the challenges to building the economy have been outlined for specific sectors, it is evident that the question is not whether economic growth is required or not, but how and at what level the economy should grow to achieve the aims of the five other strategic focus areas.

North West 2001 (SPDU, 1997b) outlines three different growth scenarios: the most likely or status quo scenario, the possible GEAR scenario and the desired growth scenario.

The status quo scenario outlines growth if the roles of the public and private sectors continue as before, without any intervention to address structural deficiencies. Moderate weather conditions and no change in platinum and gold prices are assumed. Although actual delivery since 1994 have been positive, this scenario cannot be precluded (SPDU, 1997b:9). Under such circumstances, the average economic growth rate is unlikely to exceed 2.2 percent per annum. The growth that does take place will be capital intensive. This may mean that only 49 000 new jobs can be expected, which number lower than the expected 220 000 new job seekers entering the labour market during that period (SPDU, 1997a:22). In this scenario increased unemployment and poverty can be expected. Of the different sectors, only service delivery in the form of electricity supply, transport, construction, finance and trade are expected to grow in accordance with social programmes to meet basic needs. The SPDU (1997b:9) states that these circumstances call for more effective planning, transformation and deliberate interventions.

The possible GEAR scenario projects economic growth in North West if the national GEAR strategy is successfully implemented and South Africa as a whole achieves a 6 percent average growth rate per annum by 2000. Favourable weather conditions are assumed along with a rise in platinum and gold prices. A further assumption is that growth will be more labour intensive than before (SPDU, 1997b:10). It was, however, found that even under these circumstances North West is likely to average around 3.5 percent growth per annum. The problem is identified as the fact that only 4 of the 20 manufacturing sectors that are expected to gain from the GEAR strategy also play an important role in North West, namely glass and glass products, bricks and tiles, cement and other non-metallic mineral products (SPDU, 1997a:23). With a labour intensive focus it is expected that an estimated 130 000 new jobs can be created. This is 90 000 fewer than the expected 220 000 new job seekers entering the market during the period. The economic growth rate will only match the expected population growth rate in the province. The North West government will have to consider further restructuring and interventions that will enable government and the private sector to achieve the aims of the five other strategic focus areas (SPDU, 1997b:10).

To build the economy the desired growth scenario starts from the objective that the growth should be sufficient to provide jobs for all new work seekers. Such a goal will require an economic growth rate of at least 5 percent per annum. The SPDU (1997a:24) states that this may only be possible if

- FDI can be recruited in manufacturing, tourism, agriculture and physical service delivery;
- selective targeting of public sector incentives can structurally transform the economy to focus on tourism and manufacturing;
- support of commercial farming enterprises can exploit opportunities and draw an estimated 1 300 small farmers into the economic stream;
- government/private sector/labour partnerships can succeed;
- government can succeed in promoting labour intensiveness, and if
- competitiveness can be improved through a social accord between labour, the private sector and government, concerning improved productivity and work ethics and salary increases being kept below productivity increases.

Depending on all these "ifs", the number of new jobs created could range between 274 763 and as high as 291 160 for the period 1996-2000.

From this section it is clear that a basic level of economic growth is necessary to achieve the aims of the other five strategic focus areas. In practice, small farmer development, promoting labour intensive manufacturing or recruiting foreign investment may or may not lead to economic growth and job creation in the province. The relevant question is, however, one of the decentralised provincial government's ability to face the development challenges that are central to growth and employment. That ability will be evaluated in chapter six. Growth will, however, also depend on the appropriate infrastructure, the social services and human resource development that increases the quality of the labour force, and on optimal governance. The other strategic focus areas are discussed in the following sections.

2.3.2 Physical service delivery

The importance of infrastructure in ensuring a virtuous cycle of growth and development in North West Province is twofold. The first is that it is needed by firms to remain competitive. The second aspect of importance is that infrastructure may also be essential for meeting the plight of the poor and disadvantaged. In section 2.2.3 it was shown that infrastructure in North West may be outdated and deteriorating. With the exception of Klerksdorp, all areas need upgrading and maintenance of services to meet basic needs. Outside the main nodal centres most areas do not have access to clean drinking water, energy, telephones, or postal services (SPDU, 1997b:13). To overcome these problems, North West 2001 states that provincial government will have to reprioritise, and the private provision of infrastructure must receive urgent attention (SPDU, 1997b:13).

The following discussion outlines the challenges of firstly transport infrastructure and secondly those of water, sanitation and other physical services.

Section 2.2.3 concluded that road construction in the province is to be scaled down considerably due to budget constraints and DBSA projects that are nearing completion (SPDU, 1997b:15). The development of trade and transport infrastructure could, however, present important challenges and opportunities for the province. Naudé (1998a:72) states that investment in especially transport infrastructure may enhance the competitive and comparative advantage of North West as a manufacturing base. Investment in trade and transport infrastructure may facilitate trade and the location of industries through three links. The first is the direct impact associated with the construction phase and is positive and equal to the increase in capital expenditure on the infrastructure[3]. The second link is the multiplier effect of an increase in investment and thus aggregate demand. These first two effects are only temporary in nature and cannot be the basis for sustainable growth. The third link is the forward linkages to the production process. Public investment in trade and transport facilities have the characteristics of intermediate goods that reduce production costs, increase productivity and may raise the returns on private investment. This promotes economic growth, which raises the returns on the infrastructure investment (Naudé, 1998a:73).

The North West Trade and Industrial Strategy (Naudé, 1998a:74-75) recommends that attention be given to the following developments over the next five years:

The first challenge is the development of intermodal transfer points. Section 2.2.3 emphasised that North West can be the through-traffic hub in the Southern African region. Infrastructure must be established to facilitate interaction between traders and transport service providers. Specific facilities to make intermodalism possible could be significant, for example bonded warehouses, public warehouses and materials handling facilities.

Secondly, there is the provision of specialised transport and infrastructure services. Since North West is landlocked, the possibility of declaring and developing Mafikeng airport as a dry port and the surrounding areas as an Industrial Development Zone (IDZ), should be explored (Naudé, 1998c:82). Goods can then pass directly through the traditional sea ports, and all legal and operational formalities are handled at the inland dry port. This could allow the province to manage and control the trade traffic patterns and import and export transactions, while optimising the tax base at the source of transactions. A dry port could facilitate trade and enhance small traders' access to international markets (Naudé, 1998c:82).

Lastly, to overcome fiscal constraints, transport services can be provided on contract basis by the private sector. Private funding of the expansion of the rail network with dedicated branch lines started in 1998. The branches can be constructed labour-intensively and

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[3] The construction of the Platinum Toll Road is expected to cost between R1.5 billion and R2 billion, but North West could lose this injection because half of the country's constructors and building suppliers are located in Gauteng and the Western Cape (Naudé, 1998a:72).

managed with the aim of creating empowerment opportunities on a village-by-village basis. Similarly, work could proceed on the provision of road infrastructure for parallel and feeder roads and sub-corridors (Naudé *et al.*, 1998a:7).

To face the challenges of other forms of physical service delivery North West 2001 (SPDU, 1997b:15) gives priority to providing access to clean drinking water at the RDP *level.* Section 2.2.3 emphasised the need in stating that 51.4 percent of the population of North West do not have such access. The RDP minimum level in rural areas is defined as reliable access to 25 litres of clean water per person per day within 200 metres. In urban areas the service level can be negotiated with the community, based on their preferences and ability to pay. Basic water service would entail a communal standpipe, at intermediate level a yard tap or tank, and the full service is a house connection (SPDU, 1997b:17). Currently the Department of Water Affairs and its supply authorities are continuing with its RDP water supply projects and phases three and four are expected to commence soon (SPDU, 1997b:7).

Second to water supply, North West 2001 identifies the need for adequate sanitation in order to prevent contamination of the underground water supply. Section 2.2.3 pointed out that 75 percent of the villages in North West are below the RDP level with the provision of sanitation services, while in the eastern and central regions of the province people primarily depend on dolomitic water (SPDU, 1997b:16). In rural areas the minimum RDP level for sanitation is defined as a well constructed on-site toilet. In urban areas the level of service can again be negotiated, ranging from the basic on-site toilet to simple and full water borne sanitation systems.

After basic water and sanitation, the provision of electricity, postal, telephone and transportation services remain. Currently Eskom is continuing to connect, respectively per annum, a further 27 000, 34 000 and 34 000 houses to electricity from 1997 to 1999. For postal services, 48 800 address boxes were installed during 1996/97. These are to be extended to a further 13 villages in the Ganyesa district during the next four years. Telkom is to provide 72 000 household telephones during 1997/98. This is to increase to approximately 126 000 households per annum as a result of the Malaysian deal with Telkom (SPDU, 1997b:8).

This section illustrated the importance of physical infrastructure delivery in North West Province. The needs for transport infrastructure, water, sanitation, electricity, postal and telephone services, are critical. The province's ability to face the development challenges of providing these physical infrastructure services, in order to help facilitate economic growth and relieve the plight of the poor, will be evaluated in chapter six.

2.3.3 Social services delivery

Social services influence human resource development and the quality of the labour force and is necessary for growth and development.

In section 2.2.3 it was mentioned that North West has the fewest medical officials (0.2) and nurses (2.7) per thousand of the population, of all the provinces in South Africa (table 2.4). The minimum RDP level of health care provides for 3.5 clinic visits per annum for patients without medical aid and 0.5 clinic visits per annum for patients with medical aid (SPDU, 1997b:10). The Financial and Fiscal Commission (FFC) (see section 5.2.2) estimates that the number of clinic visits per annum in North West will increase from 3 492 000 in 1997 to 4 694 000 in 2001 (SPDU, 1997b:20).

In section 2.2.3 it was also shown that health funding per capita in North West in 1995/96 was the second lowest of the provinces. There was, however, a 90.6 percent increase in the Health and Social Welfare Services budget over the last four years and it has the second highest priority after education and training. The FFC projects that allocations for health care are expected to increase with another 23 percent in real terms up to 2001. As percentage of the total budget of North West, its share is expected to increase with another 1 percent (SPDU, 1997b:21). It will be essential for the provincial government to monitor whether increased financial allocations will produce the desired outcome.

Even with increased spending, the North West 2001 development strategy (SPDU, 1997*b:20*) states that the challenge will be to foster public/private cooperation in the health system. The number of people using private health care systems have to be identified and the balance must be taken care of in the public health system. Then incentives could be introduced to increase the number of people covered by the private health system in order to alleviate the burden on the public sector. The development strategy emphasises that health is one of the departments where the provincial government could make the greatest impact, or waste money, if cost recovery principles are not used when it can be afforded (SPDU, 1997b:20).

The development challenges facing North West Province in as far as welfare services are concerned were also identified in section 2.2.3. Provincial government's goal is to provide safety nets to the disadvantaged. Existing budgets were argued to be inadequate. Further statistics and information may be required to plan and maintain social service delivery within the constraints of public sector finances. The information required could include measurement of the quantity and quality of services and subsidies offered to the total population, along with the incidence of different welfare situations which are encountered. Private sector participation and commitment for providing social welfare nets have to be increased. Currently, a solution to the problem is still outstanding (SPDU, 1997b:21).

The final important challenge of social service delivery is that of access to shelter. Housing delivery is the domain of the National Department of Housing and the National Housing Board, with funding direct from the national budget. End-user subsidies up to R15 000 is offered to assist low income households. However, problems are evident from the discrepancy between the 31 000 subsidies that have been approved and the only 4000 houses actually delivered (SPDU, 1997b:22). The province is represented on the Provincial Housing Board and plays a small role in deciding the allocation of resources in the province and in approving specific allocations for housing subsidies. The provincial government's role is to ensure appropriate bulk service delivery, efficient local government planning and ongoing management of housing related services. To ensure successful housing delivery, each local government have to formulate a local development plan encompassing municipal infrastructure and housing planning. Local governments can access funding for development through the Municipal Infrastructure Programme (SPDU, 1997b:22).

In *health*, welfare and housing services there are delays in getting social service delivery fully operational in North West.

North West Province's ability to limit the delays in the operationalisation of social services delivery and to face the development challenges of extending health care and welfare services will be evaluated in chapter six.

2.3.4 Human resource development

North West 2001 considers investment in human capital formation to be the most significant contribution that North West Province could make in improving the quality of life of its *people* (SPDU, 1997b:13). Section 2.2.2 described the low level of education attainment in the North West. The province lags behind the South African national average in the Education Attainment Index. Only 34.5 and 36.5 percent of the population have a primary and secondary education respectively and the province has the worst / highest percentage of children of school going age who are not in school. Aside from the challenge of addressing these problems, it is estimated that the number of school going pupils will increase from 1 133 000 in 1996 to 1 313 000 in 2001. A primary education must be provided for these pupils at a level of 1 teacher for 40 pupils and secondary education at a level of 1 to 38 (SPDU, 1997b:24). A demand and supply assessment of the North West labour market, based on the high growth scenario, outlines even more challenges. It shows that human resource development is not only about providing education, but also ensuring that education is relevant and in demand in the job market. The challenges to human resource development include (SPDU, 1997b:24-25):

- Growing numbers of functionally illiterate labourers, in excess of what the market can absorb.
- The number of jobs available for labourers with only a primary education level will be fewer than the supply. The opportunities that will exist will be low skilled work in mining and agriculture.
- At secondary education level there will be more job opportunities than the expected supply.
- More opportunities in services and clerical type jobs are expected.
- Small scale entrepreneurial programmes in agriculture and manufacturing may lead to high demand in those sectors.
- Relatively high growth rates of jobs in skilled occupations such as managers, professionals and technicians are expected.

The provincial government's efforts to address the challenges in education is in part reflected in the provincial budget allocation for education and training. The allocation was increased from 23.3 percent in 1994/95 to 38.2 percent in 1997/98. The FFC projects that it will continue to increase by at least 10.3 percent in real terms until 2001. This will further increase its share of the total budget to 39.5 percent in 2001 (SPDU, 1997b:23). Strict budget constraints will mean that the North West government will not be able to allocate any further share of its budget towards education and training. These allocations will have *to be sufficient* to improve on the important human resource development indicators such as literacy rates, percentage of school going population actually attending school, drop out statistics, basic adult education, life skills education, matriculation pass rate, post-school qualifications and vocational and technical training statistics (SPDU, 1997b:24).

Human resource development is reflected in the labour force. North West 2001 claims that improved education may raise productivity (SPDU, 1997b:26). South Africa is under-performing with productivity increases and in North West it is a particular area of concern. With an index value of 100 in 1995, labour productivity in North West on average improved from 75.2 in 1970 to 88.1 in 1990. Agriculture improved but finance and mining experienced significant declines in productivity. In manufacturing productivity improved from 81.2 in 1970 to 111.8 in 1980, but then declined to 86.5 in 1990 before improving again (SPDU, 1997b:26).

To limit the problems of the provincial budget constraint for training the solution could lie in increased private sector involvement. Apprenticeship training in South Africa have declined over 50 percent since 1991. On average companies spend only 2.7 percent of their payroll costs on training. That is lower than the between 4 and 7 percent in OECD countries and Korea (SPDU, 1997b:25). Criticism can also be levelled against the quality of the training that does exist. Only the employees who are already higher skilled receive formal training while only a small proportion of production workers receive formal training (SPDU, 1997b:26).

North West Province's ability to develop its human resources through improving literacy rates, extending primary and secondary education or through encouraging private sector involvement in training, will be evaluated in chapter six.

2.3.5 Safety and security

South Africa has a culture of lawlessness that extends from the crimes like murder, robbery with aggravating circumstances, rape and assault, to theft, vandalism, maladministration and corruption. Vehicle hijacking and cash-in-transit robberies have become a national crisis. This has serious implications for tourism and investment in South *Africa*. There is also a negative impact on physical service delivery in cases where some organisations and their workers are refusing to work in certain areas or insist on higher payments and additional risk coverage before taking up contracts. The consequence may be a general decline in the quality of life of the average citizen (SPDU, 1997b:27).

North West 2001 states that North West Province is in a relatively favourable position. Most serious crimes seem to be under control. However, the incidence of stock theft, rape and assault with intent to inflict bodily harm are higher than the South African average (SPDU, 1997b:13). Compared to international norms and standards the incidence of serious crime is still unacceptably high. In 1996 the following crimes were committed in the province: 1573 murders, 1831 attempted murders, 3287 robberies with aggravating circumstances, 4426 rapes and attempted rapes and 20 395 assaults with intention to inflict grievous bodily harm[4]. This is with an estimated population of only 3.3 million in the province (SPDU, 1997b:28)[5].

Although safety and security can be seen as a function and responsibility of national government, it may be argued that provincial and local government, along with the private sector and communities in general, have to be mobilised. North West 2001 contends that North West stands to gain considerably if crime can be brought under control. No provincial funding is available for crime prevention, but the government's aim is to act as a facilitator in promoting a general awareness of crime and as a catalyst in a drive against crime (SPDU, 1997b:28). The challenge will be to facilitate a contribution towards (SPDU,

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[4] Recently, farm attacks have taken on a serious dimension in North West and is exacerbating rural unemployment and inequalities (see Jansen van Rensburg & Naudé, 1998). The extent of the problem was reflected in a two-day Summit on Rural Conflict held in Rustenburg, 4-5 June 1998.

[5] Note that the CSS estimates the population in North West as approximately 3.35 million (CSS, 1995)

1997b:29):

- greater control over the use and ownership of firearms and to reduce the number of firearms lost or taken,
- building capacity to conduct lifestyle audits of individuals who are under investigation,
- *establishing* safe houses and referral services to deal with crime against women and children,
- sensitising the community against bribery and corruption,
- improving the quality of investigating services,
- a more user friendly policy service that is more accessible to victims and witnesses of crimes,
- introducing crime prevention approaches throughout the province, and
- improving the information, implementation, dissemination and general communication about crime.

It is important that this strategic pillar be recognised as a critical focus area, and that it receive attention in an integrated plan for the province. North West Province's ability to act as a facilitator and catalyst in a drive against crime and to face the challenges mentioned above will be evaluated in chapter six.

2.3.6 Optimal governance

As the final strategic focus area the North West Province's Trade and Industrial strategy (Naudé, 1998a:58) states that good governance is an internationally acknowledged necessity for economic growth and development. North West 2001 regards a range of institutional arrangements, cultural conditions, legal requirements and political agreements as preconditions for the establishment and ongoing operation of the market and management of social and human development (SPDU, 1997b:29). Governance is said to *highl*ight a fundamental qualitative change in the way government organises and manages itself. The aims are for a smaller and leaner government to participate in the development process with partnership-based initiatives that opens channels for the private sector, and organised labour and civil society to participate in planning and decision making. Integrated planning becomes a strategic framework for guiding the way public institutions operate within the market to promote development (SPDU, 1997b:30).

The province's Trade and Industrial Strategy also contends that since 1994, governance in South Africa have improved substantially, but that there are still some shortcomings, especially in the provinces (Naudé, 1998a:58). Not all the provinces may currently have the capacity to manage themselves and execute their responsibilities in a fiscally responsible manner. The national cost containment initiative launched in August/ September 1997 is an indication that provinces have difficulty in applying fiscal discipline (Naudé, 1998a:58).

In 1994 the North West Province was created from the Bophuthatswana homeland administration and parts of the Transvaal and Northern Cape administrations and inherited a bureaucracy of approximately 70 000 employees (Naudé, 1998a:58). The Bophuthatswana government created a number of parastatals, such as the Bophuthatswana National Development Corporation (BNDC) (now the North West Development Corporation) and Agricor. They also assisted and protected ventures in mining, agriculture, transport, tourism and communications. Under the new dispensation these institutions and corporations were finding it difficult to survive without state assistance (Naudé, 1998a:59). Naudé *et al.* (1998b:48) contends that despite these transition problems the province has not seen the same degree of maladministration and corruption as some other provinces have. In the restructuring process 10 provincial departments were established and by September 1995 the number of public servants were reduced to 66 971. That constituted only 5 percent of the total public service in South Africa. By the middle of 1996 the restructuring was completed in most departments and they could begin with the final placing of people, filling of posts and actual delivery (SPDU, 1997b:37).

It is necessary that the North West government builds a reputation for good governance. Good and efficient government should also be ensured at local level. The local governments have to maintain infrastructure for businesses and households, but currently almost 80 percent of local governments in South Africa experience financial difficulties (SPDU, 1997b:37). Challenges for optimal governance will be to foster private/public partnerships and to promote excellence in the public sector and the public service.

2.3.6.1 Private/Public partnerships

The necessity of private/public partnerships is due to provincial budget constraints. In discussion of the other strategic focus areas, provincial budget constraints were mentioned as inhibiting North West Province's efforts to address the development challenges that were outlined in sections 2.3.1 to 2.3.5. In the 1997/98 budget approximately 10.7 percent of the budget was available for capital formation and new development initiatives (SPDU, 1997b:23). With a 5 percent average growth rate as target for the year 2001, this may be argued to be inadequate. North West 2001 recognises that government, business and labour will have to accept joint responsibility and commitment for the planning and delivery to succeed (SPDU, 1997b:30). It is argued that growth and development initiatives can only be achieved by mobilising off-budget resources to complement the inputs that government can afford. The challenge to this approach will be in establishing the following ground rules (SPDU, 1997b:31):

- The development needs and objectives must be clearly stated and development of the strategic focus areas must be promoted in a coherent and balanced way.
- Knowledge and information must be shared as the private and public sectors openly participate in seeking solutions.
- The public sector must be prepared to apply constructive self-criticism.
- A demand culture needs to be replaced with a needs driven approach and greater acceptance that beneficiaries have to contribute more to cost recovery.
- More has to be produced with fewer financial resources, while realising a greater development impact.
- Productivity, performance and delivery must dictate salaries and conditions of employment.

2.3.6.2 Promoting excellence in the public sector

This component of North West 2001 focuses on improving the quality and efficiency of service delivery in the public sector. The first leg of such an effort would be co-operative government. The SPDU (1997b:32) contends that joint governance and co-operation by national, provincial and local government would promote excellence. When government's policies and priorities and the budget ceiling are taken into account the second approach to promoting excellence in the public sector is to reduce the size of the public sector to the minimum number of people necessary to adequately deliver on a programme. Rigthsizing, not only in terms of the personnel numbers, but also in terms of the programmes may be important, but it was found that many provincial services are essential and cannot be easily cut.

North West 2001 states that the problem of promoting excellence in the public sector lies in the attitude and commitment towards challenges faced. The capacity and ability to make a difference and the scope that is available to respond to the challenges, and to accept responsibility and accountability for the outcome are limted (SPDU, 1997b:33). A range of delivery options is available to respond to these problems. The right mode of government department provision, public/private partnerships or private sector contracts has to be found to improve management, client satisfaction and employee commitment.

2.3.6.3 Promoting excellence in the public service

North West 2001 states that the transformation of a bloated, rigid and unproductive public service into a dynamic, lean and efficient structure is a further challenge for achieving optimal governance. Such a process must provide for (SPDU, 1997b:37):

- a reframing process to change the mind set of public servants;
- the restructuring process where Strategic Management Teams are appointed to assess the situation and functions performed, and to develop an appropriate structure in terms of vision, mission objectives, functions, capacity and resources;
- revitalisation which should bring new life, orientation and motivation into the structure; and
- retraining and empowerment of empoyees to deal with new challenges, while regular reviews assess whether progress is acceptable and in the right direction.

In the context of the process of promoting excellence in the public sector, the white paper on transformation and the green paper on transforming public service delivery are most important. In North West the process is monitored by a Transformation Steering Committee that represents the MEC's and heads of departments. In each department the progress is monitored and shortcomings identified by Departmental Transformation Units.

The ability of North West Province to face the challenge of optimal governance, in order to enhance delivery through private/public partnerships and promote excellence in the public sector and public service, will be evaluated in chapter six.

Optimal governance is, however, only a part of the multi-pronged approach to face the challenge of creating a virtuous cycle of growth and development. Through focusing on all six focus areas of the National Strategic Vision, North West government must assess its position and possible contribution and prepare its Medium Term Expenditure Framework (MTEF) in response (SPDU, 1997b:24).

The MTEF is essential for focusing government expenditure on an integrated model that may ensure a virtuous cycle of growth, employment and redistribution. The provincial MTEF has to be:

- a competency of the provincial government and not in competition with national competencies,
- focused on the key issues identified in the focus areas,
- effective and economical in terms of the strategy proposed, and
- efficient in terms of outputs produced and inputs required.

The above have to be achieved with the restriction of less, but more focused governance (SPDU, 1997b:25).

2.4 Summary

In this chapter an overview of the development problems and challenges in North West Province was given. It was necessary to sketch an outline of the current situation in the province, to be able to determine whether a fiscally decentralised system will be able to address the development challenges. The North West Province is characterised by poverty, inequality, economic under-performance and unemployment. To address these challenges, the *North West 2001 Development Strategy* emphasises integrated planning and delivery in six strategic focus areas, namely building the economy, physical service delivery, social service delivery, human resource development, safety and security and optimal governance.

In section 2.2.1 it was shown that North West Province contributes approximately 5 percent to national GDP, which ranks it 7th out of the 9 provinces in terms of output. The province experienced negative economic growth per capita between 1984 and 1993, while the economy is heavily dependent on mining and agriculture. To exacerbate the problems, both mining and commercial farming have been shedding jobs. The manufacturing sector in North West is almost exclusively dependent on the performance of fabricated metals, non-metallic mineral products and food and beverages. With the exception of food these are low technology, medium wage and resource intensive products. Little value is added, the firms have a low capital-labour ratio and manufacturing is spatially concentrated. Shortcomings of the formal sectors are reflected in the size of the informal sector, where an estimated 14 percent of North West's labour force had to make a living in 1994. Subsistence farming provides a livelihood for approximately 57 percent of the total population.

In section 2.2.2 it was shown that North West is largely a rural province with a high population growth rate. The Human Development Index (HDI) for the province is lower than the national average which is reflected in high infant mortality rates and limited health care capacity. Furthermore, North West lags behind the South African average in the Educational Attainment Index (EAI). Estimations are that only 34.5 percent of the population have a primary education and 36.5 percent a secondary education. The relatively low quality of the labour force is reflected in that a significant proportion of labourers in North West are production workers and unspecified (manual) workers. The cost of labour is lower than in the neighbouring Gauteng Province.

In section 2.2.3 it was argued that North West may become a through-traffic province. Aside from the transport infrastructure, most areas outside the main nodal centres are without access to clean drinking water, energy, telephones or postal services. It is estimated that 54 percent of all villages do not have access to clean drinking water at RDP levels while 75 percent do not have access to sanitation services at the RDP level.

Section 2.3 examined the development challenges emerging from the profile. To address the problems and backlogs, the *North West 2001 Development Strategy* was formulated by provincial government during 1997. The emphasis of the strategy is on integrated planning and delivery in six strategic focus areas.

The first focus area is that of building the economy. It was emphasised in section 2.3.1 that a minimum level of economic growth is necessary to support the other five strategic pillars. The status quo, GEAR and desired growth scenarios were examined. An economic growth rate of at least 5 percent per annum was shown to be required to provide jobs for all new work seekers in the province. For mining this implies a targeted 3.5 percent growth rate per annum. It was argued that the importance of mining is not as much the contribution it can make, but the negative implications if it is not performing. North West 2001 claims that success in achieving the targeted growth rate will depend on negotiations between labour, government and management. The desired growth scenario targets a 7.5 percent economic growth rate in agriculture by 2001. The North West government sees agriculture as an area where a great impact can be made in creating low cost employment opportunities and benefiting the historically disadvantaged women and farm labourers. The focus of developing a farming support structure is on small farmer entrepreneurial development. The nature of the manufacturing sector described in the development profile shows that it will be unlikely to benefit form trade liberalisation and the GEAR strategy. One of the major development challenges will be to promote manufacturing growth and employment. To reach the 5 percent average growth target for the province, a 10.9 percent target by 2001 is set for the manufacturing sector. To achieve this target it may be necessary to facilitate human resource development, increase productivity, raise the level of competition, and improve the level of research and development. Supporting manufacturers in the Platinum Spatial Development Initiative (SDI), and promoting SMME development may also be important. However, public funding is limited. The final component of building the economy described in section 2.3.1 was that of promoting SMME development. Here public-private partnerships was identified to play an important role.

Although a basic level of economic growth may be important, it will not be achieved without the appropriate infrastructure, or social services and human resource development or optimal governance.

In section 2.3.2 physical service delivery was discussed. It was found that with the exception of Klerksdorp, most areas in North West needs upgrading and maintenance of services to meet basic needs. North West 2001 gives top priority to providing access to clean drinking water at the RDP level. Second to water supply is the need for adequate sanitation to prevent contamination of the underground water supply. The provision of electricity, postal, telephone and transportation services remain critical. Finally, road construction in the province is likely to be limited due to budget constraints. Over the next five years the challenges will be to develop intermodal transfer points to further North West as the through-traffic hub in Southern Africa. Developing Mafikeng airport as a dry port and the surrounding areas as an Industrial Development Zone (IDZ) may also facilitate trade and development.

The focus of social services delivery is to extend primary public health care services to a greater number of the population. Although increased spending on health care was envisaged in section 2.3.3, the challenge would be to foster public/private co-operation in the health system. North West 2001 stated that incentives have to be introduced to increase the number of people covered by the private health system in order to alleviate the burden on the public sector. Private sector participation and commitment for providing social welfare nets also have to be increased. Housing delivery was also shown to be an important component of social services delivery. Although it is the domain of the National Department of Housing and the National Housing Board, the challenge to North West government will be to ensure appropriate bulk service delivery, efficient local government planning and ongoing management of housing related services.

In section 2.3.4 it was stated that human resource development is the greatest contribution that North West government can make to improve the quality of life of its people. The province, however, cannot increase the share of its budget to education and training significantly. Current allocations will thus have to be used more efficiently. Additional private sector involvement in training and apprenticeships may be essential.

Safety and security was highlighted as the fifth strategic focus area in section 3.2.5. The incidence of serious crime, especially attacks on commercial farmers, is unacceptably high in the province and has negative implications for foreign tourism, investment and rural development. The challenges to safety and security include improving the quality of investigating services and the user friendliness of the police, introducing crime prevention approaches, sensitising the community to bribery and corruption and improving unity and solidarity amongst commercial farmers.

The final strategic focus area to be integrated into planning and delivery was that of optimal governance. Section 2.3.6 stated that governance highlights a fundamental qualitative change in the way government organises and manages itself. The challenge of optimal governance is in the first place to foster the private/public partnerships necessary for success in the other focus areas like physical and social service delivery. The second is to promote excellence in the public sector through cooperative government and ensuring the right attitude and commitment towards challenges faced. In the last instance, optimal governance also focused on promoting excellence in the public service. That requires changing the mind set of public servants, bringing orientation and motivation into the structure and empowering employees to deal with new challenges.

The development challenges outlined in this chapter set the scene for the rest of the thesis. Against the background of the evidence of what needs to be done, chapter three follows a theoretical approach to the role of the government in the economy. It briefly describes the efficient and equitable outcomes of the perfectly competitive model and the reasons for market failure. The failure of the market to achieve efficient and equitable outcomes necessitates government intervention in the economy. There is an effort to link these theoretical reasons for government intervention with the development challenges outlined in chapter two, in order to determine the appropriate role for government. Government can, however, also fail to achieve efficient and equitable outcomes. Chapter three poses that decentralised government may overcome the problems associated with government failure and may come closer to ensuring Pareto efficient and equitable outcomes.

The aim of the study was identified in chapter one as to determine whether a decentralised provincial government in the North West Province can resolve the development problems and challenges more efficiently and equitably than if it were only the administrative arm of central government. The theoretical arguments in favour of and against decentralisation will be examined in chapter four, and the South African fiscal system in chapter five. Chapter six will synthesise the development challenges, the theory of government's role and the theory of fiscal decentralisation and the South African fiscal system in an attempt to conclude whether or not fiscal decentralisation may contribute to development in North West Province.

Chapter 3: An analysis of government economic intervention

3.1 Introduction

In the light of the economic development challenges facing provinces in South Africa, particularly North West Province, the purpose of this chapter is to describe the rationale for government intervention in an economy. From this, the North West government's possible role in overcoming the provincial economic development challenges may be identified.

The structure of the chapter is as follows: In section 3.2 the theory of perfect competition is examined. In the perfectly competitive model competition and the maximizing behaviour of individuals, along with the price signals of the markets, lead to an efficient allocation of resources. In practice, markets fail when the conditions necessary to achieve a market efficient allocation fail to exist, or are contravened in one way or another. In section 3.3 the causes and instances of market failure, which may justify government intervention, are discussed. In section 3.4.1 and 3.4.2 government intervention is discussed with reference to the provision of public goods and services and regulation. It is concluded that policy makers may be unable to intervene successfully to restore the allocative efficiency of the perfectly competitive model, i.e. that the nature of market failure may induce government failure. Ultimately, the success of intervention may depend on the appropriate system of collective decision making. Collective choice theory is examined in section 3.4.3. It is shown that social choice, through the majority voting system, may be subject to a voting paradox which may result in inefficiency. The nature of government, in providing a system of collective decision making, is also discussed and it is concluded that vote maximising politicians and budget maximizing bureaucrats may cause government failure to achieve efficient and equitable resource allocation. In section 3.5 the aim is to establish whether fiscal decentralization can overcome some of the problems associated with government failure. The chapter concludes with a summary.

3.2 The theory of perfect competition

In a society in which the means of production are privately owned it can be expected that a system of markets may develop upon which goods and services are bought and sold (Kritzinger, 1988:40). In a perfectly competitive model it is assumed that the individual consumer or producer is (Black & Dollery, 1990:1):

- fully informed about the economy,
- unaffected by the actions of other individuals or institutions,
- completely mobile in the occupational and spatial sense of the word, and
- always striving to maximise his own utility or profit within perfectly competitive markets.

To assume that the consumer or producer is unaffected by the actions of others implies that there is no direct interaction between producers and no direct interaction between consumers. There is also no direct interaction between producers and consumers (Black & Dollery, 1990:1). The market, guided by consumer demands, furnishes a signalling system for economic behaviour. Competition ensures that producers produce what consumers demand and that they do so at least cost (Musgrave & Musgrave, 1980:6-7). The result is that productive resources are allocated efficiently amongst alternative uses and an optimal output mix is produced. It can be shown that this makes people as well off as possible, with no scope for improvements in anyone's well-being, without leaving someone else less well off (Browning & Browning, 1990:11).

A two sector model can be used to examine how an optimal mix of commodities is produced[6]. The model consists of two individuals, A and B. They consume food (f) and shelter (s) that are produced by using capital (K) and labour (L). Individuals A and B are utility maximisers and want to consume as much food and shelter as possible, but are

[6] Economic efficiency involves allocative and technical efficiency, but only allocative efficiency is examined here. Allocative efficiency is defined as the efficient allocation of productive resources amongst alternative uses (Black & Dollery, 1990:2). It is called Pareto efficiency when the allocation of resources is such that no member of the community can be made better off without some other individual being made worse off (Varian, 1990:15). Technical efficiency refers to the utilization of existing resources in the most efficient manner (Black & Dollery, 1990:4). This means production takes place on the production possibilities curve. Technical efficiency alone is an insufficient measure of economic efficiency because it does not consider the consumption desires of economic agents.

subject to budget constraints (scarce resources). As A and B are price takers, their willingness to pay is measured by the marginal rate of substitution (MRS). The marginal rate of substitution of shelter for food measures the consumer's willingness to pay for an additional unit of food, by consuming less shelter. To maximise utility, the marginal rate of substitution of shelter for food should be equal to the ratio of the price of shelter to the price of food, e.g. in the case of A:

$$MRS^{A}_{sf} = P_s/P_f \qquad (1)$$

Similarly, individual B's utility maximising bundle of food and shelter would be characterized by the following requirement:

$$MRS^{B}_{sf} = P_s/\ P_f \qquad (2)$$

There is economic efficiency in consumption when the rates at which A and B are willing to trade less shelter for more food, are equal. Then all the individuals place the same relative value on all the products. i.e.:

$$MRS^{A}_{sf} = P_s/P_f = MRS^{B}_{sf} \qquad (3)$$

Efficiency in consumption means that no reallocation of commodities between the individuals can increase the utility of either A or B, without decreasing the utility of the other.

Thus far it was assumed that the supplies of all the commodities are fixed. When this assumption is relaxed, a production possibilities curve may be used to show the maximum quantity of food that can be produced, along with any given quantity of shelters. If inputs are shifted to produce more food, the production of shelters must fall, and vice versa. The marginal rate of transformation (MRT) measures the cost of an additional unit of food in terms of producing less shelter. It shows the rate at which the economy can transform shelter into food. The marginal rate of transformation can be expressed in terms of marginal cost. Marginal cost is the additional cost of an additional unit of output. The *marginal* cost of transforming inputs into food rather than shelter, would be the costs of those inputs used, i.e. wages and salaries and interest on capital. There is economic efficiency in production when the rate at which producers are able to transform shelter into food, is equal to the ratio of the marginal cost of the shelter to the marginal cost of the food, i.e.:

$$MRT_{sf} = MC_s/MC_f \tag{4}$$

Equation (4) implies that no re-allocation of resources between sectors can increase the output of any commodity, without a decrease in the output of at-least one other commodity.

Finally, an optimal mix can only be produced if producers and consumers achieve equilibrium simultaneously. Profit maximising firms produce output up to the point at which marginal cost is equal to price[7]. This requires that the following condition holds:

$$MC_s/MC_f = P_s/P_f \tag{5}$$

and since $MRT_{sf} = MC_s/MC_f$ it means that $MRT_{sf} = P_s/P_f$

Combining equations (3), (4), and (5) results in the following condition:

$$MRS^A_{sf} = MRS^B_{sf} = MRT_{sf} \tag{6}$$

which indicates that the marginal rate at which the consumers are willing to substitute shelter for food, is equal to the rate at which it is technically possible to do so. In such a case, the marginal benefit of consumption is equal to the marginal cost. Competition, and maximizing behaviour on the part of all individuals can thus lead to an efficient outcome (Cullis & Jones, 1987:10)[8].

In practice, each individual's actions are guided by his or her self interest, but the outcomes of those actions depend on the specific individual's actions and on those of others. Brown and Jackson (1990:5) refer to it as conjectural interdependence. The interdependence occurs when individual A's expectations of individual B's actions are influenced by what A expects B is expecting he is going to do. The interdependence

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[7] In the perfectly competitive model, the MRT is equal to the marginal social cost of production. Marginal social cost is the sum of the private costs of the producer and external costs borne by society. In the perfectly competitive model the marginal private and social costs of production are equal.

[8] The point where the optimal mix is produced corresponds with a particular distribution of income between individuals in the economy. Producing an optimal output mix will not necessarily yield the most preferred distribution of income (Cullis & Jones, 1987:3). In section 3.3.2.5 income inequality is discussed as a source of market failure and reason for government intervention in the economy.

undermines the perfectly competitive model's assumption that the individual consumer or producer is unaffected by the actions of other individuals or institutions. Where interdependence exists cooperation may be needed when the benefits of collective decision making outweigh the loss of decentralized individual decision making (Boadway *et al.,* 1994a:4). Such situations, in which decentralized individual decision making is second best to cooperation, occur when the utility maximizing behaviour of individuals is not beneficial for the group as a whole. This has been formalized in the so-called prisoners' dilemma[9].

The essence of the prisoners' dilemma is that each individual benefits under conditions of universal cooperation, compared to conditions of universal non-cooperation, but the individual always benefits more by not cooperating, when others cooperate. The result is inefficiency and inequity in consumption and production, which constitute market failure. The possible benefit that individuals can get from non-cooperation means that a high degree of trust must exist before the mutually advantageous cooperation can be achieved. To achieve the necessary degree of trust requires an umpire or referee to monitor the behaviour of the players, and to enforce the rules and conventions that will give the joint payoffs from cooperation, i.e. it establishes a reason and a role for government.

The following section examines market failure and government intervention in the economy to identify government's specific role more clearly. Market failure is defined and the causes and instances of market failure are examined in more detail.

3.3 Market failure and government intervention

According to Kritzinger (1988:41) the term 'market failure' provides a generic description for a variety of problems that arises in private trade and exchange. Brown and Jackson (1990:28) define market failure as those situations in which the conditions necessary to achieve a market efficient solution fail to exist or are contravened in one way or another. A distinction may be drawn between the causes and instances of market failure (Gravelle

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[9] See Brown and Jackson (1990:7-8) or Varian (1990:465-467) for a discussion.

& Rees, 1981:503).

3.3.1 Causes of market failure

The causes of market failure may be linked to the view that the inefficiency of market failure implies that it is possible to make one individual better off and no one worse off. Under market failure, potential mutually advantageous trade or profitable production decisions exist, but are not executed. The causes of such market failure may be (a) the absence of property rights, which means that individuals do not have sufficient control over a commodity to effect the mutually advantageous or profitable exchanges and production; (b) information costs which prevents individuals from seeking out Pareto improving opportunities; or (c) when partners in a trade cannot agree how to share the gains (Gravelle & Rees, 1981:504). These causes will be investigated in turn below.

3.3.1.1 The absence of property rights

Property rights underlie the perfectly competitive market. It is the right of owners to exclude others from the benefits of the specific goods. When individuals exchange goods or services, they are exchanging the legal claims to the benefits of the commodity (Gravelle & Rees, 1981:504). Exchange cannot occur without property rights, and property rights require exclusion. The excludability property of a good or service makes the mutually beneficial exchanges between producers and consumers possible (Russel & Wilkinson, 1979:374).

Property rights can be incomplete or absent because of imperfect excludability or non-transferability. Imperfect excludability arises when control of a commodity resides with a group of individuals. Any one individual who wishes to use the commodity has to enter into contracts with all the individuals in the group. A second instance of imperfect excludability is when the legal right to exclusion does not exist. Where such a legal right does exist it must also be supported by the ability to enforce it (Gravelle & Rees, 1981:505). Non-transferability is another possible cause of incomplete or absent property rights. Gravelle and Rees (1981:506) state that even when the right to exclusion exists, the right to transfer the property rights may not, and it limits an individual's say over who may use a commodity, for what length of time and under what terms.

The delineation of property rights, their enforcement and exchange are not without costs. In the absence of property rights, or where it is complex or ambiguously defined, the enforcement costs are likely to be significant (Brown & Jackson, 1990:30). The costs associated with property rights influence marginal social costs. It was shown in section 3.2 that in the perfectly competitive model the marginal private cost (MPC) would be equal to the marginal social cost (MSC) of production when resources are allocated efficiently and equitably. The absence of property rights implies external costs which may result in a MSC that is higher than MPC. With reference to the example in section 3.2, the external costs distort the condition $MRT_{sf} = MC_s/MC_f$, which distorts the price signals $MC_s/MC_f = P_s/P_f$ and leads to inefficiency in consumption and production.

3.3.1.2 Information costs

The second possible cause of market failure is information costs. Gravelle and Rees (1981:507) state that exchange requires information regarding the identity and location of potential buyers and sellers, the validity of their property rights, the quality of the commodities and the terms at which they are willing to trade. When the information costs are more than the possible gains from the trade, the market will fail: Otherwise potentially advantageous possibilities for trade and production will exist, but will not be executed.

3.3.1.3 Indeterminancy of bargaining

The final possible cause of market failure may be a failure of trading parties to agree on the terms of trade. Section 3.2 showed that there is equilibrium in consumption when individuals' marginal rates of substitution are equal (where the marginal rate of substitution reflects an individual's willingness to pay). Where the division of gains from trade leads to lengthy and costly bargaining it is possible that no agreement may be reached (Gravelle & Rees, 1981:507). In such a case the market will fail.

The following section examines the instances in which market failure manifests itself.

3.3.2 Instances of market failure

To illustrate how the utility maximizing behaviour of individuals may not be beneficial for a group and how it may lead to inefficiency and inequity in consumption and production, the instances of market failure must be examined. They include the cases of (a) common property resources, (b) public goods, (c) externalities, (d) imperfect competition and (e) inequity and redistribution.

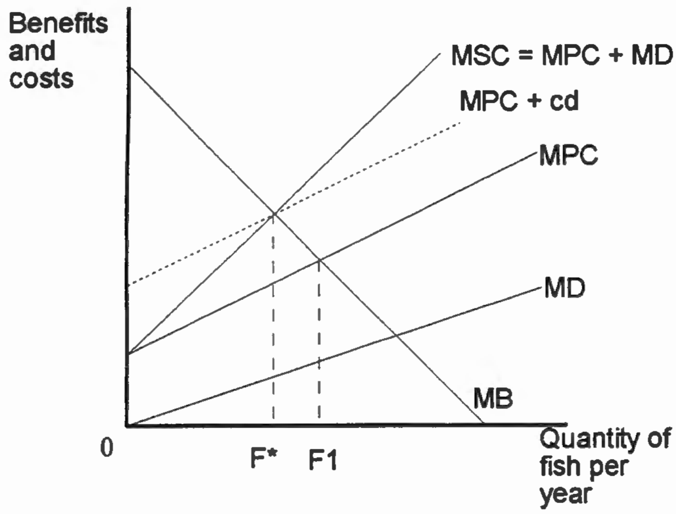
3.3.2.1 Common property resources

With common property, property rights cannot be assigned to any single individual. A group of individuals has unrestricted right to all the benefits of the asset (Brown & Jackson, 1990:30). Since everyone has free access to the good, exchange cannot exist, and since it is free, individuals will have an incentive to overuse the common property resource (Varian, 1990:554). The result is known as the tragedy of the commons, and was first described by David Hume in his "Treatise on human nature" (1740). Problems in allocating resources efficiently arise because of the indivisibility of the common property and the size of the group that consumes the good or service.

Pindyck and Rubinfeld (1995:645) illustrates the tragedy of the commons with an example on trout fishing, under the assumption that fishermen have unrestricted access to a lake. Self-interested fishermen will fish up to the point at which the marginal revenue from fishing is equal to the cost. The private cost understates the true cost to society. The fisherman has no incentive to take into account how his fishing affects the stock of fish for others. The resource allocation outcome is inefficient - too many fish are caught (Russel & Wilkinson, 1979:380). Graphically this can be illustrated as shown in figure 3.1[10].

[10] Figure adapted from Pindyck and Rubinfeld (1995) and Rosen (1995).

Figure 3.1: Common property resources



When the lake is common property, self-interested fishermen will fish until there is no longer any profit to be made. That is where the marginal private cost (MPC) is equal to the marginal benefit (MB) at a quantity of fish of F1. A fisherman has no incentive to take into account how his fishing affects the opportunities of others (Layard & Walters, 1978:195). Reducing the stock of fish has a cost to society, represented by MD. The efficient level of fishing would be the point where the marginal benefit from fish caught is equal to the marginal social cost (MSC = MPC + MD) at a quantity of F*. The unregulated behaviour of self-interested utility maximising individuals results in a deterioration in the quality of the common resource (Kritzinger, 1988:60).

The inefficient allocation of resources may be improved if everyone cooperated. Pindyck and Rubinfeld (1995:643) cite the Coase theorem to explain the possible benefits of cooperation. The theorem states that when parties can bargain, without cost and to their mutual advantage, the resulting outcome will be efficient. The assumptions are that property rights are well defined and enforceable and that the transaction costs of exchange are negligible (Black & Dollery, 1990:19). In practice the possibility of cooperation may be undermined by the problems associated with the prisoners' dilemma. The size of the group and indivisibility of the common property resource, could make the achievement of an agreement difficult and costly[11]. There also exist strong incentives for

[11] Browning and Browning (1990:29-30) have an example on building a dam to limit flooding.

individuals to 'free ride'. The free rider is an individual who misrepresents his preferences on the expectation that he can enjoy the benefits of a collective, common property resource without paying for those benefits (Miller & Meiners, 1986:608). As in the prisoners' dilemma the free rider benefits by not cooperating, when others cooperate. Market failure to allocate resources efficiently and equitably in the case of common property resources may necessitate government intervention.

In this case, government's role could be to allocate the use of the resource between individuals and across time, to maximise the common interest of all members of the group (Kritzinger, 1988:60). The government can fulfil the allocation function in a number of possible ways. For example, it can sell franchises and regulate the use of the common property resources. Another option is public ownership or production of the common property resources (Brown & Jackson, 1990:32-33). Government will be able to charge a price for franchises or when the lake is publicly owned. A tax-price will force fishermen to take the external cost of depleting the common property resource into account and fish at the efficient level F*. For example, in figure 3.1, the price of a fishing permit will increase the MPC to MPC +cd and will thus ensure efficient allocation.

3.3.2.2 Public goods

With public goods, property rights can not be assigned to any single individual. Brown and Jackson (1990:34) define a pure public good as a good where each individual's consumption leads to no subtraction of any other individual's consumption. The characteristic of non-rivalness in consumption implies that with a given level of production, consumption by one individual does not diminish the quantity available for consumption by others (Herber, 1983:30). Layard and Walters (1978:177) point out that the marginal cost of adding another person to consume the good would then be zero[12]. In addition to being non-rival in consumption, public goods are also non-excludable. It is technically impossible or prohibitively expensive to exclude potential consumers (Browning &

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[12] Section 3.2 showed that efficient resource allocation requires price to be equal to the marginal cost.

Browning, 1990:27)[13]. Musgrave and Musgrave (1980:8) explain that the benefits derived by anyone's consuming of a public good are externalised in that they become available to all others.

Layard and Walters (1978:195) distinguish between type 1 public goods, where an individual can vary his or her use of the good and type 2 public goods, where it is not possible to vary the use.

Market failure to allocate resources efficiently in the case of type 1 public goods is caused by the non-excludability in consumption. Because it is not possible to exclude consumers from using a public good, it is not possible to charge a price. In addition, the non-rivalness in consumption makes it inefficient to charge a price. The marginal cost of adding another person to consume the good is zero (Herber, 1983:31) and charging a price would imply that the price is higher than marginal cost, which in turn means inefficient allocation (Musgrave & Musgrave, 1980:56). There is thus no incentive for a profit maximising producer to supply a pure public good, and the market fails (Brown & Jackson, 1990:37).

Layard and Walters (1978:196) state that it may be efficient to charge the MRS to each individual (his or her valuation of a unit change in the public good), if it is possible to get them to reveal their preferences. Since the number of participants is usually large, any single contribution to pay for the good will make little difference to total contribution and hence no voluntary payments are made (Musgrave & Musgrave, 1980:8). Knowing this, consumers will find it in their interest to misrepresent their preferences for such goods and to act as free riders (Varian, 1990:563). The end result is likely to be that public goods will not be provided at all, or be provided at insufficiently low levels in a market economy (Rosen, 1995:53)[14]. To bypass these difficulties a political process must be used to reveal preferences and to furnish the fiscal resources needed to pay for them (Musgrave &

[13] It should be noted that non-rival goods are not necessarily non-excludable. That is the difference between pure public goods and common property resources. Common property resources are non-excludable, but rival in consumption (Brown & Jackson, 1990:35-36). Pure public goods are non-rival in consumption because once it has been supplied at a particular level or scale, consumers can jointly consume it on an equal basis (Herber, 1983:33).

[14] See also the examples in Browning and Browning (1990:29) and Varian (1990:571).

Musgrave, 1980:61)[15].

Market failure to allocate resources efficiently in the case of type 2 public goods is due to the requirement that the level of consumption must be similar for each consumer. Varian (1978:199) sees this joint consumption as the basic duality between public and private goods. In the private goods case individuals consume different amounts of the good, but pay the same price. For private goods, the marginal rates of substitution (valuation of a unit change in the provision) are revealed by the market, in that each individual adjusts his consumption bundle so that his MRS between each pair of goods is equal to the price ratio between that pair of goods (section 3.2). Pareto optimality requires satisfying the general equilibrium condition MRS = MRT (Cullis & Jones, 1987:19). In the type 2 public good case individuals all consume the same amount of the good, but have different prices (Varian, 1990:567). For public goods the individual is a quantity taker and adjusts price (Browning & Browning, 1990:32). Efficient provision requires that the sum of the MRS's be equal to MRT, for all individual consumers and for any pair of commodities (Brown & Jackson, 1990:69-72). Thus, sets of individualised prices for each consumer must be added to equal marginal cost (Varian, 1990:566). Varian (1978:200) states that because an individual cannot adjust his or her level of consumption unilaterally, the possibility of a market for public goods is lessened. The utilities of the individuals are linked since everyone consumes the same amount of the public good. Pareto efficient provision is not ensured if each person optimises with respect to his or her own consumption, as in the case of private goods. That makes it unlikely that market provision of public goods would be Pareto efficient.

Layard and Walters (1978:196) state that it may be efficient to charge an individualised MRS to each consumer, i.e. for each individual to pay exactly according to his or her true valuation of the public good. As in the case of type 1 public goods, the problem is to get individuals to reveal their preferences. A solution could require a political process to cause a revelation of preferences, and for government to provide the public goods. Social choice is discussed in section 3.4.

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[15] Provision via the public sector budget does not necessarily mean public production - subcontracting to the private sector is possible.

It should be noted that the physical and social services delivery and education challenges outlined in sections 2.3.2 to 2.3.4 are typical public goods. Exclusion may be problematic and free riders may misrepresent their preferences. The theory shows that the market may fail to ensure efficient resource allocation in these cases. It may be concluded that there may be a role for government in addressing the challenges.

3.3.2.3 Externalities

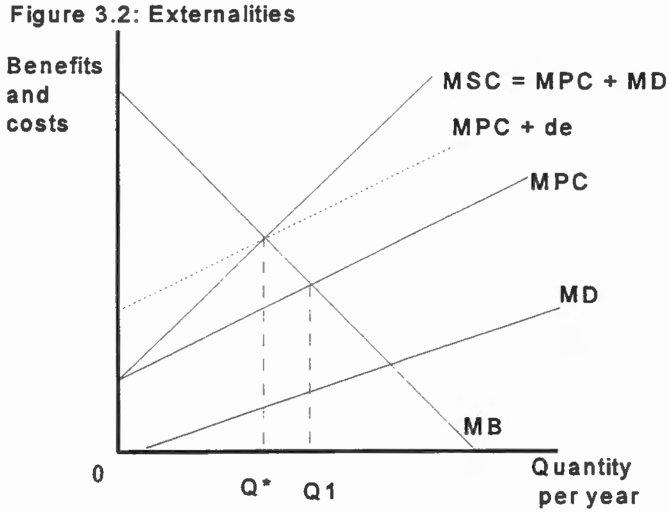
With externalities, the absence of property rights is linked to consumption or production effects which are external to the price system. In the perfectly competitive model, discussed in section 3.2, it was assumed that there is no direct interaction between producers, no direct interaction between consumers and also no direct interaction between producers and consumers. It was argued that an exact coincidence of marginal private and social costs and of marginal private and social benefits exists in the perfectly competitive market (see section 3.2). These assumptions are however contravened in the case of externalities. Externalities exist where an interdependence of production and/or utility functions occurs (Black & Dollery, 1990:16). That means that the consumption or production activities of certain agents affect the level of production and consumption and thus the welfare of other agents (Layard & Walters, 1978:23). Herber (1983:37) describes externalities as the side effects of ordinary economic activity - effects that are external to the price system. Pindyck and Rubinfeld (1995:590) state that externalities are the overproduction or underconsumption of certain goods or services, which generates costs and benefits that are not included in prices. In such cases the price does not reflect the value of the resources used and the resource allocation outcomes are not Pareto efficient.

The inefficiency stems from the absence of property rights over the external effects, which in turn is the result of the public good characteristics of externalities. The pollution associated with production is an example of how the production activities of certain agents may influence the welfare of others. The environmental damage caused by pollution carries a cost which is not paid for by producers or consumers. An externality is non-excludable and non-rival in consumption - the existence thereof assumes the non-existence of certain markets (Russel & Wilkinson, 1979:379). The absence of markets gives rise to the notion of social cost, as discussed in section 3.3.1.1. The social cost of production is the sum of the private cost of the producer, and the cost due to the externality (external cost), which is borne by the third party (Brown & Jackson, 1990:39).

Herber (1983:36) illustrates the occurrence of an externality with an example of a firm manufacturing steel. The firm uses a new blast furnace in its production process but it also significantly increases the air pollution in the surrounding area. The private cost of production is the explicit cost of acquiring the blast furnace, but the pollution affects the welfare of others. The social cost of production is not equal to the private cost of production. The producer does not take the effect of the pollution on society's welfare into account, because the scarce resource, clean air, has no property right attached to it and is not priced. The external diseconomy will result in the overproduction of the good associated with the externality. Resources are inefficiently allocated[16].

Graphically, the analysis of externalities is the same as in the case of common property resources[17].

Figure 3.2: Externalities



Production takes place at the level Q1, where the marginal benefit (MB) is equal to marginal private cost (MPC). The side effect of production, the pollution, that causes environmental damage is shown by the marginal damage curve MD. The effects of

[16] For a more complete discussion, refer to Black and Dollery (1990:17-18), Brown and Jackson (1990:39-41), Pindyck and Rubinfeld (1995:624-627), Rosen (1995:91-97), Musgrave and Musgrave (1980:78-79) and also Browning and Browning (1990:37-42).

[17] Figure adapted from Herber (1983) and Rosen (1995).

pollution are external to the price system and the costs are not paid for by producers or consumers at the point where the marginal benefit of production is equal to the marginal private cost (MB = MPC). The true cost to society is shown by the marginal social cost of production (MSC = MPC + MD). The efficient level of production is Q*, where marginal benefit is equal to marginal social cost (MB = MSC). The inefficient allocation of resources is shown by the overproduction of Q*Q1.

As with the common property resources and public goods, it may be possible to overcome the market failure through private cooperation. The Coase theorem states that the problem of externalities is due to the absence of property rights (section 3.3.1.1)[18]. If producers and consumers can however place a monetary value on property rights to the production or consumption subject to the externality, the mutually beneficial exchange of property rights may internalize the externalities into the private cost structures[19] (Black & Dollery, 1990:18 and Browning & Browning, 1990:46-47). The consumers may, for example, pay more for goods and services if producers take the social cost of pollution into account and limit or clean up the pollution[20].

In practice the Coase theorem may be difficult to hold. The public goods character of externalities and dealing with large groups result in the prisoners' dilemma with significant transaction costs to achieve cooperation (Cullis & Jones, 1987:16). This may require an allocative role for government. The allocation function could entail using regulation, such as a Pigouvian tax or subsidy, selling property rights or setting standards for production (pollution). For example in figure 3.2, a Pigouvian tax would increase the cost of production from MPC to MPC + de. It forces the producer to internalize the cost of the pollution to society, into his production decisions (Layard & Walters, 1978:195). This

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[18] The assumptions to the theorem are that property rights are well-defined and enforceable and that the transaction costs of exchange are negligible (Layard & Walters, 1978:192).

[19] Herber (1983:43) states that improvements in welfare through private cooperation will depend on whether externalities are technologically capable of divisibility under the price system. The divisibility will reflect society's willingness and ability to define the property rights.

[20] Varian (1990:549) describes this in terms of a missing market for pollutants. The polluter faces a zero price of an output that it produces, even though people would be willing to pay money to have the output reduced. From a social point of view the output of pollution should have a negative price.

ensures efficient allocation at Q*[21].

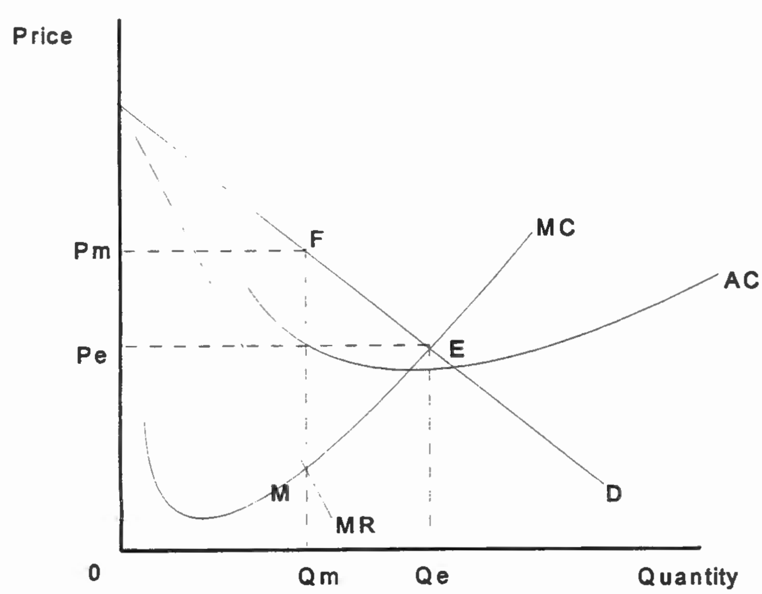
The challenge of promoting small, medium and micro-size enterprises in North West (see section 2.3.1) may create a positive effect external to the price system. The theory shows that it may be underprovided by the market. It is concluded that there may be a role for government in addressing the challenge of promoting small, medium and micro-size enterprises and building the provincial economy.

3.3.2.4 Imperfect competition

Imperfect competition is another instance of market failure. It distorts price signals which may lead to inefficiency in consumption and production.

The condition for profit maximization in a perfectly competitive market is that each firm sets marginal cost equal to the price. The firms simultaneously produce the social optimum output where marginal cost equals average revenue (price) (Herber, 1983:27) In figure 3.3[22], that is at point E on the demand curve, where P_e = MC.

Figure 3.3: Imperfect competition



[21] Also see Brown and Jackson (1990:39-41), Black and Dollery (1990:18), Pindyck and Rubinfeld (1995:628-634) and also Rosen (1995:99-107).

[22] Figure adapted from Black and Dollery (1990)

In the case of imperfect competition, a monopolist will maximize profit at point M where marginal cost equals marginal revenue. This will result in his price differing from the Pareto efficient price. At point M the equilibrium price OP_m exceeds marginal cost and the output OQ_m is less than the Pareto-optimum level (Rosen, 1995:51). As a result of the higher monopoly price and smaller output the marginal rate of transformation will decrease and the marginal rate of substitution will differ from the marginal rate of transformation. The monopolistic firm uses a different price in its output decisions than consumers use in their consumption decisions (Pindyck & Rubinfeld, 1995:589). Profit maximising behaviour by the monopolist results in a welfare loss to society as the monopolistic firm will produce less of the product and sell it at a higher price than would be the case under perfect competition (Glahe & Lee, 1989:337)[23]. The welfare loss necessitates government intervention (Brown & Jackson, 1990:43).

In the case of natural monopolies, Varian (1990:407) emphasises that even if the monopolist wanted to produce the social optimum output Q_e, it could only do so at a loss. A natural monopoly is characterized by significant capital outlays that leads to economies of scale (Black & Dollery, 1990:12). The marginal cost curve (MC) would lie below the average cost curve (AC) over the output range. In such a decreasing cost case, average cost falls as output rises, and the minimum average cost of production is reached at a level which is sufficient for a larger firm to supply the whole market (Layard & Walters, 1978:22). At the level of efficient output, average revenue will not cover cost. Since a private firm cannot sustain losses over the long run, efficiency also requires government intervention (Herber, 1983:29).

Government intervention could take the form of regulating monopolies, through multi-part tariffs or subsidies, or alternately, public production by means of nationalization (Pindyck & Rubinfeld, 1995:342-344).

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[23] In terms of the causes of market failure discussed in section 3.3.2 monopoly may represent an instance of indeterminancy of bargaining. Gravelle and Rees (1981:509) explain how a mutually satisfactory bargain may exist if consumers were to pay the monopolist a lump-sum amount to produce at the Pareto efficient price, but that consumers and producers may not be able to agree on how to divide the gain from the increase in output. There may be high costs associated with cooperation among the consumers, and cooperation will be subject to the free-rider problem.

3.3.2.5 Inequity and redistribution

In the perfectly competitive model, each Pareto efficient allocation assumes a particular distribution of initial endowments. The distribution of wealth depends on inherited wealth and the accumulation of wealth over an individual's lifetime. The distribution of earnings will depend on the initial distribution of skills, subsequent training and the market price for these skills (Brown & Jackson, 1990:46 and Musgrave & Musgrave, 1980:11). With all this taken into account, a competitive economy produces an optimal output mix, but not necessarily the most preferred distribution of income (Musgrave & Musgrave, 1980:11). Society must decide which particular distribution of income and welfare it prefers and which measures to use for achieving the preferred distribution.

A system of private contributions to redistribute income through voluntarily charities is similar to other forms of private cooperation and subject to the prisoners' dilemma. It will be possible for individuals to free-ride and the result is uncoordinated distribution on too small a scale. The market may thus fail to ensure an equitable distribution of resources.

Brown and Jackson (1990:47) state that a government is in a better position to pursue a coordinated and comprehensive redistribution policy. A government has the resources of compulsory taxation and can redistribute income on a large scale. Government is also better suited to address the possible causes of inequalities, such as imperfections in factor markets.

Addressing the challenges of physical and social services delivery described in sections 2.3.2 and 2.3.3 would require consideration of equality. The theory shows that private contributions to distribution in this form may fail for the free riders. It may be concluded that there may be a role for government in addressing the challenge.

In conclusion, there might thus be a role for government in economic development. Restoring efficiency and equity could be the objectives of economic policy (Boadway *et al.*, 1994a:4). To achieve the objectives of efficiency and equity in production and consumption, a government needs to fulfil certain functions.

The *allocation function* embodies the government's provision of social goods. It is the process by which total revenue use is divided between private and social goods and by which the mix of social goods is chosen. The *distribution function* refers to the adjustment of the distribution of income and wealth to ensure conformance with what society considers a 'fair' or 'just' state of distribution. The *stabilisation function* is the use of budget policy as a means of maintaining high employment, a reasonable degree of price level stability and an appropriate rate of economic growth (Musgrave & Musgrave, 1980:6-7).

In practice it is possible that government intervention may also not ensure efficient and equitable allocation of resources. The following section examines government failure in terms of the nature of the intervention and in terms of government as a system of collective decision making.

3.4 Government failure

The previous section established the rationale for government intervention in an economy with reference to the occurrence of market failure. In this section government failure, in terms of not achieving the goals of efficient and equitable resource allocation outcomes, is examined.

Government intervention can broadly be categorised as either public provision of goods and services or regulation of economic and social activities. The following section discusses the implications of public goods provision by government. Although regulation does not always directly involve budget policy, it does result in costs for government intervention. It will be dealt with in section 3.4.2.

3.4.1 Public goods and government failure

In section 3.3.2.2 it was illustrated how the characteristics of public goods relate to market failure and that it necessitates a political process to reveal preferences and furnish the fiscal resources needed to pay for the public goods[24]. The theory of an optimal allocation of resources between private and public goods assumes that each individual receives benefit (utility) from the consumption of public goods. The payment of taxes to finance the public goods results in a disutility for the individual (forgone private consumption). For each individual the efficient supply of public goods is where the marginal utility received from the consumption of the goods is equal to the marginal disutility of the tax payments for the goods (Brown & Jackson, 1990:62). The revelation of preferences takes place through voting on tax and expenditure decisions. The voting process should then link tax and expenditure decisions. The tax price of expenditure will depend on the total cost for the community as a whole, as well as on the share contributed by others. Voters' choices are contingent on their knowledge that others must also contribute according to the adopted tax plan (Musgrave & Musgrave, 1980:61).

How individual preferences for private and public goods are aggregated and how a collective preference is determined can be explained in terms of partial and general equilibrium analyses[25].

Partial equilibrium analysis identifies the demand and supply conditions that will produce the equilibrium price and output for a single commodity, in this case a public good. The demand curves for public goods can be derived from a set of indifference curves in the same way as the demand curves for private goods are derived (Brown & Jackson, 1990:67). The downward sloping pseudo-demand curves reveal each individual's diminishing marginal utility for public goods. The total willingness to pay for the public goods may be determined by adding the individual demand curves vertically (Browning & Browning, 1990:32). As discussed in section 3.3.2.2, each individual is a quantity taker and adjusts price. A public good equilibrium is established where the total willingness to pay for the public good output is equal to a price at which a producer is willing to supply

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[24] Herber (1983:51) states that as consumers individually demand private-type goods through the market, they can be viewed in this case as demanding public type goods through a democratic political process.

[25] Note that partial and general equilibrium analysis are not discussed at length here. Only some of the main concepts and conclusions are mentioned, with the focus on its shortcomings. See Brown and Jackson (1990:63-73), Browning and Browning (1990:32-33), Musgrave and Musgrave (1980:58-60), Pindyck and Rubinfeld (1995:650-651) and Rosen (1995:66-70) for more detail.

that level of output. The efficient pricing rule for a public good is that the sum of the individual prices equals marginal cost (Rosen, 1995:70)[26].

In a general equilibrium analysis the problem is extended to a situation in which there are many public and private goods. Brown and Jackson (1990:69-72) discuss the general equilibrium analyses in detail. The condition for the efficient supply of public goods is that the sum of the marginal rates of substitution is equal to the marginal rate of transformation, for individual consumers and for any pair of commodities. This implies that if the marginal rate of substitution reflects the marginal benefit that the individual receives from a marginal increase in the quantity of the public good, the marginal benefits must be summed over all individuals (Brown & Jackson, 1990:72). The Pareto efficient supply of a public good requires a set of individualised prices for each consumer, added together to equal marginal cost (Musgrave & Musgrave, 1980:61).

Thus, it is theoretically possible to determine the optimal allocation of resources between private and public goods. The analysis is, however, based on the assumption that individuals are willing to reveal their preferences for public goods. In practice, the problems of public goods arise primarily in the large number context and then government intervention is subject to the problems of the prisoners' dilemma. Individuals will find it to their advantage to act as free riders, by misrepresenting their preferences and by not contributing as required by an adopted tax plan (Browning & Browning, 1990:47)[27]. Without the cooperation of individuals to reveal their preferences, government may have difficulty to determine it (Varian, 1978:201). As in the cases of decentralised markets and voluntary agreements, a central planning system will not produce a Pareto efficient supply of public goods (Brown & Jackson, 1990:75). There is no satisfactory mechanism for demand revelation (Black & Dollery, 1990:20). The provision of public goods must therefore ultimately be determined through an appropriate system of collective decision

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[26] To emphasise Varian's (1978) arguments from section 3.3.2.2 it should be noted that Herber (1983:34) concurs that the market works better to meet consumer preferences in the private good case than in that of public goods. In the private good case, the marginal benefit of each quantity consumed is equal to the price. In the public good case, the "non-market" characteristic of price variance for a fixed quantity occurs. The non-exclusion characteristic of public goods means that each consumer is unable to vary the quantity purchased.

[27] The tax rates represent the above-mentioned individualised prices which must be added together to equal the marginal cost of the public goods (Russel & Wilkinson, 1979:395).

making (Black & Dollery, 1990:20). Collective choice is discussed in section 3.4.3.

3.4.2 Government regulation and government failure

A number of possible forms of government intervention, in the form of regulation, were described in sections 3.3.2.1, 3.3.2.3 and 3.3.2.4. Government may sell franchises for common property resources, use a Pigouvian tax or subsidy to compensate for externalities or set prices to regulate monopolies. Government intervention, under the category of regulation may, however, entail certain costs which could lead to government failure to achieve its goals of efficiency and equity in resource allocation.

Black and Dollery (1990:18) state that when the government uses a Pigouvian tax or subsidy to overcome the inefficient allocation caused by externalities, one should scrutinise the assumptions underlying successful policy intervention. Perfect information on the part of the government is assumed. That is information concerning the size of the externality, and thus the slopes and the shapes of the respective demand and supply curves. It is also assumed that all this information is costless to obtain. In practice, it is difficult and expensive to establish the magnitude of externalities and the costs cannot be ignored (Cullis & Jones, 1987:17).

Regulation to overcome the inefficient allocation caused by externalities is not only difficult and expensive, but could also have adverse effects on participants in the economy. The affected parties will face incentives to overstate or understate the extent of externalities in order to attract subsidies or avoid taxes (Russel & Wilkinson, 1979:397). This behaviour is described as rent-seeking. Rent refers to that portion of income in excess of opportunity cost. Government intervention, like protection to some producers, or quantitative restrictions in trade, artificially creates rent. The intervention itself creates distortions which leads to income and wealth transfers to individuals and interest groups. Individuals have an incentive to allocate scarce resources to capture a share of that rent. The resulting inefficient allocation may be detrimental to society at large (Black & Dollery, 1990:24).[28] It should be noted that any rent-seeking group's ability to lobby effectively

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[28] Rosen (1995:139) discusses this distortion in resource allocation, but in the context of special interest groups and the so-called iron triangle between interest groups, bureaucrats and elected

depends on their ability to meet the transaction costs of collective action and overcome the free-rider problem (Browning & Browning, 1990:85).

In addition to rent-seeking, it may be necessary to allow for other distortionary effects of the tax-subsidy mix. Where government intervenes with regard to monopolies, public monopolies may allocate resources more effectively. The more effective allocation should, however, be weighed against the additional cost arising from the higher level of taxation necessary to use as subsidies to induce marginal cost pricing. Improved technical efficiency in private monopolies should also be taken into account as an opposing argument in cases where government intervention equals public ownership[29].

To conclude, government intervention may take the form of providing public goods, or the form of regulation. Policy makers may not be able to intervene successfully to restore allocative efficiency. The nature of market failure may induce government failure. Ultimately the success of intervention may depend on the system of collective decision making that exists. It should however be kept in mind that the nature of government and the systems of social and public choice itself could also lead to government failure. That is examined in the following section.

3.4.3 Collective choice and government failure

In section 3.4.1 it was shown that government may fail to establish a Pareto efficient level of public outputs. The problem identified was how to aggregate diverse individual preferences into a collective outcome. Black and Dollery (1990:20) state that the provision of public goods must ultimately be determined on the basis of an appropriate system of collective decision making. In this section the focus is on the properties of the process or rule that enables one to move from a set of individual preferences to a social preference.

Two approaches may be used to investigate the relationships between the preferences of individual members of society and the collective choices made by government. Firstly,

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representatives. That relates to the section 3.4.3.2 on public choice.

[29] Section 3.4.3.2.2 discusses the behaviour of budget maximising bureaucrats as a source of X-inefficiency in public provision.

section 3.4.3.1 will examine social choice theory which analyses non-market decision making in terms of the efficiency properties of social choice rules. Secondly, it is standard to assume a fully benevolent social welfare maximising government. Government may, however, be selfish and controlled by vote maximising politicians and self-interested bureaucrats (Brown & Jackson, 1990:91). This influences collective choice and will be analysed as public choice theory in section 3.4.3.2.

3.4.3.1 Social choice

Social choice is an analysis of non-market decision making. It examines the properties of the process or rule that makes the aggregation of diverse individual preferences into social preferences possible (Brown & Jackson, 1990:91). Within the social choice approach the following normative issues are analysed, namely (a) how individual preferences should be aggregated, and (b) what criteria the social choice rule should obey.

To move from individual preferences to a social preference (for example for public goods) means that individuals choose between sets of alternative outcomes (different public goods or levels of provision or different taxes and levels of taxation) by voting for it. Through the voting process social choice produces a social ordering of all the possible outcomes (Gravelle & Rees, 1981:493-494). The social choice rule (voting process) should obey certain criteria[30].

Arrow (1963) stated that any rule or procedure, for example majority voting, that is used to translate individual orderings into a social ordering should conform to certain minimum conditions in order to be ethically acceptable. The conditions are (Brown & Jackson, 1990:94 and Layard & Walters, 1978:495):

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[30] Only majority voting is discussed in this section but other social choice rules may include absolute unanimity and relative unanimity. Absolute unanimity is required to have a situation analogous to the voluntary exchange solution of the market. Cullis and Jones (1987:40) state that unanimity is the collective decision making rule that corresponds to Pareto optimality. With unanimity, each individual may be considered to be trading with all others as a unit. A single negative vote is enough to void a budget policy. No individual can be forced to pay for and consume a public good - but at the same time, transaction and decision costs will be high and few policies will be approved. The next best solution is relative unanimity where the approval percentage should be as close to 100% as possible, without inducing excessive vetoing strategy (Herber, 1983:52-53).

- When individuals vote for alternative outcomes, the social ordering should be complete and transitive. Completeness of the ordering means that when individuals choose between two different public goods or two different levels of provision, one must be preferred to the other, or they can be indifferent about the choice. Transitivity of the ordering means that when option A is preferred to B and B is preferred to C, then A must be preferred to C.
- Social choice should not be influenced by irrelevant alternatives. If individuals must vote for the tax-spending plans X or Y, a change in the relationship between X and W should not influence the choice between X and Y. This also means that if the alternatives remain the same, but society's choice changes, the change could only have come from a change in some individual's preferences.
- The Pareto principle should hold. The social choice rule must be a response to individuals' preferences. Thus if every individual prefers A to B, then society's ranking must prefer A to B.
- An unrestricted domain. That means that the social ordering should include all logically possible individual orderings.
- Non-dictatorship. Social preferences should not reflect the preferences of only a single individual.

When a social choice rule conforms to these conditions, a unique social choice equilibrium will exist. This can be illustrated as follows. Assume that there is a community which consists of three voters, individuals 1, 2 and 3. The voters have to choose between three different budgets, a high budget (A), a medium budget (B) and a small budget (C). The voters' preferences are shown in table 3.1.

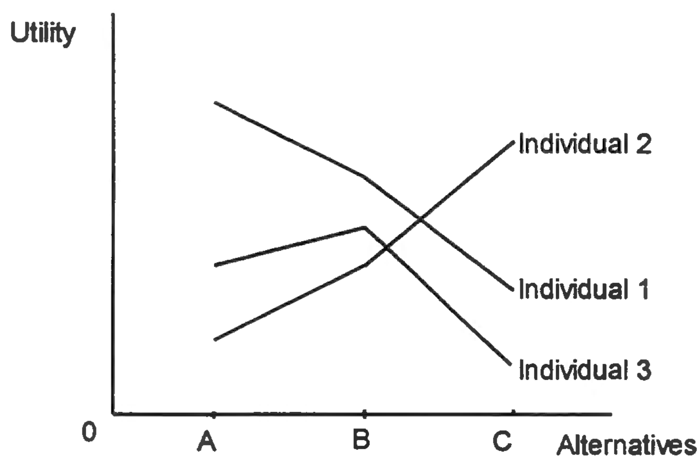
Table 3.1: Voters' preferences for budgets

	1st choice	2nd choice	3rd choice
Individual 1	A	B	C
Individual 2	C	B	A
Individual 3	B	C	A

(Source: Brown & Jackson, 1990)

With majority voting, the individual has only a single vote which is cast in favour of one of the alternatives and cannot disclose the intensity of his or her preferences. The candidate or issue, or in this case the budget, which receives more than 50 percent of the vote, wins (Pindyck & Rubinfeld, 1995:654). If an election was held on whether to adopt A or B, individual 1 would vote for A and individuals 2 and 3 would vote for B. Option B would win by a vote of 2:1. Similarly, if an election was held between B and C, B would win by 2:1. Thus, the selection of B is independent of the order in which the votes are taken and the individual voter's and the society's preferences are consistent. The preferences are referred to as single peaked preferences. This is illustrated in figure 3.4[31]. The vertical axis shows the net utility from different levels of expenditure on public goods and the horizontal axis presents those levels of expenditure in the budgets A, B and C.

Figure 3.4: Single peaked preferences



The voter deviates from his or her most preferred outcome in any and all directions. The net utility of different levels of expenditure rises until the most preferred point and then falls (Varian, 1990:573). When a social choice equilibrium exists, it may overcome government failure to efficiently provide public goods and services[32].

[31] Figure adapted from Brown and Jackson (1990).

[32] Although not discussed in any detail here, it is the median voter who determines the social choice under majority voting. Cullis and Jones (1987:46) state that with a social choice equilibrium the median voter's choice may not coincide with the efficient provision of public goods as determined by the sum of the marginal benefits equal to the marginal cost. It is illustrated that if tax prices are not in line with marginal benefits, majority voting cannot be predicted to ensure the efficient quantity of public good output (Cullis & Jones, 1987:47).

It may, however, occur that majority voting do not always conform to Arrow's conditions and may not always produce a social choice equilibrium. A discussion by Brown and Jackson (1990:95-96), shows that the outcome of the majority voting process may be intransitive if voters' preferences are as shown in table 3.2.

Table 3.2: Voters' preferences for budgets and intransitive outcomes

	1st choice	2nd choice	3rd choice
Individual 1	A	B	C
Individual 2	B	C	A
Individual 3	C	A	B

(Source: Brown & Jackson, 1990)

If an election was held on whether to accept A or B, individuals 1 and 3 would prefer A to B and A would win by a vote of 2:1. Should they compare A with C, individuals 2 and 3 would prefer C to A and therefore C would win over A. C appears like the overall winner, but if an election was held on whether to accept B or C, individuals 1 and 2 would prefer B to C. Thus, the outcome of the voting process is intransitive (Cullis & Jones, 1987:42-43). Layard and Walters (1978:44) state that the reason for the circularity in the outcome is that there is too much diversity of preference among the voters. If society votes only on one issue the outcome depends on the order in which the choices are presented, or if it votes many times on an issue, the majorities are cycled (Varian, 1990:573)[33]. A unique social choice equilibrium does not exist and is not stable (Browning & Browning, 1990:68). The result is called a voting paradox, as each individual's preferences are consistent but the community's are not (Rosen, 1995:122-124)[34]. There is no social choice rule that will satisfy all of Arrow's conditions (Gravelle & Rees, 1981:496). Any social decision making mechanism which satisfies Arrow's conditions must be a dictatorship, where all the social

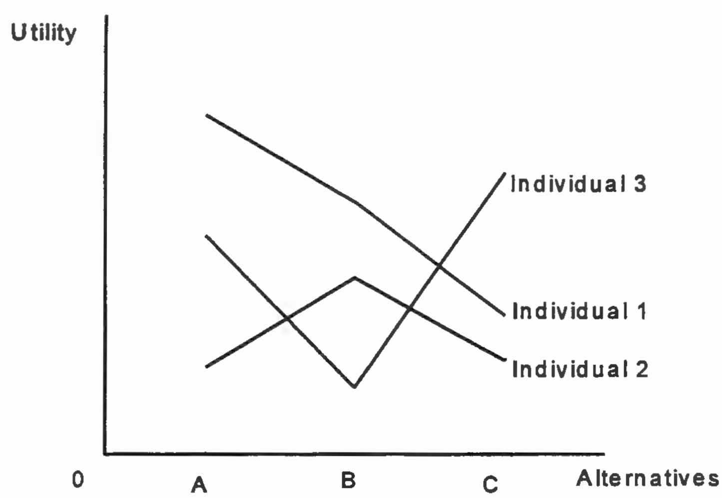
[33] Cullis and Jones (1987:43) mention that when the outcome of a voting process depends on the order in which the alternatives are presented, it lends importance to agenda setting. If one of the consumer-voters is delegated to organise the votes on an issue and he has an idea of the likely preferences of the others, he may determine the collective choice by manipulating the order of the vote. See also Russel and Wilkinson (1979:405).

[34] Varian (1990:574-577) states that even if people's true preferences are single peaked, individuals may misrepresent their preferences in order to manipulate the final outcome. He discusses methods which may ensure demand revelation in the case of a single public good and quasi-linear preferences. The use of a Groves-Clarke tax and its shortcomings are explained.

rankings are the rankings of one individual (Varian, 1990:527). Thus the system of social choice itself may not produce a Pareto efficient solution and could lead to government failure[35].

In this case, individual 3's preferences are double peaked. As the voter moves away from the most preferred outcome, utility goes down and then goes up again. This is illustrated in figure 3.5[36]. Here individual 3 has two peaks, one at A and one at C.

Figure 3.5: Double peaked preferences



Possible escapes from the Arrow paradox, to keep the system of social choice itself from leading to government failure, may be through single-peaked preferences and log-rolling[37].

The foregoing discussion showed that a unique social choice equilibrium is characterized by single peaked preferences. Black (1958) suggests that the intransitive outcomes of the Arrow paradox can be overcome by restricting individual preferences to conform to a

[35] Herber (1983:60) emphasises that the Arrow approach tends to understate the intensity of desires or preferences among alternative policy choices. That makes it difficult to accurately interpret individual demands expressed in the political process.

[36] Figure adapted from Brown and Jackson (1990).

[37] Herber (1983:61-62) also proposes the possibility of using point voting. Voters are given points whereby they can express the relative intensities of their preferences. This more closely approximates consumer sovereignty in the market sense. Potential problems include the possibility of a tie and increased opportunity for strategic behaviour. The strategic behaviour increases the cost of negotiating large-group agreements.

single peaked pattern (Brown & Jackson, 1990:97). However, to restrict individual preferences to those that are single peaked may violate Arrow's condition of the unrestricted domain. On the other hand, Black (1958) thought that in most cases individual preferences would be single peaked. Brown and Jackson (1990:99) explain this as follows: In the example from table 3.2 and figure 3.5 individual 3's preference ordering was not single peaked. In that example alternative A represented a high budget, B a medium budget and C a small budget. Individual 3's first choice was A, second choice C and third B. Such a preference ordering is not likely to occur since most individuals would not prefer a small budget to a large budget, but prefer a large budget to a medium budget. Individual 3 preferred extremes, while most people seem to act as if they have single peaked preferences (Brown & Jackson, 1990:100).

In addition to the supposition that individuals normally do not prefer extremes, De Meyer and Plott (1970) demonstrate that a unique majority outcome exists as the number of voters increase. Inversely, as the number of options tends towards infinity, the probability of a voting paradox occurring approach unity. Thus, given the number of individuals (many) and number of alternatives (few) that are normally encountered, the probability of a voting paradox occurring is small (Brown & Jackson, 1990:100). There is, however, a caveat to keep in mind. In democracies where voting takes place less frequently, the number of 'voters' is essentially reduced to the major parties, with the small parties taking the same view on specific questions. Then concurrence is difficult to achieve, and majority decision rule will only produce a Pareto efficient outcome in the trivial cases for which all individuals have identical preference orderings (Brown & Jackson, 1990:101). Moreover, even when majority voting leads to consistent decisions it may not be efficient in the sense that overall benefits exceed overall costs (Rosen, 1995:125)[38]. Thus, single-peaked preferences offer only a fine line between Pareto efficient social choice and government failure.

Log-rolling offers the second possible escape from the Arrow paradox. Log-rolling or vote trading is a way in which the intensity of preferences may be registered (Rosen, 1995:127). Log-rolling will arise when the costs and benefits of policies differ for different

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[38] Cullis and Jones (1987:44-45) provides an example of the inefficiency of "forced riders".

individuals. When it comes to voting for one policy over another the individuals will have pronounced and varied preferences. Brown and Jackson (1990:102-103) provide an example of how log-rolling takes place[39]. The member of parliament (MP) for constituency X wants to reduce unemployment in his region by ensuring that a large government contract is approved and placed with factories in his constituency. The MP for constituency Y is indifferent about the government contract, but wants his amendment to the education bill passed. The MP for constituency X is indifferent about the education bill's amendment. Thus, there are pronounced and varied preferences for the different policies, which creates incentives for vote trading. The MP for constituency X can vote in favour of the education bill's amendment, if the MP for constituency Y in turn agrees to vote for the government contract. Buchanan and Tullock (1966) demonstrate that vote trading makes majority voting more efficient in terms of both the allocation of resources and the distribution of welfare (Brown & Jackson 1990:103).

Log-rolling and pressure groups may influence the distribution of costs and benefits of public policies. Log-rolling and pressure groups can result in the public sector being larger than it might otherwise have been in the absence of log-rolling, with inefficient programmes being approved (Browning & Browning, 1990:68). The possible welfare cost of log-rolling is illustrated by Rosen (1995:127-129) and Cullis and Jones (1987:47-49). Possible approving of inefficient programmes and expansion of the public sector call into question whether or not log-rolling does indeed add much to economic efficiency (Brown & Jackson, 1990:103). Herber (1983:68) states that institutional complexities and informational problems mean that log-rolling cannot assure Pareto optimality, for example, elected representatives do not all have the same bargaining strength. Rosen (1995:129) concludes that, although log-rolling can sometimes improve the result of simple majority voting, it is not necessarily the case.

From the above discussion it may be concluded that if the success of government intervention in the economy depends on the appropriate system of collective decision making, the nature of majority voting as a system of social choice may lead to government

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[39] Herber (1983:63-64) uses an analysis of how individual voters maximise utility under conditions of uncertainty. Welfare can be increased by accepting a decision counter to one's interests in an area where preferences are low, in exchange for a decision in accordance with preferences and high utility (Herber, 1983:68).

failure.

The second part of the relationship between preferences of individual members of society, and the collective choices made by government, is public choice.

3.4.3.2 Public choice

The previous sections have focused on the normative properties of the collective choice rule and the potential shortcomings of non-market decision making. Public choice theory examines institutional structure (Brown & Jackson, 1990:91). Here the focus is on the nature of government in providing a system of collective decision making.

Often a benevolent social welfare maximising government is assumed to exist in economic theory. In practice, government may be selfish and controlled by vote maximising politicians and self-interested bureaucrats (Boadway *et al.*, 1994a:8). Black and Dollery (1990:20) state that government could fail to achieve efficient and equitable resource allocation, due to (a) rational behaviour by politicians pursuing vote maximising strategies and (b) rational behaviour by bureaucrats resulting in bureaucratic failure. Each will be examined below.

3.4.3.2.1 Vote-maximising politicians

Downs (1957) introduced the economic theory of politics based on the assumption that political parties are vote maximisers (Brown & Jackson, 1990:109). The elected representatives are guided by self-interest, rather than the idealized goal of public interest. They may be motivated by the power, prestige or money of public office and seek re-election by maximising the number of votes they receive (Herber, 1983:69).

Vote-maximising behaviour takes place because voters are ignorant of much of what politicians stand for. Cullis and Jones (1987:50) state that there are imperfections and disincentives which discourage voters to obtain information in a "political market". In representative democracy voters cannot easily vote for individual policies in the same fashion as purchasing individual products. Voting for one policy may imply voting for a party which also proposes other policies (Cullis & Jones, 1987:52-53). The outcome of the voting process becomes a public good and thus vulnerable to free riding (Browning & Browning, 1990:78). The perception is that a single vote will not influence the outcome (Rosen, 1995:134). The individual voters will then only participate politically when the information costs are low. Furthermore, voters only concentrate on the policies that have large and obvious effects on their own well-being. This provides politicians with incentives to design policies in ways that make benefits clear to those who benefit, and costs difficult to perceive for those who are harmed (Browning & Browning, 1990:82).

In addition to the absence of voter participation, the vote-maximising behaviour can also take place because politicians are elected on the basis of a package of policies and therefore do not have to please the majority of voters on each separate policy issue. This leads to implicit log-rolling. Politicians are able to put together an overall majority by combining numerous programs that benefit separate minorities (Browning & Browning, 1990:81)[40] [41]. The legislation provides the politicians with voting and financial support from special interest groups[42]. The higher degree of political participation of lobbyists and special interest groups is explained by Cullis and Jones (1987:53). High income individuals can carry the cost of participation and lobby more persuasively, while organisations may mobilise a greater degree of participation[43]. The result is special interest legislation producing a variety of relatively unpopular public goods as well as an aggregate oversupply of public goods (Black & Dollery, 1990:22).

Thus from the politicians' side government may fail to ensure efficient and equitable resource allocation.

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[40] See Black and Dollery's (1990:21) example on coalition formation and implicit log-rolling.

[41] Cullis and Jones (1987:49) states that implicit log-rolling is associated with larger-number situations in the context of representative democracy.

[42] Rent-seeking activities have already been mentioned as part of the causes of the possible failure of government regulation in section 3.4.2.

[43] As mentioned in section 3.4.2, the success of special interest groups will depend on the ability of the group to overcome the free-rider problem themselves. Cullis and Jones (1987:54) state that the smaller groups tend to be more successful.

3.4.3.2.2 Budget maximising bureaucrats

The rational behaviour of bureaucrats can be analysed in terms of the demand for and supply of public goods (Black & Dollery, 1990:22). The demand for public goods is generated by the decisions of the politicians. The supply of public goods is provided through the state bureaucracy[44]. The bureaucrats do not face any test in supplying the public goods and are motivated by budget size (Browning & Browning, 1990:83). They will attempt to maximise the budget because it is also positively correlated with their power and prestige, their office benefits, rank and pay and the possibilities for promotion (Herber, 1983:66). Musgrave and Musgrave (1980:123) state that the empire building bureaucrat will present a budget which: (a) asks for more funds than needed to perform a given function, (b) overstates the benefits to be derived from a given level of services, and (c) inflates the total in anticipation of expected cutbacks. It is also possible for the bureaucrats to increase the budget size by supplying the public goods inefficiently (Black & Dollery, 1990:22-23). There is some rational ignorance on the part of politicians which may lead bureaus to provide highly visible and easily measured services at the expense of other, possibly more important services (Browning & Browning, 1990:84). The overall result is allocative inefficiency (Rosen, 1995:135-136).

In conclusion, government tends to fail to achieve the goals of Pareto efficient and equitable resource allocation, due to the nature of its intervention in the economy and the nature of government as a mechanism of collective choice. Government intervention may thus have problems solving the development challenges outlined in chapter two.

The following section presents a decentralized government system as a possible solution to some of the problems associated with government failure and to thus come closer to ensuring Pareto efficient and equitable resource allocation outcomes.

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[44] Cullis and Jones (1987:55) view the bureaucracy as having a monopoly over the supply of public goods and the party in power as monopsonists in relation to the bureau.

3.5 Government failure and decentralisation as solution

To propose a decentralised government system to minimise government failure as described in section 3.4 above, it is necessary to evaluate the causes of government failure and the possible theoretical remedies.

In section 3.4 it was shown that government failure is firstly due to problems in aggregating preferences and demand revelation for public goods. The problems stem from the nature of public goods as well as from group size and decision making costs. Government failure may also be due to inappropriate institutional structures. Each will be examined below.

3.5.1 The nature of public goods

In sections 3.3.2.2 and 3.4.1 above it was shown that the non-excludability and non-rivalness of public goods underlie the problems of aggregating preferences and demand revelation. There are, however, few practical cases of such pure public goods. Congestion and exclusion technology lead to the existence of goods with significant public goods characteristics over certain geographic areas, or for a certain group size (Kritzinger, 1988:49). A spatial dimension can be attached to the degree of publicness of the goods and services provided by government (Döckel & Somers, 1992:144). Once a spatial dimension is attached to public goods, it may be discussed in the context of "clubs". A "club" may be described as a voluntary group deriving mutual benefit from sharing production costs and the members' characteristics (Kritzinger, 1988:50). Club goods still poses a high degree of joint consumption which means that the marginal cost of supplying the good to an individual is zero and charging a price would be inefficient. However, if the size of the group is small enough, some market-type arrangement for allocating the good is feasible (Herber, 1983:48). To charge the MRS to each individual would be efficient if they reveal their preferences. Preference revelation is discussed in section 3.5.2.

The existence of public goods as club goods and the spatial characteristics attached to them imply that groups of individuals in different locations may choose to provide different levels of public goods for themselves, even though each individual in a particular group would be able to consume only the level decided on by the group (Kritzinger, 1988:50).

Levels of government ought to correspond to the ranking of goods and services as national public goods, regional public goods and local public goods (Döckel & Somers, 1992:144). Decentralising to local public goods may bring government closer to efficient provision.

3.5.2 Group size and decision making costs

In addition to the spatial characteristics which may be attached to the costs and benefits of public goods, a partial solution for the demand revelation problems associated with group size and decision making costs may also exist. The instances of market failure in sections 3.3.2.1 to 3.3.2.5 illustrated that an individual in a large group lacks incentive to bargain or to enter into a cooperative agreement. This is because he or she may consider any contribution they might make to be greater than the potential increase in benefits (Kritzinger, 1988:49). The possible solution may be to work with smaller groups (Brown & Jackson, 1990:37). In small groups, individuals find it worthwhile to contribute and to bargain. When the group is small, individual contributions can significantly affect the individual's position and the position of others (Browning & Browning ,1990:47). Also, knowing that they must comply with the majority decision, individuals find it in their best interest to vote for the solutions that will move the outcome closer to their own desires (Musgrave & Musgrave, 1980:81). Thus, not only are shortcomings of aggregating preferences and revealing demand preferences mitigated in smaller groups, smaller groups may also be more homogeneous. Tullock and Campbell (1970:97-104) too show that the probability of the voting paradox occurring decreases as preferences become more homogeneous (Brown & Jackson, 1990:100).

3.5.3 Institutional dimensions

In section 3.4.3.2 it was discussed how vote maximising behaviour by politicians and budget maximising behaviour by bureaucrats may lead to government failure. This is because the outcome of the voting process is a public good and vulnerable to free riding (Brown & Jackson, 1990:113). The voters lack the incentives to know what the politicians stand for and to monitor effective delivery by bureaucrats. Again a solution could be smaller and more homogeneous groups, as such groups could improve accountability and overcome the institutional causes of government failure.

In summary, this section reasoned that fiscal decentralisation may offer a possible solution to some of the problems associated with government failure. If fiscally decentralised government intervention can ensure efficient and equitable resource allocation, it may also help to overcome the development challenges facing North West Province.

3.6 Summary

In this chapter the functioning of the perfectly competitive model was explained as a background to examine the shortcomings and failure of the market to ensure efficient and equitable resource allocation. The causes of inefficiency and inequity in the market economy were categorized as (a) the absence of property rights, (b) information costs and (c) indeterminancy of bargaining. The instances of market failure which were discussed included the cases of (a) common property resources, (b) public goods, (c) externalities, (d) imperfect competition and (e) inequity. A number of the development challenges outlined in chapter two represent instances of market failure. Market failure provided a rationale for government intervention in the economy. In order to ensure efficient and equitable resource allocation it was shown that government needs to fulfil certain functions, namely the allocation, stabilisation and distribution functions. After establishing market failure as the rationale for government intervention it was shown that government could also fail to achieve the goals of efficient and equitable resource allocation. Public collective action was shown to be subject to the same shortcomings as private collective action. It was shown that the nature of market failure may also lead to government failure. From an institutional point of view it was shown that the nature of government could in itself lead to government failure. By implication, government failure means that government may not sufficiently address the development challenges of North West Province. A decentralised government system was argued to minimise government failure and bring society closer to ensuring Pareto efficient and equitable outcomes.

In section 3.2 the assumptions of the perfectly competitive model was firstly outlined. A two sector model was used to illustrate how a Pareto efficient allocation of resources is reached. It was shown that there is efficiency in consumption when the rates at which individuals A and B are willing to trade shelter (s) for food (f) are equal ($MRS^A_{sf} = P_s/P_f = MRS^B_{sf}$). There is efficiency in production when the rate at which producers are able to transform shelter into food, is equal to the ratio of the marginal cost of shelter to the marginal cost of food ($MRT_{sf} = MC_s/MC_f$). The consumers and producers achieve equilibrium simultaneously where the marginal rate at which the consumers are willing to substitute shelter for food is equal to the rate at which it is technically possible to do so ($MRS^A_{sf} = MRS^B_{sf} = MRT_{sf}$). In section 3.2 it was shown that in practice conjectural interdependence between individuals exists and the utility maximising behaviour of individuals may not be beneficial for the group as a whole. The market fails to achieve efficient and equitable resource allocation outcomes. Possible private cooperation to overcome the problems of interdependence was shown to be undermined by the prisoners' dilemma. This established a justification and role for government in the economy.

Against the background of the perfectly competitive model, market failure was examined in more detail in section 3.3. Market failure was defined as those situations in which the conditions necessary to achieve a market efficient solution fail to exist or are contravened in one way or another. The causes and instances of market failure were examined in the following sub-sections.

The causes of market failure were described in terms of the view that market failure occurs when potential mutually advantageous trade or profitable production decisions exist, but are not executed. In section 3.3.1.1 the absence of property rights was discussed as a possible cause of market failure. The absence of property rights makes the marginal social cost of production higher than the marginal private cost and the price signals are distorted. In section 3.3.1.2 it was shown that when information costs are more than the possible gains from trade the market will fail. Indeterminancy of bargaining was put forward as the third possible cause of market failure. In section 3.3.1.3 it was contended that in cases where the division of gains from trade needs lengthy and costly bargaining, the market may fail.

Instances of market failure were discussed in section 3.3.2. In the case of common property resources (section 3.3.2.1), it was shown that property rights cannot be assigned to any single individual. Utility maximising behaviour by individuals leads to exploitation of the common property. Public goods (section 3.3.2.2) also have no property rights as the goods are non-rival and non-excludable in consumption, which makes it both impossible and inefficient to charge a price. Without the price signal the market economy will not provide the public goods at all, or will provide it at insufficiently low levels. In section 3.3.2.3 externalities, which occur when the consumption or production activities of certain agents affect the welfare of other agents, were discussed. The costs or benefits of these activities are external to the price system. In the example of pollution from steel production it was shown that market failure was due to the absence of property rights over clean air. The external cost of pollution increased the marginal social cost to above the marginal private cost of production. The price signals were distorted and resources inefficiently allocated.

In all three instances the possibility of overcoming the market failure through private sector cooperation was shown to be limited by the problems associated with the prisoners' dilemma. In large groups voluntary payments will not be forthcoming and individuals will find it in their interest to act as free riders and enjoy the benefits of the common property resources or public goods without paying for it. In the same way the producer of the product with the external cost can make more profit from his socially inefficient high output, without having to internalise the cost of the pollution into his private cost structure. This provides a role for government in the economy.

A fourth instance of market failure which was discussed was imperfect competition. In section 3.3.2.4 it was shown that a monopolistic firm will produce less of a product and sell it at a higher price than would be the case under perfect competition. Furthermore, in the case of the downward sloping average cost curve of a natural monopoly, the monopolist could only produce the social optimum output at a loss and no private firm can sustain losses over the long-term. Thus, from a welfare and efficiency point of view, a role for government was identified.

Inequity was identified as the final instance of market failure. In section 3.3.2.5 it was shown that even if the competitive market produces an optimal output mix, it may not necessarily represent the most preferred distribution of income. As a system of private contributions is also subject to the prisoners' dilemma and will fail to redistribute income, inequality also provides a role for government in the economy.

Finally it was stated that to achieve the efficient and equitable allocation of resources government needs to fulfil allocation, distribution and stabilisation functions.

As market failure provided a rationale for government intervention in the economy, it is possible that government may also fail to achieve an efficient and equitable allocation of resources. The nature of market failure may induce government failure. In section 3.4 government failure was discussed in terms of the provision of public goods, government regulation and collective choice.

In section 3.4.1 it was illustrated that theoretically pseudo-demand curves for public goods and services can be derived, that it is possible to determine the optimal allocation of resources between private and public goods and that government intervention can ensure efficiency. This was under the assumption that individuals will reveal their preferences for public goods. In practice, however, government intervention is also subject to the problems of the prisoners' dilemma and free riding. The consequence is that government may fail to produce a Pareto efficient supply of public goods. It was concluded that the provision of public goods must ultimately be determined through an appropriate system of collective decision making.

In section 3.4.2 it was shown that government regulation of the inefficient allocation caused by externalities and monopolies may fail. Successful policy intervention assumes perfect information on the part of the government, but in practice, information about the magnitudes of externalities, or the slopes and shapes of the relevant demand and supply curves may be difficult and expensive to obtain. It was also argued that the regulation may lead to inefficient rent-seeking behaviour.

In section 3.4.1 it was shown that government may fail to aggregate diverse individual preferences for public goods into a collective outcome. In section 3.4.3 it was examined whether an appropriate system of collective decision making may determine the efficient provision of public goods.

A social choice analysis (section 3.4.3.1) showed that the outcome of a majority voting process may be intransitive and where individual preferences are double peaked a unique social choice equilibrium does not exist and is not stable. In such a case government may not be able to determine the efficient provision of public goods. Thus, the nature of majority voting as a system of social choice may lead to government failure. Restricting preferences to single peaks and log-rolling was forwarded as possible solutions.

The second part of the relationship between individual preferences and the collective choices made by government was described in section 3.4.3.2. It was shown that the behaviour of vote-maximising politicians and budget maximising bureaucrats may cause government to fail to achieve efficient and equitable resource allocation.

As markets and government were shown to fail to produce efficient and equitable resource allocation, the final section of the chapter tried to find a solution to overcome the government failure. The causes of government failure were broken down into three categories and decentralisation was put forward as such a possible solution.

In section 3.5.1 the nature of public goods was examined as the first cause of government failure. Public goods are non-excludable and non-rival in consumption, which leads to the problems of demand revelation. The counter-argument was that in practice there are few such pure public goods, and spatial dimensions can be attached to the degree of publicness of the goods and services. Such public goods can be discussed as club goods. In a decentralised club context individuals in different locations may choose to provide different levels of public goods for themselves.

In section 3.5.2 group size and decision making costs were examined as the second cause of government failure. In large groups the individual lacks incentive to bargain or enter into a cooperative agreement and would rather free ride. In decentralised smaller groups individuals are more likely to reveal their preferences and as the preferences are more homogeneous the possibility of a voting paradox also decreases.

Finally, in section 3.5.3, the institutional dimensions of the behaviour of vote-maximising politicians and budget maximising bureaucrats, which leads to government failure, were examined. The argument in favour of decentralisation was that in smaller, more homogeneous groups the voters have more of an incentive to know what the politicians stand for and can monitor delivery by bureaucrats more effectively.

Following these arguments to overcome the problems of government failure chapter four focuses on the theory of fiscal systems. The arguments in favour of decentralisation are examined, along with the arguments against and possible disadvantages of decentralisation.

Chapter 4: An analysis of fiscal decentralisation

4.1 Introduction

Chapter three described the perfectly competitive market, market failure and government intervention in the economy. It was argued that markets and government intervention may fail to produce efficient and equitable resource allocation outcomes. Decentralisation was put forward as a solution to government failure and the development challenges facing North West Province.

The purpose of this chapter is to analyse the case for and against fiscal decentralisation. This will be done in order to determine whether fiscal decentralisation can contribute towards efficient and equitable resource allocation outcomes and in this way address some of the economic development challenges outlined in chapter two.

The structure of the chapter is as follows: Section 4.2 defines fiscal federalism and decentralisation. In section 4.3 the arguments in favour of decentralised allocation, stabilisation and redistribution are examined and an assignment of expenditure responsibilities and taxation recommended, following the fragmented localist model. In section 4.4 the arguments against fiscal decentralisation of the allocation, stabilisation and redistribution functions are discussed and further arguments against fiscal decentralisation listed. The section recommends an assignment of expenditure responsibilities and taxation following the centralist model. In section 4.5 different degrees of fiscal decentralisation and centralisation are examined in a cooperative localist model, along with the role that intergovernmental fiscal relations may play.

4.2 Definitions

"Fiscal federalism" refers to a public sector with two or more levels of decision making

(Oates, 1990:2). The vertical structure of the public sector is addressed along with the fiscal relationships among decision makers at different levels of government. Fiscal federalism refers to public finance in a hierarchical structure of autonomous governments, in which each person is simultaneously a citizen of more than one government (Söderström, 1990:37). Ferris and Winkler (1990:165) states that the term decentralisation may be used as an umbrella to refer to a variety of mechanisms through which a government may try to improve policy.

Rondinelli (1981:137-139) identifies deconcentration, delegation and devolution as three possible degrees of decentralisation[45].

Deconcentration is the least extensive form of decentralisation and involves shifting the work load to staff located outside the national capital. The degree of deconcentration can be increased through field administration and local administration. Field administration allows some decision making discretion to field staff to plan, make routine decisions and adjust central directives to local conditions, albeit under central guidelines. Under a system of local administration, subnational governments act as agents of the central government.

Delegation means that decision making and management authority are decentralised to organisations that are under the indirect control of central government. Such organisations would include public corporations, regional planning and development authorities and project implementation units.

Devolution is the most extreme form of decentralisation and involves the creation of independent levels and units of government. Devolution is related to Rondinelli's (1981:137) definition of areal decentralisation. It is a process primarily aimed at transferring responsibility for public functions and organisations, within well defined subnational spatial or political boundaries.

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[45]Hommes' (1995:332) defines deconcentration as transferring power to local units, coupled with revenue sharing or other forms of transfers from the centre to regional and local governments. Devolution is transferring power to subnational political institutions above the local level, while delegation would mean transferring it to decentralised entities.

Ferris and Winkler (1990:156) expands the definition of devolution by claiming that fiscal decentralisation entails choices about policies that affect the decision making of subnational governments over revenues and expenditures. In this regard Tanzi (1995:297) distinguishes between fiscal and administrative decentralisation. Fiscal decentralisation is where subnational governments have power to raise (some) taxes and perform certain spending activities. Administrative decentralisation is similar to deconcentration and delegation (see above). It exists when subnational governments are only regarded as agents of central government that receive centrally raised taxes and spend according to central guidelines and controls.

In this study the concern is with fiscal decentralisation, especially whether the North West Province, which is allowed some degree of decision making over revenues and expenditures[46], will be able to resolve the economic development challenges outlined in chapter two more, as, or less efficiently and equitably than if it were only the administrative arm of central government.

The fragmented localist model is explained in section 4.3 and provides the main arguments in favour of decentralised allocation, stabilisation and redistribution.

4.3 Arguments in favour of fiscal decentralisation

The main arguments in favour of fiscal decentralisation are provided by the "fragmented localist model" of fiscal federalism as described by Söderström (1990). The basis of the model is that the costs and benefits of public goods and services are limited to geographical areas and the residents of a region possess preference patterns that are homogeneous, but differ from those of residents in other regions. The individuals have a better knowledge of the costs and benefits of the public goods and services to themselves (Döckel & Somers, 1992:141), and from a welfare maximising point of view,

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[46] The Constitutional assignment of functions and finance to the provinces is discussed in section 5.2.1

representative government may work best if subsets of people have the right to vote different kinds and amounts of public services for themselves (Söderström, 1990:42).

The arguments in favour of fiscal decentralisation may be grouped into arguments for decentralised allocation, stabilisation and redistribution.

4.3.1 Arguments for decentralised allocation

Decentralised allocation is often described from an efficiency and competition point of view.

The efficiency point of view refers to the spatial characteristics of public goods and services and the mobility of resources, arguing in favour of decentralisation.

In section 3.5.1 it was described how congestion or exclusion technology may lead to the existence of goods with significant public goods characteristics, over certain geographic areas or for a certain group size (Kritzinger, 1988:50). Different spatial dimensions may thus be attached to the costs and benefits of public goods and services. Tanzi (1995:298) for instance, illustrates that defence benefits an entire country, while regional transport or water provision systems benefit only a region, and sanitation and street lighting benefit only a particular locality. In these cases the preferred amount and type of public goods and services will depend on the tastes and needs of the residents (Boadway *et al.*, 1994a:19). The level of government that provides the public goods and services will be determined by the benefits accruing to the individuals being served in that region (Shah, 1990:3).

Central government might, however, ignore these spatial characteristics of public goods and services. In sections 3.3.2.2 and 3.4.1 it was argued specifically that government may fail to determine individual preferences for certain public goods. There may also be inefficient and inequitable provision of the public goods due to public choice problems, as described in section 3.4.3.2.

In section 3.5.2 it was argued that the problems of aggregating preferences and demand revelation may be avoided in a smaller, decentralised group. It was illustrated that in a smaller group individuals are more likely to reveal their preferences for public goods and services and enter into a cooperative agreement. The mobility of consumers also helps to reveal their preferences and encourage efficient allocation (Oates, 1990:4). The contribution of consumers' mobility to preference revelation stems from the Tiebout model of voting-with-the-feet. Tiebout (1956:418) suggested that in a decentralised political structure, with many local governments providing different mixes of public goods, the consumer-voter can move to, and settle in a jurisdiction which best satisfies his or her preference for public goods (see also Oates & Schwab, 1988:333). Thus, individuals "shop" amongst jurisdictions which offer alternative levels of output of local public goods and in that process reveal their preferences (Oates, 1990:4)[47]. Tanzi (1995:299) adds that the individuals can be made to pay a price (tax) based on the benefit they receive from the local public goods. A Pareto optimal solution is achieved when the marginal benefit received from consuming the public good is equal to the cost in terms of taxes (section 3.4.1).

Smaller groups and mobility not only facilitate preference revelation, but also may imply that groups are more homogeneous. In small communities of like-minded individuals the average divergence between individual preferences on the tax and service package may be less (Döckel & Somers, 1992:142). Differences in the intensity of preferences may also be less. Section 5.3.2 argued that this may make majority voting more stable and may reduce the possibility of the Arrow paradox and government failure occurring due to the nature of the system of social choice.

In addition to the above "efficiency based arguments" are the so-called "competition based arguments" in favour of decentralisation.

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[47] Note that the size of the communities in the Tiebout equilibrium is bound by congestion costs. When an additional resident moves to the community, the cost of the public good is spread to him/her (a marginal cost saving). The community will expand until the marginal cost saving is equal to the marginal congestion cost introduced by the marginal resident. Thus the size of the jurisdiction is determined at the lowest average tax cost of providing public goods and services (Musgrave, 1990:283).

Mobility, along with competition among jurisdictions to attract citizens, may constrain the subnational political "entrepreneurs" to provide only the tax-expenditure package which the electorate wants. In the competition to draw citizens to their jurisdictions governments may have to limit their own maximising behaviour (Kritzinger, 1988:51-52). Boadway *et al.* (1994a:19) reason that at lower levels of government, the provision of public goods and services may be more effective because agency and monitoring costs may tend to be lower. Citizens are closer to government and responsive to local concerns and will move to other jurisdictions in response to vote or budget maximising behaviour by local politicians or bureaucrats. Holding subnational governments accountable would, however, require systematic disclosure of government activities as well as an institutional structure that facilitates community involvement. These requirements may be reinforced when the financing of services are decentralised as well (Shah, 1991:3). Wallich (1992:62) proposes that decentralised services should be financed at the subnational level at which the service is provided, because when "beneficiaries pay", efficiency is greater and government decision making may be more responsive and responsible (see also Oates, 1995:352). This could help ensure that governments act in the best interest of their residents (Hewitt, 1991:83, World Bank, 1993:15 and Tanzi, 1995:300).

4.3.2 Arguments for decentralised stabilisation

The efficiency and competition based arguments for fiscal decentralisation not only apply to allocation, but can also be applied to stabilisation, as long as preferences differ between regions. Residents of a particular jurisdiction could, for instance, prefer less unemployment and more inflation so that the subnational government may, as a consequence, attempt to stimulate the local economy. Even though the multiplier effect associated with the efforts may be low, the fragmented localist model contends that tailoring policy to local preferences may be more efficient than a uniform national stabilisation policy. Sewell (1996:147) states that subnational fiscal activity may be stabilising for a number of reasons. One is that major expenditure responsibilities are assigned to subnational governments, e.g. health and education, which act as automatic stabilisers because they are recurrent and inflexible. Increased reliance on direct taxes in subnational funding may similarly have a stabilising effect on a local economy. Sewell

(1996:147) cites Rabeau's (1986) claim that it has been found that significant interregional leakages from subnational economies do not occur, which voids some of the technical objections to subnational stabilisation.

4.3.3 Arguments for decentralised redistribution

Income inequality in an internal common market reflects the inequality in the distribution of private sector output, "adjusted" by the tax paid to and transfers received from government as well as the distribution of government output among households (Quigley & Smolensky, 1990:127). In the fragmented localist model, equality is defined in terms of the preferred distribution of income (see also section 3.3.2.5). To achieve equality, society must decide which particular distribution of income and welfare it prefers and the measures for achieving it (Musgrave & Musgrave, 1980:11).

The argument in favour of decentralised redistribution rests on the efficiency and competition based arguments. Public assistance programs should reflect the diverse attitudes and preferences of residents in different jurisdictions. By analogy of the Tiebout model of local public goods and mobility, economic efficiency will be enhanced when tax payers can choose the jurisdictions whose welfare policy matches their own preferences (Ladd & Doolittle, 1982:331).

Pauly (1973) illustrates that under certain assumptions, decentralised distribution may result in efficient outcomes as far as income inequality is concerned. The basis of his model is identifying a spatial dimension for concern about the poor, as the income levels of the poor enter as arguments in the utility functions of the non-poor (Brown & Oates, 1987:308). Pauly (1973:37) contends that the non-poor are more (or even only) concerned about the poor in their own jurisdiction and gives two rationales for the approach. The first is altruism. The non-poor come in contact with the local poor more frequently and the adverse circumstances are perceived at close hand. Thus, a higher value is placed on redistribution to the local poor. The second reason relies on self interest and the desire to minimise the undesirable manifestations of poverty (Ladd & Doolittle, 1982:331). When poverty contributes to crime in one's own back yard, one way to reduce crime (and increase one's own utility) may be to redistribute income (Pauly, 1973:38). Thus, there may be a spatial dimension to benefits from income distribution and decentralised redistribution is favoured.

In practice, several types of the public services that may be assigned to subnational governments on efficiency and accountability grounds are redistributive (Shah, 1991:33). For example, the incidence of disease is directly correlated with incidence of poverty and by corollary, inversely associated with economic well-being. Thus, the provision of health care or education by subnational government can be viewed as redistribution in kind (Shah, 1991:33-34). If health care is provided in accordance with decentralised preferences it implies a spatial dimension of concern about the poor. Behrman and Craig (1987:42-43) find evidence that subnational governments incorporate distributional preferences into their spending decisions and that the preferences differ between jurisdictions. Wildasin (1995:768-769) points out that among states in the United States of America the monthly average benefits for aid to families with dependent children vary by a factor of five, and that such differences vary over a long period of time.

Against the background of the advantages of decentralisation, the assignment of expenditure and taxation responsibilities in the fragmented localist model will be examined in the following sections.

4.3.4 The assignment of expenditure responsibilities

When the assignment of expenditure responsibilities between different levels of government is considered, Oates (1990:4) states that the heart of fiscal federalism lies in the proposition that the policies of the allocation branch should be permitted to differ between states, depending on the preferences of their citizens. Expenditure responsibilities should be decentralised as it is in the tailoring of outputs to the particular tastes and circumstances of different jurisdictions that the real gains from decentralisation are to be realised (Wallich, 1992:61).

Boadway *et al.*, (1994a:30) recommend that subnational governments should be responsible for public services such as health care and insurance, education, welfare services, family and child support services, regional transportation and communication services, local utilities and municipal services and resource management. With these responsibilities, the benefits accrue mainly regionally or locally (Boadway *et al.*, 1994b:2). The allocation decisions should be made by the level of government that most closely corresponds with the spatial distribution of benefits. This means allocation decisions by the lowest level of government that is able to perform the functions effectively (Wallich, 1992:62).

Bird and Wallich (1993:29) and Boadway *et al.* (1994b:2) maintain that the only public goods and services that should be provided centrally are those (a) for which there are no differences in demand in the different localities, (b) where there are substantial spillovers between jurisdictions and the benefits of the type of good or service are public in nature, (c) where uniformity of provision is important, (d) where economies of scale necessitate central provision, or those public goods and services (e) for which the additional costs of decentralising administration are sufficiently high to outweigh the advantages.

4.3.5 The assignment of taxation

Assignment of taxation responsibilities to lower levels of government is required for a reasonable matching of expenditure needs with revenue means across various levels of government (Shah, 1991:12).

The argument in favour of decentralising taxation is twofold. The first is that the efficiency of fiscal decentralisation is based on subnational governments catering for differential preferences. To achieve efficient decision making in a decentralised system, subnational governments ought to have a sufficient degree of autonomy in relation to the central government (Hommes, 1995:338). This is most likely to be the case if they can rely on own revenue sources in establishing their expenditure and revenue mix. To finance the expenditure from own sources not only provides the ability to cater for decentralised differential preferences, but since finances are obtained locally, subnational government is accountable to its electorate. The second part of the argument in favour of decentralising taxation is that a subnational tax effort allows consumers to express their preferences, and it functions as a pricing instrument through which subnational governments ascertain demand (Hommes, 1995:341, 346).

Tanzi (1995:299) emphasises that for subnational governments a Pareto optimal solution is achieved when the marginal benefit received from consuming the local public goods is equal to the marginal cost in terms of benefit taxes (see also Oates, 1972:35). McLure (1995:318) proposes taxation based on benefits received, as appropriate for financing allocation functions of subnational government (Sewell, 1996:148). In such a case there exists a closer correspondence between public goods provided and the tax price. However, Wildasin (1995:326-327) cautions that proper pricing and taxation requires a separation of taxes which reflect the true benefits from public services, from those that reflect the costs that users impose on public service providers. These two types are often confused because, for instance, children in classrooms or patients in clinics receive benefits, but also impose costs on the provider. Wildasin (1995:327) explains that an infant or an aged person may both require fifteen minutes of a doctor's time for treatment but the value of the services may be drastically different. The tax should then be based on the cost of decentralised service provision, rather than on subjective benefits, in order to avoid incentives for inefficient migration and service utilisation.

The aforementioned arguments for decentralising taxation are in favour of a bottom-up assignment of taxes to subnational governments from where a transfer of some revenue to national government for its spending needs must take place. The amount transferred upward may be determined by rule, formula or negotiation (Tanzi, 1995:311). Subnational government then chooses the tax, defines the base, set the tax rates and administers the tax (McLure, 1995a:318).

Several arguments against the decentralisation of taxes will be discussed in section 4.4, but it can be useful to point out in advance that any proposed restrictions on subnational tax capacity create two main problems, firstly that (a) vertical imbalances develop as a result of the low capacity for tax mobilisation subnationally and higher spending demands from decentralising spending responsibilities, and secondly that (b) horizontal imbalances develop as a result of the differences in income and wealth between jurisdictions (Hommes, 1995:346-347).

If significant decentralisation is to exist, subnational governments must have their own sources of revenue. Fiscal autonomy is compromised when using transfers, grants and other central monies. Dependence on grants destroys incentives for efficient subnational fiscal decisions (Oates, 1995:352). McLure (1995a:318) advises that "These governments must truly be the masters of their own fiscal destiny, at least at the margin, if they are to be autonomous and accountable and if decentralisation is to improve the allocation of resources." Prud'homme (1995a:357) claims that "If there is no freedom of choice and no tax autonomy, the benefits of decentralisation disappear."

The fragmented localist model thus argues that the spatial characteristics of public goods and demand revelation in smaller decentralised groups may help to ensure efficient and equitable resource allocation. A decentralised form of government may improve economic efficiency by providing a range of public good outputs which corresponds better to differing tastes of groups of consumers (Prud'homme, 1995b:207), when compared with central provision, which often results in more uniform provision (Shah, 1991:3). Oates (1972:11) states that if each community had its own subnational government, one might expect variation in the level of provision of public goods that to some extent reflect the differences in tastes of the different communities. For the case of perfect mobility and consumer-voter shopping behaviour, the decentralised public sector does fully as well as the private sector in allowing each individual to select the most efficient level of consumption of each good (Oates, 1990:4).

Finally, Oates' (1972:35) decentralisation theorem states: "*For a public good - the consumption of which is confined over geographical subsets of the total population, and for which the costs of providing each level of output for the good in each jurisdiction are the same for the central or the respective local government - it will always be more efficient (or at least as efficient) for local governments to provide the Pareto efficient levels of output for their respective jurisdictions, than for central government to provide any specified and uniform level of output across all jurisdictions.*"

Given the above arguments in favour of decentralisation, Boadway *et al.*'s (1994a:17) methodological rule may be adopted, namely that the decentralisation of functions to lower levels of government should be favoured, unless sound arguments can be advanced for centralisation.

The following section examines the counter arguments that challenge some of the above conclusions, or outlines conditions in which decentralisation may not automatically lead to efficient and equitable allocation of resources.

4.4 Arguments against fiscal decentralisation

The main arguments against fiscal decentralisation are provided by the "centralist model" of fiscal federalism as described by Söderström (1990). The model assumes the existence of a social welfare function for an entire country and takes as point of departure that it is government's objective to maximise this function (Söderström, 1990:43). The goals set by central government are to ensure efficient and equitable provision of services in diverse regions of a country. Efficient provision would be the delivery of government output at least cost to the central government. Equitable provision requires a minimum level of service provided throughout, or limits on the variance of the level of service provided (Ferris & Winkler, 1990:158). To achieve these goals, central government sees subnational governments as its potential agents. Tanzi's (1995:297) definition of administrative decentralisation may be relevant in this case, since decentralisation here entails subnational governments which are agents of central government that receive centrally raised revenue, which must be spent according to central guidelines and controls. Decentralisation in this context may be analysed as a system of incentives and regulatory measures by which central government ("the principle") attempts to influence subnational govemments ("the agents"). This kind of decentralisation may, however, create an agency problem. For instance, decentralising authority to subnational governments raises the possibility that central and subnational objectives may diverge. When central government cannot monitor subnational governments' performance sufficiently, it may create an opportunity for subnational governments to pursue their own objectives at the expense of central objectives (Ferris & Winkler, 1990:159).

A description of how decentralisation can thwart central government's efficiency and equity objectives will be given as part of the arguments against decentralised allocation, stabilisation and distribution in sections 4.4.1 to 4.4.3 below. Additional institutional challenges to a decentralised system will be discussed in section 4.4.4.

4.4.1 Arguments against decentralised allocation

The fragmented localist model favours decentralised allocation and expenditure responsibilities based on the spatial dimensions attached to the costs and benefits of public goods and services and the argued efficiency of catering for differential preferences (section 4.3).

The first argument against decentralised allocation arises due to the spatial dimensions of the costs and benefits of certain public goods and services. Where the fragmented localist model assumes a perfect correspondence between the individuals who consume the public goods and the jurisdiction that provides it (Oates, 1972:34), interjurisdictional spillovers of costs and benefits occur in practice. Boadway *et al.* (1994a:11) states that spillovers occur when the beneficiaries of local expenditures do not coincide with the residents of the locality undertaking the expenditure. Tanzi (1995:303) sees this as being due to a mismatch between the spatial characteristics of goods and jurisdictions responsible. An example is of non-residents of an area that enjoy the benefits of public services provided in that area, such as parks, cultural, recreational and transport facilities or health care, without paying tax in that area or jurisdiction (Shah, 1991:31). Locally educated students who relocate also serve as an example. Residents of one jurisdiction can also be subject to the costs and negative effects of pollution which spills over from a neighbouring jurisdiction (Döckel & Somers, 1992:142 and Shah, 1990:4). Subnational governments have no incentive to take the spillover benefits or costs that they generate for non-residents into account. For them, the Pareto optimal solution is achieved when the marginal benefit received from consuming the local public goods is equal to the marginal cost, in terms of benefit taxes (Oates, 1972:35). Local jurisdictions will systematically under-provide those goods that have positive spillovers. They will only provide a limited road system, to the extent that the tax price reflects the preferences and benefits of local residents, as the benefit taxes do not take the benefits that non-residents receive, into account. Correspondingly, local jurisdictions will over-provide those goods with negative spillovers (Boadway *et al.*, 1994a:20, and Hewitt, 1991:84 and Shah, 1991:3). The result is that local decision making may be inefficient (Zodrow & Mieszkowski, 1986:356). The spillover problem can partly be solved if jurisdictions can compensate each other for the public goods and services used by non-residents (a reciprocity rule), especially if the services can be standardised. However, standardisation eliminates one of the basic reasons for decentralisation, namely tailoring public output to local preferences (Tanzi, 1995:303).

The second argument against decentralised allocation arises due to fiscal externalities. These are externalities which result from the fact that persons consuming local public goods in a jurisdiction do not consider that they consume those local public goods jointly with other residents in the locality, and that those other persons reduce their own tax burden (Boadway *et al.*, 1994a:12). Thus, depending on the fiscal capacity of the jurisdiction, the value of the public services and their tax cost will differ between jurisdictions. Some subnational governments have relatively higher income or are better endowed with natural resources and therefore have a greater ability to raise revenue than others (Shah, 1991:35). Residents of communities with lower than average fiscal capacities and higher than average costs face substantially higher tax burdens and/or lower levels of public services, than residents of communities with more resources and lower costs (Reschovky & Schwartz, 1990:235 and Sewell, 1996:145 and Döckel & Somers, 1992:147). The centralist model's goal of the equitable provision of public goods and services is not achieved.

The existence of both interjurisdictional spillovers and fiscal externalities implies that different governments at a given level are providing different net fiscal benefits (NFB's) to their residents (Boadway *et al.*, 1994a:12). The NFB is the difference between the benefits received from public goods and services and the tax price paid. The existence of differences in NFB's across jurisdictions means that the benefits of residing in one jurisdiction, relative to another, include not only the relative earning differentials between jurisdictions, but also the difference in NFB's between them. This leads to the relocation of people to the jurisdiction with the positive NFB (plus the sum of earnings). The migration is, however, inefficient, as the factor movement takes place in response to fiscal considerations alone (Shah, 1991:36), while economic efficient allocation would have involved only the earnings net of moving costs (Boadway *et al.*, 1994a:12). Zodrow and Mieszkowski (1986:356) add that the people who migrate do not take into account the additional fiscal externalities (adding to income but also congestion) that they generate in the process. Fiscally induced migration is also related to the following argument on mobility and interjurisdictional competition.

In sections 4.3.1 to 4.3.3 it was shown that mobility and competition are cornerstones of the Tiebout model and, along with the spatial dimensions of public goods, provide a rationale for decentralisation. Competition and mobility that may help to ensure efficient allocation may, however, also cause inefficiency and inequity in the internal common market. When subnational governments compete against each other to attract capital and business activity, they often fear that their policies might have adverse effects on investment and economic growth. As a consequence they may be reluctant to increase tax rates or introduce new taxes (Oates, 1990:7). A reason is that capital is perfectly mobile and will flow to the community with the lowest tax rate and a jurisdiction can cut rates in order to compete (Gordon, 1983:579). In the absence of retaliation by other jurisdictions, the competitive process may continue until the tax reducing jurisdiction finds that it gains less from attracting resources and income from its neighbours, than the revenue and public services that it loses due to the lower rates. When other jurisdictions also lower their tax rates to protect themselves from a loss of resources and tax base, the lower tax jurisdiction may want to regain its previous competitive advantage by reducing taxes further. The result is a downward spiral of tax rates (Musgrave, 1990:287). In equilibrium the tax rate in each community will be driven to zero. Another way to approach the argument is that due to the mobility of demand, jurisdictions will lose substantial tax revenues when they raise their tax rates (Gordon, 1983:579). Other jurisdictions should gain tax revenues of a comparable amount as the demand for the taxed commodity in these jurisdictions increases. However, the jurisdiction which raises the rates will ignore these offsetting gains and set the tax rate too low (Oates & Schwab, 1988:343). According to Break (1967:23-24) "The problem is that state and local governments have been engaged for some time in an increasingly active competition among themselves for new business....In such an environment government officials do not lightly propose increases in their own tax rates that go much beyond those prevailing in nearby states or in any area with similar natural attractions for industry.... Active tax competition, in short, tends to produce either a generally low level of state-local tax effort or a state local tax structure with strong regressive features."

Tax competition among jurisdictions may not only lead to sub-optimal budgets on the tax side (Zodrow & Mieszkowski, 1986:368-369)[48]. If subnational government is constrained in its choice of tax instruments, inefficient levels of public goods may be provided (Oates & Schwab, 1988:334).

Interjurisdictional competition not only influences public choices in terms of tax and spending, but also the standards of environmental quality. To attract investment and create new employment opportunities subnational governments may relax the standards of environmental quality (allow pollution) in order to reduce costs for businesses (Oates & Schwab, 1988:334).

Finally, mobility and competition may also increase inequalities. This is discussed in detail in section 4.4.3. The essence of the argument is that it would be difficult for a single subnational government to tax wealthy people for schools and health care for the poor (Söderström, 1990:43). The wealthy have the option to move to some other jurisdiction where they are not similarly taxed (Oates, 1990:3 and Wallich, 1992:62). Boadway *et al.* (1994a:12) state that the distribution inherent to lower level government budgets is a source of NFB differences. If the budget has an overall redistributive effect, high income

[48] Zodrow and Mieszkowski (1986) examine the constraints in the choice of tax instruments in the context of a choice between lump-sum taxation and property taxation. Reduced reliance on lump-sum taxation implies increased reliance on property taxation, which causes a reduction in the level of public services.

persons obtain a negative NFB and they will move to other jurisdictions. However, if one compares across jurisdictions, persons in low average income localities have systematically lower NFB's than those in high average income localities. This again leads to policies to attract the suitable and repel those that are not. As noted earlier in this section, the migration is inefficient because factor movements takes place in response to fiscal considerations alone and it is inequitable because identical persons in various jurisdictions are treated differently by the public sector (Shah, 1991:36).

Thus, central government provision of public goods and services may be necessary to account for the inefficiency and inequity of interjurisdictional spillovers and competition.

4.4.2 Arguments against decentralised stabilisation

The fragmented localist model favours a decentralised stabilisation policy based on differential preferences for decentralisation and the advantages of decentralised choice (section 4.3). The counter arguments rest on practical and institutional grounds.

The first is that subnational economies are more open than national ones. Prud'homme, 1995b:205) states that there are greater leakages to other regions due to over- or underspending[49]. They will pay the full cost of stabilisation with only partial benefits. The result is that subnational governments have few or no incentives to undertake economic stabilisation policies.

The second argument concerns the effect of the political cycle. Expenditures increase before subnational elections and taxes increase after elections. The subnational political cycle may not coincide with the business cycle and may run counter to central government's stabilisation policy (Prud'homme, 1995b:206).

Tanzi (1995:305) argues against decentralised stabilisation by contending that in many

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[49] See also the arguments for decentralised stabilisation in section 4.3.2. Sewell (1996:147) claims that substantial interregional leakages do not occur.

countries the basic macroeconomic need is not for Keynesian counter cyclical policy, but to bring about a fiscal adjustment that reduces chronic fiscal imbalances. In this respect, subnational governments are likely to rather aggravate macroeconomic problems, or to make the problems difficult to correct. Tanzi (1995:305-306) states that in several cases subnational governments ran deficits, increased their debt and occasionally forced central government to bail them out. In other cases, decentralising spending responsibilities without providing adequate financing sources have lead to relations that constrained central government's ability to manoeuvre. Subnational governments can make a strong case for grants, as national government requires them to perform certain functions, or comply with certain standards. Unfunded mandates create implicit claims for future grants or for soft budgets. Furthermore, finance for additional spending is provided primarily by those outside the jurisdiction and that reduces subnational accountability. If national government do not provide the resources beforehand they may eventually be forced to do so after the spending has taken place and debt has been accumulated. Occasionally, political forces have pushed subnational governments towards higher spending or lower taxes, in which cases national government had to step in to avoid the systemic and political implications of allowing subnational governments to become bankrupt[50]. In still other cases poor public expenditure management systems make it difficult to control spending (see section 4.4.4).

The solution to the shortcomings of decentralised stabilisation is a centralised stabilisation policy[51]. The alternative to avoid the possible macroeconomic problems will require a form of decentralisation based on a constitutional or legal contract that (a) sets out subnational government's obligations, (b) assigns sufficient resources to fulfil the decentralised obligations and (c) stipulates that subnational government will under no circumstances

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[50] Wildasin (1995:326) offers the solution that subnational governments should be made sufficiently small so that their budgets constraints are "hard". Breaking up a large urban government into a more fragmented system may make these bodies "small enough to fail".

[51] McLure (1995b:224) criticises this point in that most of the budget is by definition not suited for stabilisation policy. Counter cyclical stabilisation is inefficient given the lead time in most projects and the difficulty in forecasting macroeconomic conditions. In practice the most stabilisation will come from two sources: the built-in stabilising effects of certain taxes and transfer payments and autonomous changes in taxes and transfers.

receive any additional resources from central government (Tanzi, 1995:305).

In many countries, however, such a contract does not exist. These institutional problems of decentralisation are discussed in section 4.4.4.

Finally, it should be noted that if central government conducts stabilisation policy, its share of national taxes and expenditures must be sufficiently large in relation to total taxes and expenditures, as well as to gross domestic product to be able to carry through its policies (Prud'homme, 1995b:205). The assignment of taxation responsibilities will be discussed in section 4.4.6.

4.4.3 Arguments against decentralised redistribution

In section 4.3.2 the degree of income inequality in the internal common market was defined as the inequality in the distribution of private sector output, "adjusted" by the tax paid to and transfers received from government and the distribution of government output among households (Quigley & Smolensky, 1990:127). The fragmented localist model argues in favour of decentralised distribution, based on the efficiency of allowing the tax payers to choose the jurisdiction where the welfare policy matches their preferences. The differential preferences are based on Pauly's (1973) notion of spatial dimension for concern about the poor.

The centralist model uses a different concept of equity. The focus is not on the distribution of income preferred in a jurisdiction, but that all jurisdictions should have the same tax price for various activities (Söderström, 1990:45). Thus, a certain amount and quality of public services should be equally costly to the individual tax payer wherever he lives (Sewell, 1996:145)[52]. The following arguments are made in favour of national redistributive equity objectives:

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[52] Fiscal disparities can be measured in terms of community average tax-prices and the need capacity-gap, see Reschovsky and Schwartz (1990:237-238).

The first is that part of a country's income inequality and poverty is due to national economic conditions and policies (Ladd & Doolittle, 1982:328). The main cause of unemployment related poverty is national rather than local economic conditions. Similarly, the cause of poverty for the remaining poor reflects problems and social trends affecting the entire nation. It may be reasoned that as poverty can be viewed as a national concern it is appropriate that the primary responsibility for equity be assigned to central government. Only central government can ensure that all people are treated the same, regardless of where they reside in the nation (Boadway *et al.*, 1994a:25). Heynes (1995:152) and Oates (1990:4) emphasise that redistribution to improve the well-being of the poor is a matter of national concern and poverty relief, a national good.

In Brown and Oates' (1987) model described in section 4.3.3, the income levels of the poor enter as arguments in the utility functions of the non-poor. In this context, Ladd and Doolittle (1982) provide several counter arguments to Pauly's (1973) arguments for a spatial dimension of concern about the poor. Television and advanced communication counter the argument that only close and frequent contact with the poor makes the non-poor aware of their plight, thus placing a higher value on distribution to the local poor. Another possibility is that distribution on a national level may be more likely where romanticism about poverty leads to more concern about the distant poor, than the poor living nearby, whose problems are better known (Ladd & Doolittle, 1982:331). Tax payers may also place a higher value on reducing the worst cases of poverty in the country and may be less concerned about the less severe cases of poor people in their own jurisdiction (Ladd & Doolittle, 1982:331). From the presumption that poverty is a national concern, Ladd and Doolittle (1982:329) conclude that national financing may be preferable. The arguments in favour of national distribution and financing thereof are reinforced by the problems of taxpayer mobility and tax competition that may be associated with decentralised distribution.

The problems of taxpayer mobility and tax competition were mentioned in section 4.4.1. According to Söderström (1990:43) and Oates (1990:3) mobility and interjurisdictional competition provide taxpayers in jurisdictions where there are large concentrations of poor people, with incentives to move to other jurisdictions in order to avoid responsibility for financing public assistance (Ladd & Doolittle, 1982:329 and Prud'homme, 1995b:202). As a result the demands on the tax base increase while the size decreases (Heynes, 1995:152). The effect of mobility can also be explained in terms of Brown and Oates' (1987) model. As the income levels of the poor enter as arguments in the utility functions of the non-poor (Brown & Oates, 1987:308), the non-poor will continue to transfer income to the poor until the marginal utility to the non-poor, of a marginal dollar (rand) of disposable income to themselves, equals the marginal utility of another dollar (rand) transferred to the poor (Brown & Oates, 1987:310-311). The marginal utility (to the non-poor) of another dollar transferred to the poor depends on the "effectiveness" of the transfer to raise the per capita income of the poor (Brown & Oates, 1987:311). When the poor can move to jurisdictions with more distribution, it increases the number of poor and the cost to the non-poor to render the assistance. This reduces the non-poor residents' level of utility. The mobility of the poor may then result in a decline in the level of transfer payments (Brown & Oates, 1987:316). No jurisdiction would want its redistribution policy to get out of step with those of the other jurisdictions due to this threat of mobility. The result is a almost uniform redistribution policy, with insufficient overall distribution (Heynes, 1995:156). Brown and Oates (1987) show that in a general equilibrium framework, with two jurisdictions the mobility of the poor pushes the support levels of jurisdictions closer together, with a sharp decrease in the average payments across jurisdictions.

In the context of the administration of distribution, Ladd and Doolittle (1982:333) put forward an economies of scale argument against decentralised distribution. Economies of scale exist in the fixed costs of staff training programs. There is also a scale argument for data management and the resources to investigate fraud (Ladd & Doolittle, 1982:334). Subnational governments may not have the capacity (financial and human resource) to manage public assistance programs and it should be left to central government. These problems of a lack of institutional infrastructure are further discussed in section 4.4.4.

Finally, in as much as redistribution is a national public good, decentralising the administration may create a principal-agent problem (see also section 4.4.2). Programs administered by one level, but designed and financed by another, exacerbates the problem of managerial control. The possibility of different attitudes to the poor in different jurisdictions means that national and subnational objectives diverge and the jurisdictions may not operate the distribution system in the national interest (Ladd & Doolittle, 1982:333). Given the potential conflict between national policy makers and subnational administrators, formal systems are needed to monitor and control program implementation (Ladd & Doolittle, 1982:334). This could be costly and inefficient and may strengthen the case for national administration.

4.4.4 Institutional shortcomings of decentralisation

In addition to the arguments against decentralised allocation, stabilisation and distribution, set out in sections 4.4.1 to 4.4.3, some institutional shortcomings of decentralisation can be identified.

In section 4.3.1 the fragmented localist model was shown to assert that central government does not have the necessary information on subnational preferences, or lacks the right incentives to act on available information. As a consequence central government was held to tend to over- or underproduce public goods and services (Tanzi, 1995:300). The argument may be challenged on the grounds that in some countries with unitary fiscal systems, central government assigns officials to decentralised offices, where they closely follow decentralised developments and asses the needs. Tanzi (1995:301) states that the question should be if the information that the officials send back to the centre is better than, or inferior to that available to subnational policy makers.

Even if subnational decision makers have sufficient information, several other issues call the advantages of decentralisation into question. Prud'homme (1995b:208) argues that, especially in developing countries, it is not important to reveal the fine differences in preferences for public goods and services between jurisdictions. The main differences are in income and the need is to satisfy basic needs[53]. The potential welfare gains associated

[53] McLure (1995b:224) provides a counterpoint to Prud'homme's (1995b:208) criticism of differential preferences and his focus on basic needs. According to him it is not only differences in preferences between the jurisdictions that should be taken into account. There are also differences between the preferences of subnational governments and central government. Households may want to provide public goods and services to satisfy basic needs, where central government prefers military

with a better match of supply and demand are not large.

Furthermore, the efficiency of subnational governments depend on their decision making mechanisms. Wildasin (1995:324) points out that if, for example, entry to or exit from jurisdictions in response to their net fiscal benefits is constrained due to a dictatorial regime, the benefits of mobility and interjurisdictional competition are lost, and there will be no reason to presume that fiscal decentralisation enhances efficiency. Tanzi (1995:301) suggests that various incentives and political decision making mechanisms may determine whether subnational governments are more or less likely than central government to respond to local preferences. A local government that is not democratic may not have interest in meeting local needs. Where local elections take place, they may be decided on the basis of personal, tribal or political party loyalties (Prud'homme, 1995b:208). In many cases local elections are a rehearsal for national elections and may not accurately reflect local preferences. Criticism of the decision making mechanisms at subnational levels is related to the following arguments on the quality of subnational bureaucracies and governance.

The argument concerning the quality of subnational bureaucracies is that decentralisation may fail due to a lack of institutional infrastructure. Prud'homme (1995b:209) claims that central bureaucracies may be more efficient providers than subnational bureaucracies. The main reason is that central government bureaucracies are more likely to attract better qualified labour, as they may offer better careers, more promotion possibilities, less political intervention, a greater divergence of tasks and a longer view of issues. This view is shared by Tanzi (1995:301) who claims that talented individuals tend to choose fields that offer better opportunities for advancement over the long run. Furthermore, central government bureaucracies also invest more in technology, research, development and innovation (Prud'homme, 1995b:210). Decentralising, even when central government bureaucracies offer these advantages, can be costly. Decentralisation means a contraction in the centre's role and activities - the best people leave, networks are broken, the *sense* of public service is shaken and investments in research and development are

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spending. In such a case decentralised decision making may be more efficient.

sacrificed (Prud'homme, 1995b:210)[54].

Regarding the quality of governance, Prud'homme (1995b:208) contends that there is much less accountability than theory suggests. At a local level the electoral mandate may often be vague or inconsistent or both. Even if the elected officials wanted to fulfil it, they usually cannot, because of the mismatch between their promised spending and the available resources. A lack of institutional infrastructure becomes relevant in that the elected officials lack incentives to fulfil their mandate. Some of the local politicians do not expect to run for reelection or know that their reelection will not depend on their local performance. There may further be a principal-agent relationship between the elected official and the local bureaucrats (Prud'homme, 1995b:208). Especially in developing countries the local bureaucracy may be unresponsive, poorly motivated and sometimes poorly qualified, and also have reasons to pursue their own agenda.

The arguments concerning the quality of subnational bureaucracies are often raised in conjunction with those about corruption. Tanzi (1995:301) and Prud'homme (1995b:211) provide several reasons why corruption may be more common at the local than at the national level, especially in developing countries. A main reason is that the officials and citizens live and work alongside each other in local communities. Local bureaucrats spend their career in the same location and the contiguity brings personalism into relationships. The result is that local politicians and bureaucrats may to be more subject to the pressure of local interest groups - decisions are made in favour of particular individuals or groups. Often, corruption requires cooperation between politicians and bureaucrats. At local level that may be easier, as the distinction between them may be less severe. Furthermore, local officials usually have more discretion than national officials, which can lead to corruption[55]. Monitoring and auditing procedures are usually better developed at national than local level, while pressure from the media would also be a greater disincentive at the

[54] Wildasin (1995:327) argues that decentralisation in itself does not create or destroy administrative talent. Administrative skill have to be decentralised along with public sector functions. Such a reallocation, and rethinking the reward structures, may take time.

[55] Wildasin (1995:327) states that it may be difficult for local officials to engage in significant corruption schemes, whereas a corrupt central government minister can do much more harm.

national level.

In the last instance, the institutional arguments against decentralisation express doubts as to whether subnational governments are capable of handling the increased flows of revenue which they receive to finance their functions. Tanzi (1995:303) emphasises that good public expenditure management systems must be in place (this was discussed in section 4.4.3 as part of administrating distribution). Efficient public expenditure management systems include budget offices that can forecast expected revenue and spending as well as accounting systems that allow for the monitoring and control of cash flows. The systems must also provide control over other commitments. The skills required to perform these tasks are scarce, especially in developing countries and especially at the local level (Tanzi, 1995:304). The problems of soft subnational budgets were discussed in section 4.4.2. These may lead to financial difficulties and misallocation of resources in the long run. The potential benefits of decentralisation may be reduced or even disappear if the minimum public expenditure management infrastructure is not in place (Tanzi, 1995:304).

Against the background of the arguments against and disadvantages of decentralisation, the assignment of expenditure and taxation responsibilities in the centralist model will be examined in the following sections.

4.4.5 The assignment of expenditure responsibilities

Many of the arguments for centralising expenditure responsibilities have been set out in section 4.4.1. Although section 3.3.1 argued that tailoring outputs to residents' preferences in a decentralised system may enhance efficiency, some costs and benefits may spill over into neighbouring jurisdictions, as argued in section 4.4.1. When substantial spillovers to other jurisdictions cannot be handled in some other way (for example a reciprocal agreement), central government provision is necessary to account for the benefits of the public goods and spillovers. That ensures the optimal provision of public goods and services and the maintenance of an efficiently functioning internal common market (Boadway *et al.*, 1994a:30). Section 4.4.1 illustrated how interjurisdictional competition may lead to sub-optimal budgets on the tax side, inefficiently lower provision of public goods and services and to inefficient factor movements in response to fiscal considerations alone. These factors may suggest greater centralisation. Sections 4.4.2 and 4.4.3 provided arguments in favour of central responsibility for stabilisation policies and for national redistributive equity objectives (Shah, 1990:5). Spending aimed at stabilisation and spending that can be viewed as redistribution in kind, should be left to central government. This view implies a very limited role for subnational government - only those public goods and services that they can finance with benefit taxes (Söderström, 1990:43).

4.4.6 The assignment of taxation

Although decentralisation may possibly improve allocation on the expenditure side, despite spillovers and inefficient competition, Tanzi (1995:310-311) contends that the efficiency gains may be lost when the financing of the expenditure is distorted. Before the assignment of specific taxes in the centralist model is discussed, the following economic principles of assigning taxes to levels of government can be set out:

(a) Efficiency in the internal common market. When assigning taxes to different levels of government it should allow the unimpeded flow of resources among jurisdictions. In contrast to this principle section 4.4.3 illustrated that subnational tax competition may lead to lower taxes on mobile factors of production, which may result in inefficiency and inequity. Efficiency may be improved when subnational governments recognise that resources are mobile and that the uncoordinated setting of taxes could cause distortions.

(b) National equity. The tax structure is the main instrument used for redistribution. In as far as equity is seen as a national objective (section 4.4.3) it must be ensured that decentralised taxes do not interfere with that objective. A possible problem is that tax competition in a decentralised system may lead to less distribution than what is nationally preferred.

(c) Administrative costs. In principle, taxes should be administrated efficiently, thus, when assigning taxation responsibilities, decentralisation should not unduly increase the costs of collection and compliance. With decentralisation of certain types of taxes, the possibilities for evasion and avoidance may increase.

(d) Fiscal need. The final principle of tax assignment is that revenue means should be matched as closely as possible to revenue needs. This may facilitate accountability. Thus, tax instruments intended to further specific policy objectives should be assigned to the level of government that has the responsibility for such a service (Boadway *et al.*, 1994b:7-8)[56].

Against the background of these principles of assigning taxes to different levels of government, the vertical structure of the revenue system will be discussed next. The sub-section considers Musgrave's (1983) general guideline for the assignment of revenue instruments to levels of government.

4.4.6.1 Progressive taxes

Tanzi (1995:312) states that if government regards income distribution or stabilisation as important objectives, progressive taxes should be centralised. The arguments concerning redistribution were outlined in section 4.4.3. Lower levels of government are characterised by mobile populations (Shah, 1991:13). Decentralised ability to pay taxes will distort residents' choice of community and may lead to an inefficient pattern of migration. A citizen will be able to lower his tax price by moving to a richer community (Goodspeed, 1990:83). The individual's marginal private cost of consuming public services in a wealthier community will be less than the marginal social cost, resulting in horizontal inequity (Goodspeed, 1990:84 and Sterks & De Kam, 1990:70). Hewitt (1991:85) adds that such fiscal externalities could have a severe impact on the economic health of a region. For example, in many less developed countries urban-rural disparities in income

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[56] Note that the first three principles of assigning taxes tend to favour centralisation, where the fiscal need principle stands in clear contrast. It proposes that revenue means should match revenue needs and thus favours some degree of decentralisation. The balance between such opposing principles is discussed as part of the cooperative localist model and intergovernmental fiscal relations in section 4.5.

and wealth are pronounced and may be accentuated when already wealthy urban local governments stand to benefit most from an increase in local government taxing powers (World Bank, 1990:73). Centralising progressive income taxes can thus assist national government in fulfilling the objective of national equity (Boadway *et al.*, 1994b:9). It may also ensure that administrative and compliance costs are minimised and may also assist government in the management of macroeconomic policy objectives (Boadway *et al.*, 1994:32).

The same type of arguments in favour of centralisation applies to corporation income taxes. Boadway *et al.* (1994:10) views a corporate tax partly as adjunct to personal tax, or as a withholding device for personal tax. To this extent it is more optimally levied at the same level as the personal tax, so that it can be easily integrated. McLure (1995a:320) adds that corporate profit is a poor foundation for benefit taxation. Moreover, when the tax rates are not uniform across the jurisdictions they distort the location of economic activity[57]. In as much as corporate tax is a device to obtain revenues from foreign companies, it is best levied at the national level. Administrative simplicity also favours the centralising of corporate tax. Many corporations operate in a number of jurisdictions which would make decentralised administration complicated and costly.

4.4.6.2 Taxes on mobile bases

In general, taxes on mobile tax bases should not be decentralised. Decentralising such taxes can also distort the locational pattern of economic activity (Oates, 1990:5, Shah, 1991:13 and also Gordon, 1983:579). Boadway *et al.* (1994:32) claim that in the case of capital taxes, taxes on wealth inheritances and bequests, mobility considerations are paramount. Subnational taxation of capital will be inefficient because of tax competition among jurisdictions or it will lead to distortions in the allocation of capital. Compliance and collection costs and possibilities for evasion make the preferential treatment to capital generated within a jurisdiction difficult. The mobility argument may also apply to sales

[57] To argue in favour of uniform tax rates across jurisdictions, in order to limit the distortion of the location of economic activity, also means to eliminate tax competition and in that way the efficiency rationale for decentralisation.

taxes where citizens may be inclined to shop in the lower rate jurisdictions (Tanzi, 1995:313). Destination based value added taxes may also not be suited for decentralisation as they require border checks between jurisdictions, which increase the administrative burden.

4.4.6.3 Taxes on unequally distributed tax bases

The use of tax bases that are unequally distributed across jurisdictions ought to be centralised (Oates, 1990:5 and Shah, 1991:13). Giving subnational governments the right to tax resource rents could lead to NFB differentials across jurisdictions (Boadway *et al.*, 1994a:32). This will result in inefficiencies and inequalities as discussed in sections 4.4.1 and 4.4.3. Specifically taxes on deposits of natural resources should be centralised to avoid geographical inequalities and to prevent allocative distortions (Oates, 1990:5). McLure (1995a:320) adds that subnational governments should, however, be allowed to collect taxes and charges that compensate them for the environmental damage and other public costs related to the exploitation of the resources in their area.

Taking the first three guidelines for tax assignment into account, Oates (1990:5) concludes with Musgrave's (1983) fourth guideline to recommend user taxes and fees for decentralisation.

4.4.6.4 User taxes, fees and property taxes

In principle, user taxes and fees will not distort incentives for movements among jurisdictions. These taxes are efficient because they are charged for publicly provided goods and services, where the benefits accrue to individuals within the jurisdiction (World Bank, 1990:74). It is also appropriate where the services in question are not provided for redistributive purposes. Many local services are of this sort, including water, garbage, local utilities and recreational facilities[58]. Pricing for public services with user charges also

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[58] This does not imply that the pricing is redistributively neutral. Many of the services are necessities that are consumed by low-income persons, but then redistribution may be better left to higher levels of government which have access to income taxes in order to promote equity (Boadway *et al.*,

helps promote efficient use of the services (Boadway *et al.*, 1994b:17). Oates (1990:6) states that it provides the right cost signals to residents for the determination of levels of public services.

Boadway *et al.* (1994a:33) contend that the immobile nature of property makes it ideal to tax at lower levels of government, especially municipal governments (see also Shah, 1991:13). Property values vary from jurisdiction to jurisdiction, but because the property is immobile, the tax causes no reallocation and economic inefficiency (Hewitt, 1991:85). Possible problems and difficulties to note include the assessment of the property values to determine the tax liability. Secondly, while it is true that old structures are immobile, tax competition may mean that new structures will not be built in jurisdictions that tax them more than other jurisdictions do (Tanzi, 1995:312). McLure (1995a:320-321) claims that when land ownership is concentrated, a property tax is unlikely to be an important source of revenue.

Taking into account the principles of assigning taxation and the preceding discussion of the assignment of the four categories of taxes, a general prescription for the vertical tax structure may be suggested. Oates (1990:6) recommends that the central government should employ progressive redistributive taxes, while decentralised levels of government should use relatively immobile tax bases or should rely on user charges (see also World Bank, 1990:74). Intermediate level governments, like provinces, could use a combination of the above recommendations, although potential mobility still places some constraint on tax policy (Shah, 1990:9).

In summary, the centralist model argues that complete fiscal decentralisation may not be a panacea for all instances of government failure. In practice society can only come closer to achieving efficient and equitable outcomes through centralising certain functions and decentralising others. Oates (1990:6) states, with reference to the concept of fiscal federalism, that the issue is one of the degree of decentralisation or centralisation. Döckel and Somers (1992:142) adds that the degree of centralisation lies on a continuum scale.

1994b:17).

The opposite ends of the continuum being on the one hand the making of all meaningful fiscal decisions at the national level, and on the other hand where subnational governments are predominant.

On the continuum of the degree of centralisation a compromise exists in the form of the cooperative localist model of fiscal federalism. This is discussed in the next section.

4.5 The cooperative localist model

The cooperative localist model (Söderström, 1990) attempts to establish a compromise between the ideals of the fragmented localist model and the centralist model. This is done by identification of the level of decentralisation appropriate for each function of government (Wildasin, 1995:325). The assignment of functions should:

- secure an efficient provision of public goods and services and prevent free riding;
- assure a fair distribution of shared tax bases and of revenue therefrom among jurisdictions;
- provide a fair interpersonal distribution of tax burden among residents of each jurisdiction;
- leave the efficient flow of taxes and commodities in the internal common market unaffected, and
- permit a diversity of fiscal structures consistent with voters' preferences.

In terms of the sequence of assignment of functions, expenditure assignment should precede tax assignment, because tax assignments should be guided by expenditure requirements at different levels (Shah, 1991:2). The World Bank (1990:73) recommends that the proper mix of subnational government revenues should depend in part on the expenditure responsibilities that are assigned to subnational government[59]. The following assignment of expenditure and taxation responsibilities can thus be suggested.

4.5.1 The assignment of expenditure responsibilities

In section 4.3, arguments in favour of the decentralisation of expenditure responsibilities were based on the spatial dimensions of public goods, differential preferences and mobility. The counter arguments referred to the negative effects of spillovers and interjurisdictional competition along with national redistributive equity objectives as arguments in favour of a role for central government. In the cooperative localist model the aim is to draw on the efficiency of catering for decentralised differential preferences while minimising the possible negative effects of spillovers and interjurisdictional competition. The consequence should be a mix of more efficient allocation, spillovers and competition. Central government, for example, can be responsible for defence, foreign affairs, international trade and relations, criminal law, the control of the money supply, national roads and highways and civil aviation and national environmental issues (Boadway *et al.*, 1994a:26, Wallich, 1992:62 and Shah, 1990:4). This may contribute to the optimal provision of public goods and services where the costs and benefits accrue nationally and to the achievement of national redistributive equity objectives. Subnational government for example, can be responsible for public services such as health care and insurance, education, welfare services, family and child support services, state transportation and communication services and local utilities and municipal services. The focus should be on expenditure responsibilities where the costs and benefits accrue regionally or locally (Boadway *et al.*, 1994b:2). In that way the efficiency of decentralisation may be realised, while minimising the possible negative effects of spillovers and interjurisdictional competition.

The prescriptions for the assignment of expenditure responsibilities as indicated above are broad and not seamless. Decentralising some responsibilities causes some degree of

[59] Tanzi (1995:310) argues that for a successful centralised-decentralised mix the spending and revenue decisions must be made at the same time.

inequity, while centralising others is less efficient. That may be compensated for in the system of intergovernmental fiscal relations. The assignment of expenditure responsibilities may also depend on the revenue that subnational governments are able to generate. The assignment of taxation responsibilities is discussed in the following section.

4.5.2 The assignment of taxation

Once expenditure assignment has been agreed upon, the assignment of revenue should be done so as to provide a reasonable matching of expenditure needs (Shah, 1991:12). Boadway *et al.* (1994b:4) claim that the case for decentralising expenditure responsibilities is stronger than for decentralising revenue raising. While decentralising expenditure responsibilities may lead to more efficient service delivery, it may not be clear that there are equivalent efficiency advantages from decentralising revenue raising. Section 4.4.6 presented arguments in favour of centralising progressive taxes, and taxes with mobile or unequally distributed bases. The discussion suggested that only user taxes, fees and property taxes should be allocated to subnational governments. These arguments are not repeated in this section. Instead, some options for expanding subnational tax capacity beyond the general guidelines are explored. The possibility of using progressive income tax at subnational level is explored first.

The orthodox view, like Musgrave's (1983), is that income taxes should be left to higher levels of government. Goodspeed (1989) challenges this view by using a general equilibrium analysis. His model's results show that relative to a head tax, a local income tax causes inefficient allocation of people to communities, but the aggregate welfare loss from migration is relatively small for the model's benchmark parameter values. This may be due to the relatively small budget share of the local public good compared to the share of housing in the individual's budget. Goodspeed (1989:340) maintains that even if local governments increase their expenditure to ten percent of an individual's budget, the aggregate welfare loss attributable to migration is likely to remain insignificant as long as people continue to spend twenty five to thirty percent of their income on housing. The model also shows that when local governments use ability-to-pay taxes, it would result in some distribution, relative to head taxes, without significant efficiency consequences resulting from the migration (Goodspeed, 1989:340). This theoretical analysis suggests possibilities for the use of progressive income taxes at the subnational level.

Goodspeed (1990:85) argues that it may be necessary to recognise that the relationship between national and subnational taxes differs among countries. Central government, for instance, can collect the tax and then share the receipts with state and local governments based on a predetermined formula. In Germany, for example, this process is centralised. The local income tax portion amounts to a grant that tries to smooth income disparities between regions. Grants will be discussed as part of intergovernmental fiscal relations in section 4.6. Furthermore, the decentralised option is to give subnational governments control over the tax base and the tax rate. In between the latter two options, the local and national levels can use the same tax base, but local government can set its own rates, as it is done in Belgium, Canada, Sweden, Denmark and Norway.

Sterks and De Kam (1990:71) argue that the mobility drawback of taxes based on income and wealth are less than mentioned in the general arguments. For residents the decision to move may be a drastic one. By moving, households miss the benefits of better service levels in high tax jurisdictions. Sterks and De Kam (1990:71) recommend that central government increase the scope for local taxation through a municipal surcharge on personal income tax. Oh (1990:60) refers to the use of such surcharges as the overlapping approach, which makes it possible for each level of government to share tax bases simultaneously. In this way, subnational governments gain access to the income elastic and fast growing tax revenue of central government. This has the added advantage that the surcharge method saves tax collection and compliance costs (Oh, 1990:61).

When it comes to using indirect taxes to expand subnational tax capacity there are arguments for and against it. Boadway *et al.* (1994a:33) claim that it would be difficult to decentralise a value added tax (VAT). The use of a destination basis for a VAT (taxing final consumption) requires custom houses at subnational borders and impedes the free flow of goods and services (Boadway *et al.*, 1994b:12). The system of crediting under a

VAT would require that cross-border transactions be accounted for, in order to be able to credit taxes paid on earlier stages of sales which cross the borders of the jurisdiction. This could create significant administrative problems, especially when different subnational governments have different tax rates and different sets of exemptions.

An alternative to decentralising a value added tax would be to decentralise a single stage retail tax. The base would, however, be narrower than optimal along with the problems of evasion. The inability to exempt taxes on capital purchases and exports leads to cascading the tax through purchases of taxed inputs (Boadway *et al.*, 1994a:34).

Sterks and De Kam (1990:70) add to this view that taxes based on spending ought not to be levied at subnational level because they also apply to tax payers from other localities and contribute to the problem of cross-border shopping. Gordon (1983:578) states that decentralised decision making could ignore the utility loss of non-residents who pay the taxes. To the extent that non-residents pay the taxes, as with sales taxes or wage taxes on non-residents, these taxes may be used excessively when taxing authority is decentralised (see also negative spillovers discussed in section 4.4.1). Furthermore, the effects on the distributional pattern of income may be ignored. For example, a sales tax increase may be paid equally by rich and poor residents, but only poor non-residents may have taken the time to travel in search of a lower price.

Excise taxes have been claimed to be better candidates for decentralisation. If specific excise taxes are levied on a destination basis they may become a form of taxes on residents that are unlikely to be significant enough to cause migration. Boadway *et al.* (1994a:34) mention cross-border shopping as an efficiency concern with the use of selective excise taxes at a decentralised level, but does not consider this to preclude decentralisation. It could, however, restrict the ability of subnational governments to set widely differing rates. Another problem arises from the fact that excise taxes distort the market for the goods being taxed. This distortion may be significant if subnational governments rely on excise taxes for a significant part of their revenues (Boadway *et al.*, 1994b:14). Decentralising excise taxes may have administrative advantages. Boadway *et al.* (1994b:15) claim that it has fewer problems than some other taxes, for example eliminating taxes on exports and imports are less of a problem. Collection costs may not be excessively high for either the seller or the government. Enforcement should not be more of a problem than with other taxes, especially if the tax rates are neither too high nor too varied across the jurisdictions.

In section 4.4.6 user taxes and fees and taxes on property were mentioned as sources of revenue for subnational government. Sterks and De Kam (1990:71) argue that property taxes may not necessarily induce migration because costs and benefits of local public services will be (partly) reflected in property prices, and thus relative prices would not be affected. Houses in high tax municipalities will ceteris paribus have lower prices, due to capitalisation. When property taxes go up, in the case of full capitalisation, it may not be desirable to move because the additional tax has already been "paid" by a reduction in house prices (Hewitt, 1991:85). Boadway *et al.* (1994b:16) add that many benefits of local public services accrue to property owners, so the tax may be seen to be a sort of benefit tax.

In summary, there are arguments in favour of centralising certain taxes, but also for decentralising others. It was shown that the possibilities of expanding subnational tax capacity beyond the general guidelines are few. Subnational tax instruments are by and large limited to user taxes and fees, property taxes and possibly excise taxes. Boadway *et al.* (1994a:34) state that the more expenditure responsibilities are decentralised to subnational governments, the more tax authority ought to be decentralised, despite the disadvantages of doing so. For the cooperative localist model to realise the advantages of decentralising the functions described in the previous section 4.5.2, subnational governments must have their own sources of revenue. Subnational governments require a measure of fiscal autonomy to be able to cater for differential preferences in their jurisdictions (section 4.3.5). The disadvantages of decentralising tax authority may be compensated for in the system of intergovernmental fiscal relations (section 4.5.4).

4.5.3 The assignment of borrowing powers

In section 4.4.2 it was pointed out that fiscal decentralisation may contribute to macroeconomic instability. Tanzi (1995:305-306) discussed the incentives for subnational governments to increase spending and accumulate debt. In several countries the borrowing powers of subnational governments have contributed to a deterioration in the fiscal situation (Tanzi, 1995:309). There have also been the emergence of hidden debt where debts have not yet shown up in the available statistical information (Tanzi, 1995:304).

There are a number of reasons for the problems associated with allowing substantial subnational borrowing. One reason is the mismatch between subnational revenue assignments and expenditure functions. The need to borrow goes hand in hand with a lack of incentives against borrowing. Borrowing gives immediate benefits, while the costs are paid later, perhaps by a different administration. In many cases there is also the implicit assumption of central government assistance which leads to soft budgets and excessive borrowing. Tanzi (1995:309) identifies a lack of public expenditure management systems to monitor and register debt obligations, and a lack of good subnational budgetary systems to prepare projections of revenue and expenditure as further reasons. Finally, the number of ways that money can be "loaned" also encourages borrowing and its problems. Loans may come from the national government, the central bank, national or foreign banks, provincial banks, the capital market, pension funds, suppliers, arrears on civil servants' salaries or on payments to utilities.

In the cooperative localist model the causes of the problems of substantial subnational borrowing are addressed similarly as described in section 4.4.2. It is recommended that subnational borrowing can only be allowed within the framework of strict rules and a constitutional or legal contract between national and subnational governments. These should spell out subnational governments' obligations when borrowing, and stipulate that central government will never bail them out.

In conclusion, it may be stated that even the best combinations of centralisation and decentralisation will generate some inefficiency and inequity. Intergovernmental fiscal relations may be necessary to ensure the efficient and equitable functioning of the fiscal system.

4.5.4 Intergovernmental fiscal relations

The goal of intergovernmental fiscal relations is to mitigate the disadvantages of decentralising expenditure and taxation responsibilities. Boadway *et al.* (1994a:38) state that the aim of intergovernmental fiscal relations is to replicate the financial consequences of a unitary state (efficiency and equity), while at the same time allowing for the advantages of fiscal decentralisation.

The economic justification for intergovernmental fiscal relations includes efficiency (spillovers, common market arguments and differential net benefits) and equity (fiscal gap, differential net benefits and redistribution) and also to a minor degree, stabilisation objectives. The aim of intergovernmental fiscal relations can be achieved by firstly correcting the vertical imbalances of expenditure responsibility and tax capacity among levels of government, and secondly by reducing horizontal differences between rich and poor jurisdictions to permit a more equal level of expenditures among jurisdictions (World Bank, 1990:76).

The role of intergovernmental fiscal relations may be illustrated as follows: Expenditure responsibilities may be decentralised for its efficiency advantages, but may at the same time generate interjurisdictional spillovers. Central government can use the system of intergovernmental fiscal relations, in the form of matching or conditional grants, to encourage a subnational government to consider spatial externalities and to provide more adequate amounts of services (Ferris & Winkler, 1990:160). In this way, inefficiencies arising from the spillovers are minimised. Shah (1991:31) states that open-ended conditional matching grants (section 4.5.4.2.1) are often the most appropriate. The extent of cost sharing by the higher level of government should be consistent with the degree of the spillover.

In the case of interjurisdictional competition, the role of intergovernmental fiscal relations can be seen as one of fiscal harmonisation.

On the tax side, it may be more efficient for central government to collect tax revenues on behalf of subnational governments and to then turn the funds over to them allowing them to carry out their expenditure responsibilities (Boadway *et al.*, 1994a:37). Central government could collect tax revenues at lower administrative cost as well as with less excess burden, than when subnational government collected the revenues (Ferris & Winkler, 1990:160). If the size of the revenue transfers is contingent on the fiscal capacity of the jurisdiction, it can guarantee that all jurisdictions have the minimum fiscal capacity required to provide services that are consistent with central government objectives. In order to overcome the problems associated with the fiscal gap that arises from inappropriate expenditure and tax assignment, and the limited and unproductive tax bases available to lower levels of government, unconditional grants (section 4.5.4.2.2) or revenue sharing (section 4.5.4.2.3) on an origin principle are appropriate (Shah, 1991:31). That means that the revenue is shared on the basis of the jurisdiction from which it originated. Subnational governments may then be able to provide comparable services to all residents and NFB differentials would not arise. Shah (1991:36) further advocates fiscal equalisation grants to reduce NFB differentials across jurisdictions. Such grants transfers would be from an interstate revenue pool which provides both negative and positive equalisation grants.

On the expenditure side, intergovernmental fiscal relations take the form of minimum standards and mandates (section 4.5.4.2.4). Mandates are central government expenditure directives to the subnational governments, for specific services or purposes (Ferris & Winkler, 1990:161). Requirements such as uniformity and portability, for example in areas such as health, education and welfare, improve the free flow of goods, services, capital and labour in the internal common market (Boadway *et al.*, 1994a:39).

Thus, intergovernmental fiscal relations allow government to rely on normally more efficient centralised taxation, while still availing itself of the advantages of decentralised expenditure decisions (Hewitt, 1991:83). The following section discusses the factors that influence the choice of intergovernmental fiscal relations.

4.5.4.1 The choice of intergovernmental fiscal relations

Intermediate decentralisation, as recommended by the cooperative localist model, involves a relative mix of intergovernmental fiscal instruments. Before the different types of instruments are discussed, some of the considerations that influence the choice of fiscal arrangements are briefly outlined.

Firstly, given that central government have a number of objectives that it might wish to achieve through decentralisation, certain forms of decentralisation may be more appropriate than others (Ferris & Winkler, 1990:161). For instance, central government may wish for intergovernmental relations to be equalising, or it may want to use them to influence the way in which subnational governments behave.

If the objective is an equalising system that reduces NFB differences, to achieve fiscal efficiency and equity, Boadway *et al.* (1994a:43) maintains that it influences the choice of intergovernmental fiscal instruments in the following ways. The central government will want to equalise tax capacity. One way is to use a formula to determine the equalising grant. The grant owed to a subnational government is then the difference between the revenue that the subnational government can raise by applying the national average of the subnational tax rates to its own bases, and what can be raised by applying the national average tax rates to the national average tax bases (Boadway *et al.*, 1994a:43). Ferris and Winkler (1990:162) support the use of revenue transfers to alter the fiscal capacity across subnational governments or to increase the efficiency of taxation.

If the objective is to influence the outcome of subnational government choices and performance, it also influences the choice of fiscal instruments used. Ferris and Winkler (1990:162) recommend that when central government wants to account for benefit spillovers to improve the efficiency of subnational expenditure decisions, a matching grant may be appropriate. It is then restricted to programmes that generate the externality. The amount is determined by the ratio of external benefits to those realised within the jurisdiction. In this way the central government may induce subnational government to provide the public services at higher levels than they otherwise would (Boadway *et al.*, 1994a:43). Thus, through mandates accompanied by selective subsidies central government accommodates the diverse preferences of subnational governments, while at the same time ensuring that a minimum level of services is provided (Ferris & Winkler, 1990:162).

The shortcoming of intergovernmental fiscal instruments is the possibility of opportunistic behaviour on the part of the subnational government (Ferris & Winkler, 1990:162). Central government's ability to monitor and enforce sanctions leads to another consideration that influences the choice of fiscal arrangements, namely the information requirements.

In terms of the informational requirements the revenue transfer approach is the least demanding. The central government can distribute revenues according to the fiscal capacity or need to the different subnational governments (Ferris & Winkler, 1990:163). The informational requirements are more substantial when the central government is concerned with how the subnational government spend their resources. When using mandates and incentives, the central government will need to gather information to monitor subnational performance. Gathering the information is dependent on the nature of the service. For certain public services the production and cost functions may not be well known and the outputs difficult to measure. When the information costs of intergovernmental relations are significant, central government may be most likely to use closed-ended grants in the hope that localised collective choice processes will help monitor subnational service delivery performance (Ferris & Winkler, 1990:164).

The final consideration that impinges on the choice of intergovernmental fiscal arrangements is the governance of subnational governments. An effective subnational government may be run by public service professionals, who are held accountable by their constituents. In such a case subnational government decisions reflect the constituency's preferences and the use of unconditional grants adds to the benefits of decentralisation. If subnational governments are no more efficient than the central government, the more centralised form of intergovernmental fiscal relations, like mandates, becomes more appropriate (Ferris & Winkler, 1990:164).

Now that the factors that need to be taken into account in the choice of inter-governmental relations have been examined, the different instruments will be examined in more detail.

4.5.4.2 The types of intergovernmental fiscal instruments

4.5.4.2.1 Conditional grants

The funds of conditional grants have to be used by the subnational government in specified ways. The grants can be specific or block. Specific grants must be used on a specific programme. This can require that the subnational expenditure programme must satisfy certain design features. Block grants are for more generally defined areas (Boadway *et al.*, 1994a:36).

Conditional grants are used to induce subnational government to provide more adequate amounts of services[60] (World Bank, 1990:76). Conditional grants are appropriate as a means of subsidising activities which have a high priority to a higher level government, but are given low priority by a lower level government (Shah, 1991:22). This is particularly so when the national objectives of giving fiscal assistance to subnational government is implemented through the programmes of many different departments, for example education or health. The different departments do not want subnational governments to shift their programme funds towards expenditure in other areas (Shah, 1991:23, 25). The grant is usually tied to a specific subnational activity that involves external benefits to other jurisdictions. The grant should be equivalent to the proportion of benefits that spills over into the jurisdictional area of the higher level of government (Döckel & Somers, 1992:147 and also Bird & Wallich, 1993:53). For example, with conditional non-matching block grants it can be ensured that funds are spent in a national department's area of interest, but do not distort subnational priorities among alternative activities, or induce inefficient

[60] Note however, that the aim is to provide subnational government with sufficient funds (own source revenue and grants) to deliver the services. To attempt to equalise outlays in per capita terms ignores differences in local preferences and undermines the basic rationale for decentralisation. It would also discourage subnational revenue raising effort and expenditure restraint (Bird & Wallich, 1993:52).

allocations in that expenditure area.

Conditional grants are "matching" if the magnitude of the grant is a proportion of certain subnational expenditures (Boadway *et al.*, 1994a:36). The recipient must match the funds received to some degree. For example 50: 50 or 66,3: 33.3 (Shah, 1991:25). Thus, with a grant of *m* percent of cost, the effective cost to the subnational government is (1-*m*). To ensure maximum total expenditure on the specific service, the optimal way to allocate the given total transfer among jurisdictions will be inversely to the price elasticity of the local demand for the service (assuming no cross price elasticity effect) (Bird & Wallich, 1993:53). Furthermore, the grant should be inversely correlated to the income level of the recipient government. The idea is to set the price of the service (1-*m*) to each subnational government in such a way as to neutralise differences in capacity by varying the matching rate (*m*). The higher the income elasticity, the higher the matching rate needed for low income recipients. The higher the price elasticity, the lower the matching rate needed to achieve a given level of total expenditures (Bird & Wallich, 1993:54). The matching grants thus lower the price that subnational governments face in delivering services (Ferris & Winkler, 1990:160), which may induce them to internalise the benefits provided to other jurisdictions into the local decision making calculus (Gordon, 1983:582, Oates, 1990:7, and also Hewitt, 1991:85). The result may thus be a double effect identified by Shah, (1991:25-26). In his example on transportation services, more transportation is acquired. The income effect that is due to the subsidy gives the community more resources, and some of it goes towards obtaining more transportation. The price (or substitution) effect also stimulates the acquisition of more transportation services, since the subsidy reduces the cost per unit to the community.

Finally, grants may be open-ended or closed-ended. The magnitude of open-ended conditional grants depends on subnational expenditure, without any upper limit, where closed-ended ones have an upper limit (Boadway *et al.*, 1994a:36). Central government may use open-ended matching grants to encourage subnational governments to consider spatial externalities. Closed-ended matching grants are appropriate to ensure that subnational governments meet minimum service levels for equity purposes (Ferris & Winkler, 1990:160). Shah (1991:27) points out that grantors (central government making the grant) usually prefer closed-ended matching grants as they are then better able to control their budgets.

Although conditional grants may correct inefficiencies arising from spillovers, they may not be appropriate to address problems arising from inadequate fiscal capacities among subnational governments (Shah, 1991:26). For instance, in the case of grants with a matching requirement, jurisdictions with ample resources can afford to meet the matching requirements and can in that way acquire a substantial amount of assistance. Jurisdictions with more limited capacity may not be able to do thus[61]. Another possible problem with conditional grants includes the distortions caused by the significant transfer of resources. The aid is often only available for a few activities, which results in excessive spending in those areas, while others are underfunded. Thus, local priorities are distorted. It is often also the case that capital outlays are subsidised while operating costs are not - which results in the selection of alternatives that may be too capital intensive to be at a least cost.

In should be noted that on the continuum of decentralisation-centralisation mentioned in the conclusion of section 4.5, conditional grants tend towards centralisation. It is to provide subnational governments with funds to realise central government's equity objectives. The use of conditional grants limits subnational autonomy to cater for differential preferences (section 4.3.5). In the cooperative localist model conditional grants could negate the efficiency advantages of decentralising certain expenditure responsibilities.

4.5.4.2.2 Unconditional grants

The second type of intergovernmental grants consist of unconditional grants. There are no conditions on how this type of grants should be spent (Oates, 1990:7). The grant monies can be spent in any combination of providing public goods and services and/or to

[61] Bird and Wallich (1993:52-53) also make this point with reference to a fiscal effort element in transfer formulae.

provide tax relief to residents (Shah, 1991:23). The grants are given with little or no condition attached to them to address the issue of a general lack of finance at the subnational level (Döckel & Somers, 1992:147). Oates (1990:7) argues that the case for such transfers, with no strings attached, rests partly on equity grounds. "Equalising grants" would promote society's redistributional goals by giving larger sums to poorer jurisdictions (Bird & Wallich, 1993:52).

The magnitude of unconditional grants is influenced by the factors that determine the allocation of grants across jurisdictions and those that determine their growth rate over time (Boadway *et al.*, 1994a:36 and also Shah, 1991:20). Factors used in an allocation formula would typically include population, age structure of the population, urbanisation, average incomes, tax capacity, tax effort and measures of the cost of producing particular decentralised public services or the relative need for subnational expenditure (World Bank, 1990:76). The rate of growth in unconditional grants over time may be determined by the rate of growth of GDP or the rate of growth of subnational expenditure of a particular sort (Hewitt, 1991:85).

Shah (1991:23) states that unconditional non-matching assistance is the least stimulative of local expenditures. Local expenditure will only increase by less than R0.50 of each additional R1.00 of unconditional assistance, with the remaining funds applied towards tax relief. Given the amount of available assistance recipients prefer unconditional non-matching transfers. These grants provide them with the maximum flexibility to pursue their own objectives, because they augment resources without influencing the pattern of spending.

In the case of unconditional grants, the criticism that grants compromise subnational fiscal autonomy, are not as severe as in the case of conditional grants. However, it may be argued that unconditional grants may break the link between subnational expenditure and revenue, and that impairs accountability (Döckel & Somers, 1992:147). The tendency is for recipients to increase their spending levels beyond what they would have been if they had to rely on own sources. Thus the grants to subnational governments may result in higher expenditure than would result if the same transfers were made directly to the residents (Shah, 1991:23). Closed-ended grants are not expected to stimulate expenditures on subsidised activity more than open-ended grants, but the empirical literature finds just that. Shah (1991:27) puts forward the following reasons, namely that (a) the type of grant is frequently used to encourage spending in areas with elastic demands, (b) the grants are large relative to normal spending by recipients in these areas, and the granting government takes measures to discourage the reduction of recipients' expenditure in the aided activities.

In the cooperative localist model the use of unconditional grants to provide subnational revenue does not limit the ability to cater for differential preferences. It may however reduce the efficiency of beneficiaries paying and make subnational government less responsive and responsible (section 4.3.5).

4.5.4.2.3 Tax and revenue sharing

Revenue sharing occurs when taxes are collected centrally, and partially or fully returned to lower levels (Döckel & Somers, 1992:148). In this way two central government objectives are achieved. Central government retains the authority to levy taxes on more productive tax bases, but gives subnational governments a flow of revenue (World Bank, 1990:75). The revenue is collected efficiently, at a lower administrative cost and with less excess burden, than if subnational government had collected it. The sharing of tax revenue can assist all jurisdictions to have a minimum fiscal capacity required to provide services consistent with central government objectives (Ferris & Winkler, 1990:160).

Tax and revenue sharing can assume a variety of forms. Firstly, central government can determine the base and the rate structure of a particular tax source, collect the tax and turn the revenue over to the subnational government. When subnational government's share is determined on the basis of the origin of the tax, McLure (1995a:318) refers to it as tax sharing. When subnational government's share is based on equalising factors, McLure (1995a:319) refers to it as revenue sharing. Moreover, each tax source can be treated separately, with a unique percentage of each to be returned (Shah, 1991:20). This is analogous to an unconditional grant scheme.

Secondly, national government could determine the base and rate structure and choose the rate that will generate the revenue required from the tax. The subnational governments can piggy-back on the national base and rate structure by setting a tax rate that would apply to national tax liabilities (see section 4.5.2). The national government can collect the tax and pass on the subnational shares according to an allocation formula (Boadway *et al.*, 1994a:37).

Thirdly, subnational governments can use the national tax base, but set their own rates (also as a surcharge), tax credits and tax brackets. They can participate with national government in the choice of the base, or can also participate in collection procedures (Boadway *et al.*, 1994b:22).

Tax and revenue sharing can thus be an effective instrument of intergovernmental fiscal relations, which can address horizontal and vertical inequities simultaneously. There are, however, some shortcomings.

It should be considered that the amount of tax room available to one level of government will depend on that occupied by the other (Boadway *et al.*, 1994a:19). Tanzi (1995:308) argues that too much tax sharing limits the central government's room to manoeuvre especially in its stabilisation policy. This has efficiency implications on the revenue side of the budget. When central government needs to raise revenue, but has to share it with subnational governments, it has an incentive to raise revenue from the taxes that are not shared, or where the greater share goes to central government. Unshared taxes will be used more, even if they are less efficient and the structure of the tax system will be distorted. When central government gets only a small share of a tax, it may be prone to grant exemptions from the tax. The other side of this problem is that subnational exemptions could erode a tax base that is shared with central government.

Aside from possible strategic behaviour in the sharing process it should be noted that because the subnational governments are passive recipients of revenue collected by the national government, the advantages of decentralising tax responsibility (autonomy, accountability) are absent (Boadway *et al.*, 1994b:21). In addition, the more the aim of revenue sharing is to provide subnational governments with a minimum fiscal capacity so that they can provide services in accordance with central government objectives, the less it is possible to realise the advantages of decentralisation of those services.

4.5.4.2.4 Mandates and regulation

Mandates involve coercive provision that requires lower levels of government to take affirmative steps, or prohibits them from specified activities (Hirsch, 1990:167). This involves a regulatory approach to intergovernmental relationships as opposed to incentives. Ferris and Winkler (1990:161) define selective mandates as central government expenditure directives to subnational government for specific services or purposes. The mandates mitigate the disadvantages of decentralisation by, for example, preventing lower levels of government in engaging in activities that may lead to interjurisdictional competition. Externalities are internalised, which fosters efficiency. Shah (1991:34) advises that common minimum standards could help to reduce intra-regional barriers to factor and goods mobility and could thereby contribute to efficiency gains from intra-regional trade. Mandates reduce discrepancies in essential services among jurisdictions, which reduces inequity (Hirsch, 1990:168).

Hirsch (1990:172) distinguishes between different categories of mandates according to their funding and criteria. Mandates can be funded or unfunded. When faced with an unfunded mandate, the lower level government can either raise the funds in part or in whole, or it can meet the costs by curtailing non-mandated services. Shah (1991:35) states that common minimum standards should be encouraged through conditional non-matching or conditional closed-ended matching grants. Conditional non-matching grants would leave the subnational governments free to spend the grant monies as they choose, provided that the minimum standards are met. That would serve both efficiency and equity objectives. As illustrated by Hirsch (1990:172-178), unfunded mandates can have immense efficiency and redistributive effects.

Mandates can also be input- or output-orientated. Output-orientated mandates require the production of a minimum or maximum quantity, depending on whether the activity is a good or a bad. Output criteria are used when output is readily measured. Otherwise, input-orientated mandates stipulate minimum or maximum levels of inputs (Hirsch, 1990:172).

As in the case of conditional grants, mandates and regulation favours more centralisation on the decentralisation-centralisation continuum. The use of mandates and regulation severely limits subnational autonomy and the ability to cater for differential preferences. It may void the advantages of decentralising expenditure responsibilities in the first place.

In summary, it may be said that the use of intergovernmental fiscal instruments requires a value judgement concerning the degree of decentralisation or centralisation that is required in the system.

4.7 Summary

In this chapter, the arguments in favour of and against decentralisation were examined. The fragmented localist model of fiscal federalism advanced the arguments in favour of decentralisation. The advantages of decentralisation showed that it could possibly overcome the problems of government failure discussed in chapter three. On the opposite extreme, the centralist model of fiscal federalism advanced arguments against decentralised allocation, stabilisation and redistribution. It highlighted the conditions in which decentralisation may be a less attractive policy than described in the fragmented localist model. The cooperative localist model of fiscal federalism advanced that, in practice, a mix of intergovernmental fiscal instruments may be used to mitigate some of the disadvantages of decentralisation, while still realising some of the benefits of it. The choice of intergovernmental relations depends on the objectives of central government, the informational requirements and the governance of subnational governments. A relative mix of conditional and unconditional grants, revenue and tax sharing and mandates and regulations may be used to refine the fiscal system.

In section 4.2 fiscal federalism and fiscal decentralisation were defined. The section emphasised the difference between administrative and fiscal decentralisation. In this study the focus is primarily on fiscal decentralisation where subnational governments are autonomous and have some degree of decision making powers over revenues and expenditures.

In section 4.3 the arguments in favour of fiscal decentralisation were provided. The arguments stem from the fragmented localist model of fiscal federalism described by Söderström (1990). The arguments in favour of decentralised allocation were based on the spatial characteristics of public goods and services. When the costs and benefits of public goods and services are limited to a particular locality it is possible that residents of different localities may have different preferences for those public goods and services. Chapter three argued that a central government may fail to determine such individual preferences for public goods. The section 4.3.1 argued that decentralised allocation may be efficient. In smaller, decentralised groups individuals reveal their preferences for public goods and services, because misrepresentation could mean that the public good or service is not provided at all. With reference to the Tiebout model it was argued that individuals will reveal their preferences through their mobility between jurisdictions. The consumer-voter will move to and settle in a jurisdiction that best satisfies his or her preferences for public goods and services. In addition to the advantages of demand revelation, smaller decentralised groups were argued to be more homogeneous and the differences in the intensity of preferences less. As a consequence majority voting may be more stable and may it reduce the possibility of government failure due to the nature of the system of social choice. Decentralisation was also argued to address the public choice sources of government failure, as citizens are closer to the government which may reduce agency and monitoring costs and they can move in response to vote- or budget-maximising behaviour.

In section 4.3.2 decentralised stabilisation was proposed by using similar arguments as those put forward in the case of allocation. Stabilisation and distribution may be more efficient when it is in line with differential decentralised preferences. In the fragmented localist model an equitable distribution should reflect the diverse attitudes and preferences of residents in different jurisdictions. It was argued that a spatial dimension of concern about the poor may exist and that decentralised distribution will favour equitable income redistribution.

In sections 4.3.4 and 4.3.5 the fragmented localist model's assignment of expenditure responsibilities and taxation was outlined. According to the model subnational governments should be responsible for all public goods and services if the benefits accrue mainly regionally or locally. The only centralised expenditure responsibilities should be those (a) for which there is no difference in demand in various localities, (b) where the benefits of the public good or service are public in nature and uniform provision is necessary or result in significant spillovers to other localities, and those (c) for which the additional costs of decentralising administration are sufficiently high to outweigh the advantages. Then the decentralisation of taxation responsibilities should provide a correspondence between expenditure needs and revenue means. In section 4.3.5 the importance of own revenue in order to realise the advantages of decentralisation was emphasised. Subnational governments require a certain degree of revenue autonomy from central government to be able to cater for differential preferences. A subnational tax effort furthermore functions as a pricing instrument and benefit taxes may increase the accountability of subnational governments.

In section 3.4 it was concluded that the decentralisation of functions to lower levels of government should be favoured unless sound arguments can be advanced for centralisation.

In section 4.4 the arguments against fiscal decentralisation were provided and the situations in which decentralisation might not lead to an efficient and equitable allocation of resources were identified.

The arguments advanced in section 4.4.1 against decentralised allocation were based thereon that a mismatch may occur between the spatial characteristics of public goods and services and the responsible jurisdictions. Subnational governments may have no incentive to take the spillover benefits or costs that they generate for non-residents into account. It was argued that they may under-provide those public goods and services that have positive spillovers and over-provide those with negative spillovers. Decentralised decision making will in such cases be inefficient and justify a role for central government. It was also argued in section 4.4.1 that the mobility of residents and competition between jurisdictions may cause inefficiency and inequity. When individuals move they create fiscal externalities. They do not take into account that they consume the decentralised public goods jointly with other residents in their locality and that they reduce one another's tax burden. The movement of individuals causes changes in the net fiscal benefits all receive and NFB differences may lead to further inefficient factor movements in response to fiscal considerations. It was shown that the mobility of citizens and resources lead to tax competition which results in sub-optimal budgets on the tax and expenditure side. Inefficient decentralised decision making due to the above reasons may provide a role for more centralised government.

The arguments against decentralised stabilisation, discussed in section 4.4.2, were based on institutional and practical considerations. The first was that decentralised subnational economies are open to leakage and will pay the full cost of stabilisation with only partial benefits. The second reason forwarded for stabilisation to be a function of central government was that in practice subnational governments have tended to exacerbate macroeconomic instability. It was argued that a centralised stabilisation policy may better deal with subnational deficits and debt before it leads to instability.

The centralist model's arguments against decentralised distribution were set out in section 4.4.3. In this case an equitable distribution was defined in terms of a social welfare function that the central government seeks to maximise. The focus is that all jurisdictions should have the same tax price for various activities. On this basis a number of arguments were forwarded in favour of national redistributive equity objectives. The first is that income inequality and poverty are mostly due to national economic conditions and policies. Poverty can thus be viewed as a national concern and distribution as a national public good. It was shown that in the case of decentralised distribution on the basis of differential preferences mobility makes it possible for the poor to move to jurisdictions where distribution policies are more pronounced. This may increase the cost to the non-poor to render the assistance and reduce the non-poor residents' utility levels. The result may be a uniform distribution policy amongst various jurisdictions, without optimal distribution. This equilibrium may be seen to provide a role for central government. Section 4.4.3 concluded with economies of scale and capacity arguments in favour of centralised administration of redistribution.

In section 4.4 the institutional shortcomings of fiscal decentralisation were highlighted. The efficiency of subnational decision making mechanisms may be constrained due to a dictatorial regime or local elections may not reflect local preferences if they are decided on the basis of personal, tribal or political party loyalties. Elected officials may face a vague or inconsistent electoral mandate, along with a mismatch between spending and resources and a principle-agent relationship with their bureaucrats. Decentralised bureaucracies may lack the human resources and technology to be efficient. Corruption was furthermore argued to be more prevalent at local and decentralised levels than at national level. These institutional shortcomings were seen as further arguments in favour of centralisation.

The centralist model's assignment of expenditure responsibilities and taxation was outlined in sections 4.4.5 and 4.4.6. It was recommended that the allocation, stabilisation and distribution functions should largely be left to central government. Subnational governments were given the limited role of supplying only those public services that they can finance with benefit taxes. Section 4.4.6 discussed the economic principles of assigning taxes to lower levels of government and recommended that progressive taxes, taxes on mobile bases and taxes on unequally distributed bases be centralised. Only user taxes, fees and property taxes were found to be suitable for decentralisation.

It was concluded in section 4.4 that complete fiscal decentralisation may not be a panacea for all instances of government failure, but in practice society can come closer to achieving efficient and equitable resource allocation outcomes through centralising certain functions and decentralising others.

In section 4.5 the cooperative localist model was described as the middle of the continuum between the extremes of complete decentralisation or centralisation. Section 4.5.1 concluded that some expenditure responsibilities may be decentralised with the aim to capture some of the efficiency benefits of decentralised allocation, while others can be centralised to compensate for spillovers and inequities. In section 4.5.2 arguments to expand subnational tax capacity beyond the guidelines of the centralist model were put forward. Excise taxes were shown to be candidates for decentralisation along with user taxes fees and property taxes. It was argued in section 4.5.3 that subnational borrowing should only be allowed within a framework of strict rules that stipulate the subnational governments' obligations and specify that central government will never bail them out.

However, even in the cooperative localist model the combinations of centralisation and decentralisation may generate inefficiency and inequity. That shortcoming were shown to be dealt with through intergovernmental fiscal relations in section 4.5.4.

Intergovernmental fiscal relations can be used to refine the fiscal system and compensate for inefficiencies and inequities created by the combination of decentralising and centralising functions. The objectives of the intergovernmental fiscal relations, the informational requirements and the governance of the subnational governments influence the choice of the type of intergovernmental fiscal instrument used. The intergovernmental fiscal instruments include conditional grants, unconditional grants, tax and revenue sharing and mandates and regulation.

In conclusion, it can be said that chapter four found that a fiscally decentralised system may achieve efficient and equitable resource allocation. There are however a number of instances where fiscal decentralisation may not lead to such allocations and which need to be compensated for in the system of intergovernmental fiscal relations. If a cooperative localist model can be defined to realise the efficiency advantages of fiscal decentralisation and at the same time ensure equitable allocation, it may offer a solution to the problems of government failure and to the development challenges facing North West Province.

Chapter five will examine fiscal decentralisation in South Africa. The focus is on the new constitutional assignment of functions, the financing proposals by the Financial and Fiscal

Commission (FFC), and its implementation.

Chapter 5: Fiscal decentralisation in South Africa

5.1 Introduction

Chapter two outlined the development profile of, and development challenges in North West Province. Chapter three argued that markets may fail to produce efficient and equitable resource allocation outcomes, and by implication may fail to address the development challenges in North West Province. Government intervention was proposed, but shown to be subject to forces that induce government failure. Fiscal decentralisation was proposed as a possible solution to the problems of government failure. Chapter four discussed the arguments for and against fiscal decentralisation and concluded that a relative mix of decentralised and centralised allocation, stabilisation and distribution may ensure efficient and equitable resources allocation outcomes.

In the light of the latter conclusion, the purpose of this chapter is to examine fiscal decentralisation in South Africa.

The structure of the chapter is as follows: In section 5.2 the constitutional assignment of functions and finance to provincial government is discussed along with the Financial and Fiscal Commission (FFC), Budget Council and Inter-Governmental Forum (IGF) as components of the framework of intergovernmental fiscal relations. The norms applicable to the system of intergovernmental fiscal relations are outlined in section 5.3. In section 5.4 the FFC's recommendations concerning potential revenue sources, minimum standards and revenue sharing in the fiscal system are discussed. Section 5.5 deals with the FFC's proposed vertical division of resources between national and provincial governments and section 5.6 outlines the proposed horizontal division of resources between the provinces according to a provincial grants formula. In section 5.7 provincial borrowing is discussed. In section 5.8 the implementation of the FFC's proposals and the Budget Council's recommendations are discussed. The chapter concludes in section 5.9 with a summary.

5.2 The Constitutional assignment of functions and finance to provincial governments

The interim Constitution (section 1 of Act 200 of 1993) and the final Constitution (section 40 of Act 108 of 1996) of South Africa established a unitary state with national, provincial and local levels of government. The Presidential Review Commission (PRC, 1998:4) states that the establishment of three distinctive but inter-related spheres of government committed government as a whole to the principle of decentralisation. Certain powers, functions and financial resources are assigned to each level of government. Some of these are exclusive and other powers, functions and resources are concurrent and shared. The constitution also creates a framework for intergovernmental fiscal relations, with the Financial and Fiscal Commission (FFC) as a central component thereof (FFC, 1995a:1).

The establishment of this new fiscal system was preceded by lengthy multi-party negotiations at the World Trade Centre in Kempton Park. During the negotiations the African National Congress (ANC) at first proposed that 10 regions should replace the old dispensation of four provincial administrations, the independent homelands and self-governing territories. The criteria that played a role in determining the borders of the regions included economic sustainability and development potential, geographic and demographic concerns, nodal points for administration, cost aspects as well as socio-economic concerns including language and culture (Badenhorst, 1993a:10). At that stage of the negotiations, the second level governments were referred to as SPR's, meaning States/Provinces/Regions. The possible legislative and executive powers of the SPR's were outlined to include: local government, traffic control, safety services and local policing, housing, education, health services, welfare, cultural affairs, public works, roads, transport, tourism, conservation, gambling and language policy (Badenhorst, 1993b:11). These were shared with national government. The SPR's had no exclusive powers (Davis, 1993:18). During the course of the 1993 negotiations, the concept of a FFC was also agreed upon. Although its powers and functions were not yet outlined in detail, it was clear that the FFC was to have a consultory function in giving advice and recommendations on intergovernmental fiscal relations - especially on the equitable allocation of resources between the SPR's (Badenhorst, 1993b:11). Emphasis was placed on the independence of the commission (Badenhorst, 1993c:9).

When the negotiations concluded, the interim Constitution (1993) established nine provinces with shared and exclusive powers and the FFC as a central role player in intergovernmental fiscal relations (Anon., 1994:33-34).

The following subsections discuss the constitutional framework for provincial governments and the role of the FFC and the other intergovernmental coordinating structures.

5.2.1 The constitutional framework for provincial governments

Schedule 4, part A of the final Constitution (1996)[62] lists the functional areas for which national and provincial governments are jointly responsible. Schedule 5, part A lists the functional areas which are exclusive provincial responsibility.

Schedule 4, part A lists the following functional areas:

- Administration of indigenous forests
- Agriculture
- Airports other than international and national airports
- Animal control and diseases
- Casinos, racing, gambling and wagering, excluding lotteries and sports pools
- Consumer protection
- Cultural matters
- Disaster management
- Education at all levels, excluding tertiary education
- Environment
- Health services
- Housing
- Indigenous law and customary law, subject to chapter 12 of the constitution
- Industrial promotion
- Language policy and the regulation of official languages to the extent that the provisions of section 6 of the Constitution expressly confer upon the

[62] Only the final Constitution's (1996) description of the shared and exclusive functional areas is given. This concurs with the interim Constitution's (1993) assignment. It should be noted that technically the interim Constitution remained in force until 1 January 1998 when chapter 13 of the final Constitution (1996) which deals with intergovernmental fiscal relations, came into effect (PRC, 1998:4).

provincial legislatures legislative competence

- Media services directly controlled or provided by the provincial government, subject to section 192
- Nature conservation, excluding national parks, national botanical gardens and marine resources
- Police, to the extent of the provisions of chapter 11 of the Constitution
- Pollution control
- Population development
- Property transfer fees
- Provincial public enterprises in respect of the functional areas in this Schedule and Schedule 5
- Public transport
- Public works only in respect of the needs of provincial government departments in the discharge of their responsibilities to administer functions specifically assigned to them in terms of the Constitution or any other law
- Regional planning and development
- Road traffic regulation
- Soil conservation
- Tourism
- Trade
- Traditional leadership, subject to chapter 12 of the Constitution
- Urban and rural development
- Vehicle licensing
- Welfare services

Schedule 5, part A lists the following exclusive provincial functions :

- Abattoirs
- Ambulance services
- Archives other than national archives
- Libraries other than national libraries
- Liquor licences
- Museums other than national museums
- Provincial planning

- Provincial cultural matters
- Provincial recreation and amenities
- Provincial sport
- Provincial roads and traffic
- Veterinary services, excluding regulation of the profession

The PRC (1998:4) states that the key feature of the constitutional framework is the principle of cooperative governance. The three spheres of government are required to coordinate their actions and legislation and exercise their powers in a manner which does not encroach on the geographic, functional or institutional integrity of government in another sphere.

To accompany the decentralised functions, the interim Constitution (section 156) and the final Constitution (section 218) give provincial legislatures the competence to raise taxes, levies and duties. The power to tax is interpreted to mean the competence to determine the tax base, the rate and to administer the tax (FFC, 1995a:18). There are three exceptions, namely income tax, value-added tax and sales tax, which are exclusive national competencies. The provinces may however impose surcharges on these taxes. The provinces may also levy user charges and have exclusive competence to impose taxes, levies or duties on casinos, gambling, wagering, lotteries and betting.

It should be noted, that the following provisos apply to provincial taxing powers, (a) the province must receive authorisation by an act of Parliament, subject to Parliament's consideration of the FFC's recommendations, and (b) there must be no discrimination against non-residents of another province who are South African citizens (FFC, 1995:2). The overriding proviso is that provincial taxes should not detrimentally affect national economic policies, inter-provincial commerce or the national mobility of goods, services, capital or labour (FFC, 1995a:18).

In addition to the decentralisation of powers to tax, sections 155 and 156 of the interim Constitution and section 214 of the final Constitution provide that each province is also entitled to an equitable share of revenue collected nationally, in order to provide services and to exercise and perform its powers and functions (FFC, 1995a:1).

The equitable share comprises three elements, namely (FFC, 1995c:2):

- percentages of nationally collected individual income taxes, value added taxes and sales tax and the fuel levy,
- transfer duties on property situated within a province, and
- other conditional and unconditional allocations out of national revenue.

It should be noted that the phrase "revenue collected nationally" refers to revenue collected at the national level. Revenues collected by the national tax administration on behalf of a subnational government are not considered to be included (FFC, 1995a:2).

Section 227 of the final Constitution states that lower spheres of government may also receive other conditional or unconditional allocations from national government revenue[63].

Besides taxing powers and sharing in national revenue, subnational governments may also require access to loans in order to fulfil the decentralised functions described in schedules 4 part A and 5 part A.

Section 157 of the interim Constitution and section 230 of the final Constitution grant provinces the competency to borrow in order to finance capital expenditure. Loans can only be used for current expenditure, when it is bridging finance that is redeemed within 12 months. Furthermore, all borrowing must be done within a framework of norms and conditions as prescribed in an act of Parliament, subject to Parliament's consideration of the FFC's recommendations (FFC, 1995a:25). The above mentioned sections 157 and 230 of the interim and final Constitutions specify that provincial governments may not guarantee loans by local governments within the province, or for agencies or corporations of the provincial government. That is unless the FFC verified the need for the guarantee and recommended it be given (FFC, 1995a:2, 25). Similarly, section 188 of the interim Constitution and section 218 of the final Constitution stipulate that the national government may not guarantee any provincial or local government loan unless the

[63] The proposed Intergovernmental Fiscal Relations Bill may require the Minister of Finance to table a Revenue Sharing Bill along with the budget each year, which spells out the revenue decisions that have been made and justifies it in terms of the constitutional requirements for equitable revenue shares and in terms of the FFC's recommendations in this regard (PRC, 1998:11).

guarantee complies with the norms and conditions of an act of parliament, and the FFC verified the need for the guarantee and recommended it be given.

5.2.2 The FFC and intergovernmental coordinating structures

The FFC was established from section 198 of the interim Constitution, which is affirmed by section 220 of the final Constitution. In the previous section 5.2.1, the constitutional framework for provincial governments established the importance of intergovernmental fiscal relations in the principle of cooperative governance and provisions for revenue sharing. The following section discusses the FFC as a central component of the framework for intergovernmental fiscal relations[64].

The FFC's role is to be an impartial statutory institution, accountable to the legislatures with the objective to contributing towards the creation and maintenance of an effective, equitable and sustainable system of intergovernmental fiscal relations (FFC, 1995a:1). The FFC has the following overall tasks (FFC, 1995a:1):

- It must advise legislative authorities on financial and fiscal policies and the equitable financial and fiscal requirements of all three levels of government.
- It should make recommendations to the national and provincial governments on (a) equitable fiscal and financial allocations from revenue collected nationally, (b) the intention of provincial government to impose certain taxes, levies and surcharges, (c) the raising of loans by provincial and local governments and (d) the criteria used for determining the allocation of fiscal resources.

In performing its functions the Commission is obliged by section 214(2) of the final Constitution to take the following into account:

- provincial fiscal performance and efficiency of revenue utilisation,
- provincial needs and economic disparities,
- provincial administrative responsibilities,

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[64] Greater clarity on the powers of the FFC and the nature of its interaction with other institutions is anticipated from the FFC Bill and the Intergovernmental Fiscal Relations Bill.

- other legitimate provincial interests,
- national interest and debt, and
- other objective criteria identified by the FFC.

In addition to the FFC's role in the system of intergovernmental fiscal relations the Budget Council (Finance MinMec) and Inter-Governmental Forum (IGF) are designed to facilitate coordination between the national and provincial governments. The Budget Council is to ensure the exchange of information and coordination of legislation between levels of government. It consists of the Minister and Deputy Minister of Finance, the nine provincial MEC's for Finance, the DG's and heads of Finance departments and the FFC as an observer. The Budget Council is supported in its work by the Technical Committee on Finance (TCF). The Inter-Governmental Forum comprises all the national ministers and provincial premiers, with the President and Deputy President *ex officio*. The IGF meets quarterly to promote intergovernmental consultation and coordination, including of financial matters (PRC, 1998:9).

When the Government of National Unity came into power after the general election in 1994, the constitutional framework outlined above was to be put into practice. After the first 100 days, however, all powers and functions were still centralised and the FFC was not as yet appointed. The Commission was only appointed in August 1994 (Marais, 1994:10-11). As a result of this slow start and the problems of reallocating functions, the presentation of the 1994/95 budget was delayed by three months. The allocations for the 1994/95 and the 1995/96 fiscal years were made according to the pre-election structures (Basson, 1994:19). The majority of the functions, income and spending remained at national level (Volschenk, 1995b:9). Until the FFC was fully operational, function committees were used as interim structures to determine the criteria used in making budgetary allocations for line functions, including the provinces.

At that stage there was already criticism from the then Gauteng Finance and Economic Affairs MEC[65] that the function committees were biased in favour of national government interests. The claims of a national bias were dismissed by both the FFC and the

[65] Mr. Jabu Moleketi was the Gauteng Finance and Economic Affairs MEC at that stage (Dludlu, 1995:1).

Department of State Expenditure as inherent to the budgetary and bargaining process (Dludlu, 1995:1). In the light of that confrontation the Department of Finance used "soft figures" in a Consolidated National and Provincial Budget. Along with the criteria of the function committees already mentioned, the provinces were asked to give an indication of their budgetary needs for 1995/96 according to a functional classification. Only five of the nine provinces responded. KwaZulu-Natal, Northern Province, North West and the Northern Cape did not respond. The available responses were used to make projections for all the provinces (Marais, 1995:14). The Department of Finance thus had the final say in the setting of provincial budgets, down to individual budget lines. Provincial legislatures approved provincial budgets, but only as a formality (PRC, 1998:9). These interim measures were to be replaced by the FFC's framework document for intergovernmental fiscal relations in June 1995.

5.3 Norms applicable to the system of intergovernmental fiscal relations

In order to bring the operation of the system of intergovernmental fiscal relations closer to the constitutional assignment of functions and finance than it was in the 1994/95 and 1995/96 fiscal years, the FFC identified norms applicable to the system[66]. In the Commission's 1995 framework document for intergovernmental fiscal relations the norms identified were: effective resource use, accountability, fiscal autonomy, certainty of revenue, transparency, equity, development and administrative feasibility.

5.3.1 Effective resource use

The first norm is that the system of intergovernmental fiscal relations should ensure effective resource use. The FFC's framework document states that the scarcity of resources requires efficient allocation, but (as shown in chapter three) the existence of,

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[66] Note that to some degree the FFC's discussion of the norms corresponds with the arguments for a continuum of decentralisation and centralisation discussed in section 4.5 . The theoretical arguments concerning the advantages and disadvantages of decentralisation, as well as equity, will not be repeated in detail.

for example, public goods leads to market failure to allocate resources efficiently. In the case of public goods, no mechanism exists to reveal citizens' preferences (FFC, 1995:4). As in section 3.3.2.2 it is argued that the market failure provides a role for government. However, the problems of collective choice and related government failure to achieve efficient and equitable resource allocation outcomes are present, as discussed in section 3.4.3. Nevertheless, the framework document argues that government does have a role to play to ensure effective resource use and the system of intergovernmental relations should contribute to it. Government's role and the possibility of failure make the second norm of accountability necessary.

5.3.2 Accountability

To help ensure that resources are allocated efficiently the FFC (1995:4) states that government's decisions should be subject to public scrutiny. Accountability refers to the government's obligation towards the constituency which has endowed it with specific responsibilities. That means that government is required to justify expenditures and to explain why the revenue necessary to sustain expenditure is raised in the way it is. The accountability norm has section 133 of the final Constitution as cornerstone. The section provides that members of the executive council of a province are collectively and individually accountable for the exercise of the powers and the performance of the functions (PRC, 1998:5). The framework document contends that emphasising accountability may help to overcome the public choice problems of vote maximising politicians and budget maximising bureaucrats (see sections 3.4.3.2 and 4.3.1). It is thus argued that it is important that the system of intergovernmental fiscal relations should be designed to encourage beneficiary pays participation and in that way accountability.

5.3.3 Fiscal autonomy

The third norm that the framework document focuses on is fiscal autonomy. The FFC (1995:5) refers to fiscal autonomy as the degree to which lower tier governments can establish their priorities and make decisions consistent with the expenditure, taxation and borrowing powers assigned to them. In the South African system a degree of autonomy is established by the Constitution, as each level of government has certain powers, functions and financial resources that are exclusive, concurrent and shared.

The advantages of fiscal autonomy as a norm for intergovernmental fiscal relations concur with sections 4.3.1 to 4.3.3's efficiency and competition-based arguments in favour of decentralisation. Fiscal autonomy at subnational levels allows for regional differentiation. In smaller groups there is a measure of homogeneity in the demand for public goods, and residents can move to communities where the public goods and the tax price suite their tastes (FFC, 1995:5). As seen from section 4.3.5, fiscal autonomy may be regarded as a prerequisite for complying with the first two norms, to achieve effective decentralised resource use and accountability.

As in the centralist theory discussed in section 4.4, the framework document also recognises the disadvantages of decentralisation and fiscal autonomy. Interjurisdictional spillovers and competition are inefficient and may exacerbate disparities in terms of wealth and poverty between communities. The solution proposed by the FFC concurs with what the cooperative localist model suggested (see section 4.5). Different degrees of decentralisation and centralisation, coupled with the use of minimum standards and grants, may mitigate fiscal decentralisation's disadvantages of interjurisdictional spillovers and competition, while retaining some of the benefits of decentralised decision making. The framework document states that the interim Constitution and the constitutional principles strive to maintain a balance between the centralised and decentralised functions (FFC, 1995:5).

5.3.4 Certainty of revenue

To harness the advantages of fiscal decentralisation, not only the balance between autonomy and centralisation is important. Provincial and local governments should also be financially sustainable. The FFC's fourth norm for the system of intergovernmental fiscal relations is that of certainty of revenue. Each level of government must receive adequate revenue sources to finance the services they are expected to provide (FFC, 1995:6). The framework document maintains that a province or local government must be able to rely on the predictability of its revenue flows in order to plan its activities. It is also useful for national government to obtain certainty regarding its liabilities towards subnational governments (FFC, 1995:6)[67].

5.3.5 Transparency

Sections 215 and 216 of the final Constitution require transparency in the budgetary process on the revenue and expenditure sides. Transparency is to foster accountability. The norm of transparency is relevant for the notion that finance should follow decentralised functions. The FFC's framework document places transparency in the context of subnational revenue sharing. The FFC states that the method of calculating the equitable shares referred to in the Constitution should be transparent and comprehensible to promote credibility and stability (FFC, 1995:6). Section 195 of the final Constitution requires the public service to provide the public with timely, accessible and accurate information to encourage public participation in the policy-making process. Uniform definitions of key concepts, common reporting, accounting and auditing procedures are needed in any system of intergovernmental fiscal relations. Regarding financial sustainability, loan financing should be taken into account. The system of intergovernmental grants should not impede provinces' reasonable access to other sources of finance. Loan financing of long term infrastructural projects would make it possible for costs to be spread over the same period during which the benefits arise. That may ensure intergenerational equity (FFC, 1995:8).

The first five norms focuses on the efficiency aspects of the system of intergovernmental fiscal relations. There is also an equity dimension.

5.3.6 Equity

The FFC (1995:7) describes equity as characterised by the spirit of fairness, justice and impartiality. Equity has many dimensions, such as in income distribution, economic development and equal opportunities. In the system of intergovernmental fiscal relations,

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[67] FFC argues that should national government allow lower-tier governments to, for example, shift additional debt unto it, moral hazard could be introduced. "Moral hazard" refers to incentives that encourage an ensured person or institution to cause the events against which they are ensured. If national government is seen as the ensurer of subnational debt, there could be an increase in subnational default on debt because provinces are shielded from the adverse effects (FFC, 1995:7).

the norm's aim is to ensure fiscal fairness in the provision of public services to all households. The FFC's framework document interprets the fiscal fairness in that each individual should have equal access to publicly provided services such as education, health care, sanitation or water and each household should receive equal or similar public services for an equivalent tax effort (FFC, 1995:7). Aside from equity in expenditure, the equity norm also demands tax equity. Tax equity requires that taxable entities pay tax in accordance with their ability to pay. In addition, vertical equity means that individuals in different positions should be treated differently by the fiscal system, whereas horizontal equity refers to the equal treatment of individuals in equal positions. In the final instance, the equity norm also extends to the system of intergovernmental fiscal relations as each province is entitled to an equitable share of revenue collected nationally. This has been explained in the constitutional framework in section 5.2.1.

5.3.7 Development

The system of intergovernmental fiscal relations should also help to ensure development. The FFC (1995:8) defines development as a multidimensional process that is more than economic growth and focuses on human development. Applied to the system of intergovernmental fiscal relations this means that fiscal transfers may be used to encourage regional development and employment. Attempts may also be made to eliminate backlogs in the provision of essential infrastructure and to provide sufficient economic opportunities within provinces.

5.3.8 Administrative feasibility

Finally, a system of intergovernmental fiscal relations is not only evaluated in terms of efficiency or equity in allocation, but also in terms of the ease and efficiency of administration. While it may, for example, encourage accountability to decentralise taxing powers, rather collecting it at national level would minimise the administrative burden. The framework document states that the norm of what is administratively feasible places a check and balance on the norms of what is theoretically optimal.

As chapter four illustrated the advantages and disadvantages of decentralisation and that a middle road is needed between the extremes of decentralisation and centralisation, the FFC's framework document concludes that many of the norms described above may be in competition with one another. The decentralisation and fiscal autonomy that contribute to effective resource use may undermine equity which may require centralised minimum standards. As discussed above, the norms applicable to autonomy or accountability may conflict with the requirements for administrative efficiency. As in the cooperative localist model, the FFC's framework document for intergovernmental fiscal relations contends that the solution may be to apply a combination of the norms. The norms to ensure efficiency should be tempered to allow for equity through minimum standards and intergovernmental transfers.

The following section will examine the FFC's recommendations concerning potential revenue sources, minimum standards and revenue sharing in the system of intergovernmental fiscal relations.

5.4 Potential revenue sources, minimum standards and revenue sharing

In accordance with the proposed norms applicable to the system of intergovernmental fiscal relations, the FFC's framework document (FFC, 1995) interpreted the constitutional assignment of functions and finance to the provinces, in order to describe how the system of intergovernmental fiscal relations may function. In order to replace the interim measures of the 1994/95 and 1995/96 fiscal years, where the Department of Finance had the final say in setting the provincial budgets, the FFC examined the provinces' potential revenue sources, minimum standards and revenue sharing as the key components to the system of intergovernmental fiscal relations.

5.4.1 Potential revenue sources

For the provinces to successfully deliver on the functional areas assigned to them in the constitution, access to revenue is the first concern. The FFC's framework document describes two opposing sides to provincial revenue sources in the advantages and disadvantages of decentralising the following taxes (FFC, 1995:20-23):

- Personal income tax
- Company income tax
- Value-added tax (VAT)
- Retail sales tax
- Excise duty
- Fuel levy
- Transfer duties
- Customs duty
- Import surcharge
- Financial services levy
- Capital transfer taxes
- Betting taxes
- Property taxes
- User charges
- Marketable securities tax and stamp duty
- Regional Services Council and Joint Services Board levies
- Natural resources, mining and mineral taxes

The norms applicable to the system of intergovernmental fiscal relations illustrate the importance of finance to follow decentralised functions. The advantages of decentralisation depend on the autonomy of the subnational government, which means that it should have revenue sources which it can determine independently. A direct link between raising taxes and spending on public goods and services also fosters accountability. From this it follows that subnational government should be competent to raise taxes (FFC, 1995:19). This corresponds with the arguments of the fragmented localist model in section 4.3.5.

The arguments opposing the decentralisation of taxation responsibilities are based on the inefficiencies and inequalities that it may create. The content of the FFC discussion is not repeated here, as the essence was sufficiently covered in section 4.4.6. Equity, macroeconomic policies and administrative efficiency may be prejudiced if lower-tier taxes were raised indiscriminately (FFC, 1995:19). In regard to provincial revenue sources the FFC emphasises the equity norm. The lower-tier governments are left with only property taxes, user charges and betting taxes and the possibility of surcharges of income tax, value-added tax and sales tax (see also section 6.3.1). The alternative to tax devolution is revenue sharing and grant allocations. Before discussing this alternative the importance of minimum standards is explained.

5.4.2 The development of minimum standards

Minimum standards in the system of intergovernmental fiscal relations are the second concern if provinces are to successfully deliver on the functional areas assigned to them in the Constitution. Section 126 in the interim Constitution and section 44 of the final Constitution provide for the national setting of standards for the rendering of public services. National standards are also supported by the equity (section 5.3.6) and development (section 5.3.7) norms that the FFC identified for the system of intergovernmental fiscal relations.

The FFC (1995:13) states that it is, however, essential to ensure that the fiscal requirements resulting from minimum standards are sustainable. The previous section argued against decentralisation of taxation and in favour of revenue sharing and grant allocations. Where minimum standards are applicable, their sustainability will thus depend on the shared revenue and grants.

A number of factors may determine the inclusion of schedule 4 and 5 functions allocated to the provinces in a revenue sharing formula in the form of minimum standards. The functions with maximum socio-economic impact (from the perspective of the RDP) should be introduced as soon as possible, along with those that have maximum fiscal impact. Education, housing and health services should be included on both counts, whereas local government is an essential ingredient in the government structure, that should also be incorporated (FFC, 1995:14).

The final component of the system of intergovernmental fiscal relations is revenue sharing.

5.4.3 Revenue sharing

The previous two sections briefly discussed the problems associated with decentralising taxes and the importance of minimum standards in the system of intergovernmental fiscal relations. Revenue sharing may be used for financing the functions allocated to subnational government and in incorporating minimum standards in delivery.

Revenue sharing is the process whereby governmental incomes are pooled and then divided between the national and subnational governments (FFC, 1995:12). As noted in section 5.2.1, sections 155 and 156 of the interim Constitution and section 214 of the final Constitution provide that each province is entitled to an equitable share of revenue collected nationally, in order to provide services, and to exercise and perform their powers and functions (FFC, 1995:1). The framework document interprets the "equitable share of revenue collected nationally" to comprise of three parts.

The first consists of percentages of certain national taxes, namely income tax on individuals, value-added tax and the national fuel levy (FFC, 1995:10). The emphasis is on the collection of revenue at the national level and on dividing this pool equitably. The needs of the various jurisdictions are taken into account (FFC, 1995:12). The FFC's (1995:19) framework document states that revenue sharing is an approach for achieving equity in the provision of public goods and services across all jurisdictions in the country. It underscores the norm of equity applicable to the system of intergovernmental fiscal relations. As revenue sharing, however, eliminates provincial discretion and the concomitant fiscal autonomy and accountability the norm of certainty of revenue is essential. The framework document argues that when lower-tier governments' share of revenue is legally enforceable, the stability will allow the revenues to be regarded as quasi-own revenues, along with the ensuing advantages of decentralisation (FFC, 1995:19).

The second part of the "equitable share" is a share of the transfer duties collected nationally and is termed "shared transfer duties". In this case the share is determined on the basis of the origin of the revenue (FFC, 1995:10). Because the revenue is generated for lower-tier governments in this way, vertical imbalances are alleviated to some extent.

The framework document notes that sharing does not necessarily contribute to alleviating horizontal disparities at the provincial level. Provincial discretion, autonomy and accountability are eliminated and it is argued that such shortcomings make the stability of the sharing agreement important.

The third part of the "equitable share" consists of other conditional and unconditional allocations. These must be made according to the criteria listed in section 155(4) of the interim Constitution and section 214(2) of the final constitution. Grants made in this category are referred to as "allocations".

To avoid making the fiscal allocations in an ad hoc manner, the framework document for intergovernmental fiscal relations reasons that it is necessary to identify the programmes and activities which should be undertaken by the public sector, and to agree on the key indicators by which these activities can be measured and on a structure to accommodate the elements. It was proposed that an allocation formula be developed to define a procedure for dividing the available funds (FFC, 1995:11). The FFC (1996:1) argued that using a formula funding mechanism has distinct advantages. The first is its relative objectivity, which means it is less likely to be manipulated by the politicians or civil servants (PRC, 1998:10). The second is that when the formula is set for more than one year, it ensures compliance with the certainty of revenue norm. When the flow of revenue is predictable, national and subnational governments' development planning may be facilitated.

For the purposes of the FFC, the aim of a formula is an equitable allocation of public resources. The PRC (1998:10) identified the goals of using a formula as achieving effective and efficient resource allocation, fiscal equity in the provision of services, and raising of possible provincial taxes and the development of fiscally sound and democratically responsive governments. It is to be used to accomplish the vertical and horizontal division of revenue sources. From a vertical perspective an equitable allocation means distributing the necessary revenue for subnational government to fulfil its functions. From a horizontal perspective it is argued that reasonably comparable levels of basic public services should be available in all provinces within a country. Thus, when allocating resources by formula, the fiscal needs and capacities of the different provinces and local governments should be taken into account (FFC, 1995:12).

The framework document states that when aiming for an equitable allocation, minimum standards should form basic parameters within the allocation formula. The method for determining the minimum standard can be "needs-assessed". This means that the requirements are estimated from a functional or technical point of view, for example pupil-teacher ratios. The problem is that with backlogs in the provinces, the minimum standards can be fiscally unattainable. The alternative is to use "fiscally determined" minimum standards. National average per capital expenditure of the past will reflect society's priorities. A province providing less of a service than the national average would then receive conditional grants, to spend on raising the service to the national average level. The problem is that past norms are likely to differ from those of the future (FFC, 1995:13). In the end, a combination of the two approaches may be a solution: Determining the "needs-assessed" norms, but constraining it by what is fiscally feasible.

After identifying the expenditure categories to be subject to minimum standards, the next step in developing a formula funding mechanism is to decide on the independent variables of the formula. The variables to use will depend on the circumstances. The FFC's framework document (1995:14) states that the variables should be chosen so as to correlate as closely as possible with the normal and generally acceptable expenditure obligations of the provinces in a given category. Individual provincial priorities should not be taken into account at this stage.

In the FFC's framework document population is the first variable that is brought into a formula. It is argued that fiscal needs emanate from people and a population variable will affect most expenditure categories. For example, the demand for schools will depend on the population numbers in a given area (FFC, 1995:14). This emphasises needs as reflected by the numbers of people that would make use of a facility if it were available (FFC, 1995:15). The framework document states that it may also be useful to differentiate between population groups, such as using only the number of children of school going age or the number of patients visiting public health centres, as independent variables (FFC, 1995:14). This approach emphasises utilisation as indicated by the number of people who actually make use of an institution's services (FFC, 1995:15).

The FFC does, however, also describe the reservations to using population figures in the formula. Inaccurate census data are identified as a possible problem. Rapid urbanisation is also said to complicate the estimates of population numbers between the censuses, along with the third problem of cross-border population flows. Cross-border population flows are particularly a problem when the major hospitals are concentrated in metropolitan areas and patients from other provinces are referred to them. If these hospitals are funded on the basis of their provincial population figures, these additional patients would not be taken into account. An alternative could then be to allocate grants on the basis of the institutions providing the services.

To summarise, the framework document outlined the problem of decentralising taxing powers and the importance of minimum standards. This left revenue sharing as the alternative for financing decentralised functions. The three parts of the equitable share of revenue collected nationally were explained. A formula is a procedure for dividing the shared revenue and the FFC's aim is an equitable allocation of public resources. Then minimum standards were discussed as parameters for the formula, along with the use of population as an independent variable in the formula. The following discussion will focus on the FFC's 1996/97 and 1997/98 recommendations for the division of resources between national and provincial governments[68].

5.5 The vertical division of resources

In section 5.4.3 the necessity of revenue sharing in the system of intergovernmental fiscal relations was described. This section will describe the division of resources between national and provincial governments.

If the system of intergovernmental relations function in accordance with the FFC's norms and recommendations concerning provincial revenue sources and revenue sharing,

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[68] Once the Intergovernmental Fiscal Relations Bill has come into law it will require the FFC to submit to the Minister of Finance at least ten months before the start of the financial year recommendations regarding (a) the vertical split of resources between national, provincial and local governments, (b) the horizontal split of resources between provinces and (c) ad hoc grants from national to provincial and local governments. The Minister of Finance will have to consult the Budget Council, the FFC and the Local Government Budget Forum (PRC, 1998:11).

approximately 95 percent of tax revenues are collected nationally. The provinces, however, have 50 percent of the expenditure responsibilities (FFC, 1996:3). Thus, the vertical division of resources is about finance following functions. Revenue have to be distributed to subnational governments to enable them to fulfil their functions. The division of resources between national and provincial governments depends on the allocation of categories of functions (FFC, 1995b:3).

In its 1995 recommendations the FFC (1995b) distinguished between two categories of national level government departments. The first category is where the activities are not related to the size of the population, for example those of the Departments of Defence, Foreign Affairs, Parliament, Finance and State Expenditure. The second category is where the functions vary according to the changes in the population, such as (tertiary) Education, Water Affairs and Correctional Services (FFC, 1995b:4). The revenue share allocated to national government necessary to match these expenditure requirements is defined as α (FFC, 1996:3).

At the subnational level the provinces are responsible for major services to the public, like education, health, housing and welfare. These functions have to be expanded as the population increases (FFC, 1995b:4). The provincial revenue share including the amounts for local government can be defined as β (FFC, 1996:3).

It follows that $\alpha + \beta = 1$ and the vertical division of revenue between national and provincial governments is α/β.

To calculate the revenue for the vertical split, the Department of Finance estimates the amount of revenue raised nationally as R and takes into consideration the performance of the economy, the business cycle, taxation policies and revenue projections (FFC, 1996:2). The national government (G) gets $G=\alpha R$ and the provincial governments (P) receives $P=\beta R$. This is subject to the condition $\alpha + \beta = 1$ (FFC, 1996:4).

The FFC's 1995 recommendation for the vertical division was that the proportion of resources going to the national government should not grow in real terms for the three years beginning in the 1996/'97 fiscal year. Possible saving (or even real decreases) in the first category functions was proposed to be used for the second category. The global amount allocated to the provinces was to absorb the total growth in resources during the three year period (FFC, 1995b:4). However, in such a formulation $G_t = G_{1995/96}$, P is determined by R-G=P and the α/β ratio is determined *ex post*. This was changed in the 1996 recommendations.

The FFC's 1996 recommendations see the *ex post* approach as rigid, as the α/β ratio will change in a mechanistic way as β increases and α decreases. That does not correspond to the reorganisation of budgets or planning objectives of government (FFC, 1996:4). The approach used in the recommendations for 1996/97 is that the Budget Council must determine the α/β ratio, while taking into account the national development planning priorities, constitutionally assigned functions and provincial plans (FFC, 1996:4)[69]. Furthermore, a 0.5 percentage point per annum shift in the α/β ratio in favour of the provinces is recommended. Using the FFC's projected GDP growth rates that means real growth of 2 percent per annum for the national government and 4 percent per annum for the provinces (FFC, 1996:5). Of further importance is that the impact of unforeseen economic circumstances are taken into account in the 1996 recommendations. That could include changes in the cost of servicing national debt or in provincial borrowing. After the first three years, the α/β ratio can be set for three year cycles (FFC, 1996:5). This links up with the idea that limits should be set on the range of change in α/β to ensure transparency, accountability and predictability of budgets. Finally, it was recommended that should policies be set to exceed the budget, $\alpha + \beta > 1$, the shift should occur in favour of the provinces, with reprioritisation at the national level (FFC, 1996:4)[70].

In the longer term the FFC proposed the introduction of tax room in the formula for the vertical split. When the possibility of a provincial surcharge on the personal income tax base comes into law, tax room will be created at the national level, to be taken up by the

[69] The Constitution does not explicitly state that the FFC cannot play a role in the vertical split, but aside from the above recommendations, the Commission has stayed on the background and the Budget Council has driven the vertical split (Karras, 1996:3).

[70] Criticism of the vertical split recommendations is that it will squeeze central government's share of revenue and make the creation of tax room difficult (Osborn, 1996:38). Cohen (1996:1) also states that in this context, fiscal discipline can adversely affect the provinces. Also see De Villiers (1996:21).

provinces. An amount of revenue equivalent to a number of percentage points on the personal income tax base (which was initially part of the vertical transfer to the provinces) may be given to the provinces as provincial own revenue (FFC, 1996:3). In the interim, the provincial own revenue will be represented by a proxy called the Transitionally Assigned Surcharge (TAS), that is deducted from the total revenue pool.

The vertical division and the provinces' share of revenue collected nationally can be simulated in table 5.1. The vertical division includes provincial revenues from a surcharge on the PIT base, phased in from 1 to 7 percentage points.

Table 5.1: Vertical division of nationally collected revenues

Tier	1996/97 BUDGET (BASE YR.)	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03 TARGET
Provincial (%)	51.85	52.35	52.85	53.35	53.85	54.35	54.85
National (%)	48.15	47.65	47.15	46.65	46.15	45.65	45.15
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00

(Source: FFC, 1996:6)

In table 5.1 the base year figures are derived from the 1996/97 budget as it was presented to the South African Parliament on 13 March 1996. The table then shows an annual shift of 0.5 percentage point of nationally collected revenues and surcharges towards the provinces. The FFC's recommendations state that it is important to keep in mind that the improvement of conditions of service is a national competency and must be adjusted in the provincial totals (FFC, 1996:7).

With the vertical division done, the provincial share has to be horizontally distributed amongst the provinces.

5.6 Horizontal division of resources

The provinces' allocation from the vertical split is divided between them according to a provincial grants formula. In the FFC's recommendations for the 1996/97 fiscal year, the grant formula consisted of three major elements: a basic grant (B), national standards grant (S) and a tax capacity equalisation grant (T). A separate fourth grant was included to fund academic medical centres in the provinces that have such institutions (m). In the recommendations for 1997/98 the grant for academic medical centres was expanded to provide financing for all those services which have interprovincial spillover effects and is referred to as the spillover grant. An institutional grant (I) was also added for the 1997/98 fiscal year.

The relationships can be expressed in the following equation:

$$\beta R = S + m + T + I + B$$

Each of the grants will be discussed in detail below[71].

5.6.1 Minimum national standards grant

The **S**-grant is the national standards component of the grant formula. It is also referred to as the minimum national standards grant in the 1997/98 recommendations. Its aim is to ensure that each province can provide the minimum national standard of basic human capital (FFC, 1996:7). The FFC divides the S-grant into two components: a national standards grant for education and a national standards grant for health. Thus each province should have sufficient and equitable resources to provide primary and secondary education and primary health care at the levels of the national minimum service standards. The argument is that public expenditure on education and health care is investment in human capital which increases productivity and is an important way of achieving sustained long term growth. As it will increase the earnings of the majority of residents, the process facilitates a more equal distribution of income in the future (FFC, 1996:7).

The FFC calculates the National Standards Grant from estimates of the expenditures necessary for providing the services at minimum service standards (FFC, 1996:7). The grant that each of the provinces receives, depends on the eligibility of the particular

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[71] The PRC (1998:10) offers a brief summary of the components of the provincial grants formula.

province's residents. The provinces will thus receive different per capita grants that reflect the different demographic and socio-economic structures of the provinces. The total allocation will be based on interpersonal equity (FFC, 1996:8).

An analysis of the minimum national standards for education shows that the formula for this grant has demographic, policy and cost components. The minimum level of education must be provided to children aged 5-17, who make up the demographic component in the formula. The policy component quantifies the minimum national standards in a weighted teacher-pupil ratio of 1:38. The cost component is obtained by the product of the number of teachers required and the average salary and non-salary costs. The non-salary or non-teacher costs include the operating and other expenditures and also capital expenditure. The ratio of salaries to other costs was determined empirically as 71:29. The average grant per pupil was calculated as R2 256 in 1997/98. The amount received by a particular province may then be calculated by multiplying the average grant per pupil with qualifying population between 5 and 17 years old (FFC, 1996:9). The average grant per pupil ensures equity amongst the provinces but differences in demographic profiles lead to different per capita allocations (as opposed to allocations for the eligible population) (FFC, 1996:10).

The same can be done for the minimum national standards for health. The purpose of the grant is to ensure the provision of minimum national standards in primary health care and the establishment of a district-based health system (FFC, 1996:10). To determine the demographic component, it was concluded that people with membership of medical aid schemes visit public health clinics once in two years. Other persons do so on average twice a year. The policy component is the establishment of a referral based system that will encourage patients to first visit clinics and then go to hospital if referred there from the clinic. It is assumed that medical aid patients will still use the clinics 0.5 times per year, while average clinic usage by public patients will increase to 3.5 times per year in ten years time (FFC, 1996:11). The cost component was calculated by dividing the total amount set aside for primary health care in the National Department of Health's Medium Term Expenditure Framework, by the eligible population. In addition, the actual expenditure of 1995/96 was used for the costing of district hospitals. A capital component is included for upgrading and maintaining facilities. From these components the qualifying population was calculated by applying the above-mentioned weights to the population in the province: 0.5 for people in the private system and between 2 and 3.5 for people in the public system each year. The sum of the two calculations gives the estimated number of clinic visits per year. Dividing the estimated number of visits by the target usage rate results the qualifying population of the province for that year. Finally the number of the qualifying population is multiplied by the average cost per year.

It may be important to note that the national minimum standards grants for education and health care make provision for only a limited amount of capital spending. So-called "routine" capital expenditure that meets the needs of the growing population has to be included in the formula. The FFC (1996:8) states that capital spending to upgrade existing facilities can be partly accommodated in the formula. Capital spending to address backlogs are regarded as a national development issue and can, for example, be funded by the Reconstruction and Development Programme (RDP). Of the total financial allocation to provinces, the national standards grant is allocated first. What is then left of the total amount is distributed as basic grants, as described below. Then each province can spend as much of its basic grant on additional education or health care as they prefer.

5.6.2 Spillover grant

The grant for medical training from the FFC's 1996/97 recommendations is referred to as the spillover grant (**m**) in the 1997/98 recommendations[72]. The aim is to provide finance for academic health training and certain "unique" health services in certain provinces.

The FFC states that the reasons why academic hospitals in Gauteng, the Free State, KwaZulu-Natal, Western Cape and Eastern Cape have to receive such an additional grant are threefold (FFC, 1996:13):

- The hospitals are involved with national training. A grant to compensate academic hospitals for fulfilling a national function should be based on the number of clinical students at each hospital.

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[72] See section 4.4.1 for the theoretical discussion of interjurisdictional spillovers.

- Certain unique services are national in character and will in the long term not be provided by each province (e.g. heart transplants). If left on their own, individual provinces will have no incentive to provide the service unless national government can internalise the spillover effect with a grant.
- Other health services that are not unique also spill over between provinces. Provincial hospitals that provide the services to patients from another province should be able to bill the province in which the patient lives. A provincial spillover grant will have the same internalising effect.

Thus the proposal is that the grant is made to the province where the hospital is allocated and earmarked for the hospital that is providing the service (FFC, 1996:13). However, the national and provincial commitment is to primary health care and the FFC proposes that spending be kept constant in real terms for a period.

5.6.3 Fiscal capacity equalisation grant

The constitution allows for provinces to impose surcharges on taxes[73]. Due to problems associated with levying surcharges on company income tax, value added tax and customs duties, the FFC foresees that surcharges on personal income tax are likely to be the most significant source of provincial own revenues (FFC, 1996:14). Provinces are encouraged to raise their own revenues to promote fiscal accountability. The FFC argues for accountability at the margin. Each province must be accountable for any additional spending that it has planned, through being responsible for raising the additional revenue.

[73] The Constitutional assignment of functions and finance was discussed in section 5.3.1 but the following can be added: When the possibility of a provincial surcharge was proposed by the FFC in its framework document (1995), the Commission emphasised that the surcharge should only be a few percentage points and should not influence people's decisions to live in certain provinces or not (Senekal, 1995:1 and Motlhabakwe, 1995a:3). There were, however, cautious responses as the surcharge raised fears of an even higher tax burden (Motlhabakwe, 1995b:3 and Lunsche, 1995:7). At this stage the wording of the interim Constitution on this issue was seen as ambiguous and SABEK stated that the FFC's framework document was not clear on whether national personal income tax rates would be lowered to allow for the surcharge (Schoombee, 1995:25). The controversy surrounding surcharges surfaced again in December 1995 in the drafts of the final Constitution. The draft prohibited provinces from raising surcharges on a range of taxes. The FFC however emphasised that the ability to raise a surcharge on personal income tax is crucial for the effective functioning of provincial government (Steyn, 1995:1). In line with the FFC's submission the surcharges were allowed into the final constitution, as explained in section 5.3.1 (Steyn, 1996b:2). The proposal of creating tax room in the vertical split formula, to accommodate the surcharge was made in the FFC's May 1996 allocation recommendations for 1997/98 (Malunga, 1996:1).

To implement this use of surcharges, the FFC recommended that the national government has to make the necessary tax room available. The national rate on the personal income tax base must be lowered to allow for the provincial surcharges, while maintaining the overall tax burden limits (FFC, 1996:15). Tax room of up to 7 percentage points of the personal income tax base will be created and phased in over five years at 1 percentage point per annum and 1.5 percentage point in each of the last two years (FFC, 1996:16). An additional 5 percentage points of the personal income tax base will also be available for provinces, if they want to use it to fund additional programmes or more public goods (FFC, 1996:26). However, provincial tax bases are unevenly distributed and the use of surcharges on personal income tax may compromise the principle of horizontal equity (FFC, 1996:14).

The fiscal capacity equalisation grant (T) aims to supplement provincial revenues when a province's taxing capacity is below the national average, in order to promote fiscal equalisation (FFC, 1996:14). The grant will fill the revenue gap between what the province would have raised if it had the national taxing capacity, and what it actually raises from its own taxing capacity (FFC, 1995b:7). One should distinguish between "tax base" and "revenue". The T-grant compensates for tax base differentials and not for revenue differentials. Only fiscal capacity determines the amount of the grants and own revenue raised is not brought into consideration (FFC, 1996:18). A zero-sum system of tax equalisation grants is proposed to partially compensate for the horizontal fiscal disparities. The zero-sum does not apply to any province specifically, but in total. Full equalisation implies that the yield from the effective per capita tax base of the richer provinces is lowered to the national average and that of the poorer provinces is raised to the national average (FFC, 1996:17).

The FFC proposed that the level at which the tax base is to be equalised should initially be set at 50 percent of the tax room. In the first year it is calculated on half of one percentage point of the personal income tax base, in the second year on one percentage point and so on until 3.5 percentage points (FFC, 1996:16). That means full equalisation to the national average for a tax base equal to 50 percent to the tax room created by the national government (FFC, 1996:18). The value of the T-grants can be illustrated in table 5.2.

Table 5.2: Value of the T-grants by province

PROVINCES	DIFFERENCE PER CAPITA (R)	TOTAL (R000)
Western Cape	(14.50)	(57,796)
Eastern Cape	12.66	94,357
Northern Cape	(2.86)	(2,304)
KwaZulu-Natal	5.71	54,019
Free State	2.78	8,605
North West	9.79	38,233
Gauteng	(26.55)	(227,788)
Mpumalanga	0.16	490
Northern Province	16.31	92,183
All Provinces	-	-

(Source: FFC, 1996:19)

The second column of table 5.2 shows the proportional per capita adjustment which is made to each province. This equates the provinces with the national effective per capita tax base at a surcharge rate equal to one half of a percentage point of the personal income tax base. The T-grant will be negative for Gauteng, the Western Cape and Northern Cape and positive for the rest of the provinces, as it totals to zero (FFC, 1996:19).

As already noted, the grant is independent of whether the province raises taxes or not. The provinces are, however, encouraged to levy the surcharge for two reasons: (a) the province can keep the revenue it raises without deduction, and (b) will also need it as the creation of tax room will reduce the revenue sharing pool, and transfers of nationally collected revenue will then not be sufficient to cover the expenditure requirements (FFC, 1996:19).

The fiscal capacity equalisation grant will only come into effect once national legislation has been passed on the taxing power of provinces. Until then the Transitionally Assigned Surcharge (TAS), mentioned in the previous section 5.5 on the vertical split, will be used as a proxy for the surcharges. The size of the TAS will be equal to the size of the tax room (FFC, 1996:25).

5.6.4 Institutional grant

The introduction of the institutional grant (I) in the FFC's recommendations for 1997/98 arises from concerns expressed by the Northern Cape government after the recommendations for the 1996/97 fiscal year. Funding the provinces only on a population driven formula places the Northern Cape at a disadvantage as its transport, communication and access costs are far higher than the national average and the very small population means fewer benefits from economies of scale in administration and service delivery (FFC, 1996:20).

To solve these problems with a cost adjusted equalisation component that makes it possible for the Northern Cape government to deliver the same level of services on an equal per capita grant, is difficult (FFC, 1996:20). To adjust the allocation formula for density makes some of the poorer provinces like Northern Province worse off, while using land area will result in a relative cut to KwaZulu-Natal. Both cases contradict the objective of the allocation formula to fund services on an equal per capita basis (FFC, 1996:21). Furthermore, it could be that there is no overall change if all the provinces can each include their own cost differential factor. There is also difficulty in costing administrative expenditure and the use of the grants will have to be monitored to ensure it is used efficiently and that it is not used for other functions. In the last instance, it is important that any incentives that lead to inefficient spending and shelter provinces from restructuring should be excluded (FFC, 1996:20).

The solution chosen is to give each province a constitutional or "bottom slice" grant. The cost of running a very basic administration in terms of the constitution was calculated and the amount will be given to each province from the provincial revenue pool before the rest of the FFC formula is applied (FFC, 1996:21). That is R32 million for each province for 10 MEC's, ten heads of department and a basic infrastructure to support them. When national legislation empowers provinces to raise taxes (surcharge on the personal income tax base), it will be possible for the Northern Cape government to raise additional revenue from its tax base.

5.6.5 Basic Grant

The basic grant (**B**) is in essence a block grant received by the provinces over and above the specific "S", "T", "m" and "l" grants. The FFC proposes that the basic grant should consist of two parts, namely a component intended for distribution by the province to local authorities within its geographical area and the second part for general provincial use (FFC, 1996:22). The provinces may use this basic amount of money to undertake the functions assigned to them in the Constitution and supplement the allocations to functions specifically provided for in the other grants. The grant enables the provinces to budget as they see fit. A province thus has some discretion to set its own priorities and tailor the services to the citizens' needs and preferences (FFC, 1995b:5). The autonomy is, however, exercised within the boundaries of nationally legislated priorities and policies (FFC, 1996:22).

The total amount of the basic grant is related to the size of the population of the particular jurisdiction. The resources available for distribution in the form of the basic grant are divided between the provinces in proportion to weighted provincial population numbers. The FFC states that the basic grant needs to be adjusted to take the economic needs and disparities within and between provinces into account, as well as the development needs of the provinces. In the absence of reliable income and expenditure data, the rural population was used for this purpose (FFC, 1996:23). Ruralness may serve as a proxy for differences in wealth, as poverty and unemployment levels are higher in rural areas and there is limited access to housing services, water, electricity, sanitation and transport. Education and health care services are also inferior to that of the urban population. The FFC recommended that a weight of 25% be attached to the number of people living in rural areas. Thus each rural person "counts as 1.25 persons" in the basic grant formula (FFC, 1995b:6)[74].

The total basic grant to be distributed amongst the provinces is then determined as the

[74] There was criticism that using the rural population does not take account of rural people who have recently migrated to urban areas. The result is that the needs of Gauteng and the Western Cape is under reflected (Anon., 1996a:30). In a concession to these criticisms the FFC later agreed to count the people living in informal settlements within city limits as rural, if their living conditions approximate those in rural areas (Dasnois, 1996:13).

residual amount after the minimum national standards grant, the spillover grant for medical training and unique health services, the fiscal capacity equalisation grant and the institutional grant have been deducted from the aggregate provincial revenue pool (FFC, 1996:24).

5.6.6 *Ad hoc* grants

Outside of the distribution formula, certain ad hoc allocations can also be made. The reasons for such allocations include addressing of backlogs, emergency expenditure, provision for specific problems and project funding for national development planning (FFC, 1996:25). These funds can not be distributed by formula as they are generally for indivisible projects that spill over the borders of a number of provinces and attempt to meet multiple objectives. Currently the ad hoc allocations fall under the RDP fund and also take the form of contingency funds which are conditional grants to the Provinces (FFC, 1996:24).

The amount and objectives of an ad hoc fund are politically determined and must be taken into account when the vertical balance is determined. Furthermore, the FFC emphasises that it is important that ad hoc allocations should meet specific objectives and should not serve as a back door to get more funds than the allocation formula provides for (FFC, 1996:25). On these grounds, the FFC also recommends that the bridging finance component of RDP grants should be phased out as soon as possible. Transparency requires that the bridging finance be shown as a special item for each province (FFC, 1996:24).

In conclusion, the FFC warned that the above recommendations for the horizontal division of resources was envisaged to take some time to be phased-in. The target shares and allocations per province are calculated for the financial year 2002/03. If the formula was first to be used in 1997/98, this implies a five year phasing-in period. Thereafter the base year allocations will be used as a starting point, and the target shares and allocations determined by using a straight line method (FFC, 1996:28).

5.7 Provincial borrowing

As discussed in the Constitutional assignment of functions and finance in section 5.2.1, the provinces can supplement their shared revenue by borrowing. This Constitutional power is put into practice in the Borrowing Powers of Provincial Governments Bill. The first draft of the bill was published in August 1995. In accordance with the Constitution, the bill restricts provincial borrowing powers to short-term bridging finance and longer-term loans.

The provinces can raise the bridging finance to cover current short-term budget shortfalls. The Constitution requires provinces to redeem such loans within twelve months. The bill, however, requires provincial borrowers to retire outstanding bridging loans after ten months, as the budgets tend to be cash flush during the last two months of the fiscal year. Furthermore, a limitation is added in that interest payments on bridging finance should not exceed 5 percent of the total annual budgeted revenues for each province (Anon., 1995:48-49)

The longer-term loans are for financing of approved budgeted capital expenditure shortfalls (Anon., 1995:49).

The bridging and longer-term loans can be obtained by the provinces in the local capital market and will not be guaranteed by national government. They are also allowed to borrow from international development agencies like the World Bank (Volschenk, 1995a:8). The provinces are allowed to obtain private syndicated loans from foreign banks, but are prohibited from raising funds on foreign bond markets (Anon., 1995:48). The foreign loans will be guaranteed by national government (Volschenk, 1995a:8).

Provincial borrowing will be decided on by a loan co-ordinating committee to ensure that fiscal policy is consistent at all levels of government, and that a consensus is reached on an aggregate level of borrowing. The Minister of Finance has the final say if consensus can not be reached. In January 1996 the draft Bill was changed and the Finance Minister's power to override the provinces and unilaterally set their borrowing totals, was removed. It was argued that borrowing decided by the Finance Minister could be viewed as carrying a guarantee. That should not be assumed unless a guarantee is explicitly given, as in the case of foreign loans. Assuming a guarantee would undermine provincial accountability. The minister does, however, retain a negative veto as no borrowing will be possible if he refuses (Steyn, 1996a:1).

5.8 Recommended allocations and the implementation

The principles of the formula for the horizontal division of resources was given substance to in FFC recommendations for financial allocations to the provinces.

5.8.1 FFC's proposed allocations for 1996/97

The September 1995 recommendations for the 1996/97 fiscal year consisted of a basic grant, national standards grant, tax capacity equalisation grant and a grant to fund academic medical centres. Based on the minimum national standards for providing education and health, the provinces' tax capacity compared to the national average and the ruralness weight, the provinces were allocated the following percentages (table 5.3) of the split between national revenue, approximately R86.5 billion and provincial revenue of approximately R66.7 billion (Volschenk, 1995b:9).

Table 5.3: Financial allocations per province (percentage share)

PROVINCES	1995/96 Base year	1996/97	1997/98	1998/99	1999/00	2000/01
Western Cape	11.26	10.50	9.80	9.14	8.53	7.69
Eastern Cape	17.58	17.12	16.69	16.30	15.92	15.58
Northern Cape	2.38	2.21	2.05	1.91	1.77	1.64
KwaZulu-Natal	20.04	20.30	20.54	20.77	20.98	21.18
Free State	7.08	7.07	7.06	7.06	7.05	7.05
North West	8.33	8.38	8.43	8.47	8.51	8.55
Gauteng	14.91	15.75	16.53	17.25	17.93	18.57
Mpumalanga	5.81	5.96	6.11	6.24	6.37	6.49
Northern Province	12.61	12.70	12.78	12.86	12.93	12.99
South Africa	100.00	100.00	100.00	100.00	100.00	100.00

(Source: FFC table 6a, 1995:16)

As outlined in section 5.5, it is assumed that all income growth over the five year period is granted to the provinces. Assuming a 2.5 percent growth rate along with a provision for a decrease in the budget deficit the national government's share will remain static in real terms, while the provincial governments' revenue share will increase to R79.3 billion in 2000/01 (Cohen, 1995a:1). In the horizontal division, as shown in table 5.3, declining shares were recommended for the Western Cape, Eastern Cape and Northern Cape. With this proposed allocation care was taken to ensure that no province's income decreased more than 4 percent a year. To make that possible the date that the criteria would come into operation was set at the year 2000 (Cohen, 1995b:10). The Free State's share was to remain almost unchanged at approximately 7 percent, while the North West, Gauteng, KwaZulu-Natal, Mpumalanga and the Northern Province stood to gain from increased shares (Volschenk, 1995c:19).

The FFC's recommendations for the 1996/97 fiscal year were, however, not implemented. During Budget Committee meetings in October 1995 the FFC accused the Department of Finance that it did not allow provinces enough room to develop and implement their own budgets in accordance with the Constitution.

It appeared that the Departments of Finance and State Expenditure were using the same system as in 1995/96 in which the provinces' budgetary needs were projected and the national departments, through the function committees, had the final say in setting the budgets (see section 5.2.2). In addition, no block grant allocations were made to the provinces. The then Deputy Minister of Finance, Alec Erwin, contended that block grants were not envisaged by the Constitution and that the Constitution only emphasised equity in the form of national norms and standards. In addition, he stated that the Exchequer Act did not allow for block grants to the provinces, as all expenditure had to be budgeted for (Cohen, 1995c:1-2). The provinces could also not shift funds between departments (Bisseker, 1997:31-32). The FFC's view was that with national government setting the provincial budgets and without block grants, provinces cannot spend according to their own priorities and development needs. The provinces were only spending agencies of national government (Cohen, 1995c:1-2). This violated the FFC framework document's norm of autonomy, without which the efficiency and accountability advantages of decentralisation can be called into question.

In addition to the lack of decentralisation, inaccurate population statistics also provided problems. Gauteng felt that it received too little in the 1996/97 allocation because inaccurate population statistics were used (Schimke, 1996:10).

After the confrontation over allocations in the 1996/97 fiscal year the Department of Finance stated that provincial budgeting powers would only be complete once their powers and functions had been fully delegated and once the norms and standards were set during the course of the 1996/97 fiscal year (Cohen, 1995c:1-2). The FFC's formula for dividing revenue between the national and provincial governments and between the nine provinces was approved for inclusion in the final Constitution on the 7th of February 1996 (Volschenk, 1996:1).

In the final budget presented to parliament the provinces received the following amounts for the 1996/97 fiscal year. The total amount of the allocation to provinces made up 43.4 percent of total expenditure and 54.1 percent when interest payments are not taken into account. Of that KwaZulu-Natal received the largest transfer of R14 564 million, followed by the Eastern Cape with R13 900 million and Gauteng with R11 107 million. The Western Cape received only R8 378 million, which is even less than the R9 324 million for the Northern Province. North West received R6 460 million and the Free State R5 195 million while Mpumalanga received R4 610 million and the Northern Cape R1 770 million. Provincial legislatures approved provincial budgets for 1996/97, but only as a formality (PRC, 1998:9).

5.8.2 FFC's proposed allocations for 1997/98

The 1997/98 budget was the first to be prepared under the authority of the interim Constitution, after the function committees had been disbanded at the end of 1996/97 (PRC, 1998:10). In May 1996 the FFC made recommendations for the 1997/98 fiscal year and the following five years. The allocation formula was supplemented as explained in section 5.6. The grant for academic medical centres was referred to as the spillover grant to provide finance for academic health training and certain unique health services in certain provinces. An institutional grant was added for the cost of running a basic administration. The recommendations also took tax room into account that the provinces can use as a surcharge on the personal income tax base. It was also recommended that until legislation has been passed on the taxing power of provinces, a Transitionally Assigned Surcharge will be used as a proxy for the surcharges.

When only taking into account the formula allocations, the provinces were allocated the following percentages of the split between national and provincial revenue.

Table 5.4: Total formula allocations per province (percentage share)

PROVINCES	1996/97 Base year	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03 Target
Western Cape	11.13	10.58	10.03	9.48	8.92	8.31	7.69
Eastern Cape	18.46	18.38	18.30	18.22	18.15	18.16	18.18
Northern Cape	2.35	2.23	2.12	2.00	1.88	1.76	1.64
KwaZulu-Natal	19.34	19.67	20.00	20.33	20.66	21.04	21.42
Free State	6.90	6.68	6.82	6.78	6.74	6.71	6.68
North West	8.57	8.63	8.70	8.77	8.84	8.94	9.06
Gauteng	14.75	17.79	14.81	14.84	14.85	14.68	14.49
Mpumalanga	6.12	6.19	6.25	6.31	6.38	6.44	6.50
Northern Province	12.38	12.68	12.98	13.28	13.58	13.96	14.35
South Africa	100.00	100.00	100.00	100.00	100.00	100.00	100.00

(Source: FFC table 19c, 1996:32)

Table 5.4 shows that the Western, Eastern and Northern Cape's proportionate shares of revenue declines from 1996/97 to the target year 2002/03. The Free State's share decreases slightly and all the other provinces receive an increase in their proportion of grant revenue.

When own revenue is introduced in the form of the surcharges, the picture changes as follows:

Table 5.5: Financial allocations per province (percentage share)

PROVINCES	1996/97 Base year	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03 Target
Western Cape	11.09	10.66	10.26	9.87	9.51	9.19	8.91
Eastern Cape	17.95	17.59	17.24	16.91	16.58	16.20	15.83
Northern Cape	2.33	2.21	2.10	1.99	1.89	1.79	1.71
KwaZulu-Natal	19.40	19.60	19.79	19.97	20.14	20.26	20.36
Free State	6.95	6.89	6.83	6.77	6.17	6.66	6.61
North West	8.64	8.61	8.57	8.54	8.50	8.45	8.39
Gauteng	15.16	15.84	16.51	17.16	17.79	18.57	19.33
Mpumalanga	5.99	6.06	6.13	6.20	6.26	6.31	6.37
Northern Province	12.48	12.53	12.57	12.60	12.62	12.57	12.50
South Africa	100.00	100.00	100.00	100.00	100.00	100.00	100.00

(Source: FFC table 20c, 1996:34)

The Western Cape, Northern Cape and Gauteng are shown in table 5.5 to benefit from own revenue, when the shares in the target years are compared with those in table 5.4. As the allocation to the Western Cape was recommended to decline up until 2002/03 the province at that stage urged the national government to accept the FFC's recommendations for 1997/98 and allow provinces to raise the surcharge as soon as possible (Marais, 1996:10 and Braid, 1996:1). But using the tax equalisation formula could also affect productive provinces like the Western Cape adversely - its total revenue may fall as the creation of provincial tax room will decrease the total amount of revenue collected nationally and thus the revenue shared (Ensor, 1996:2). In addition, the Northern Cape's problems, discussed in the FFC's May 1996 document (section 5.6.4), were also discussed with the Senate committee on finance and at that stage it was recommended that its sustainability as a separate province be re-examined (Swart, 1996:17 and Anon., 1996c:6).

In August 1996 the Budget Council rejected the use of the FFC's allocation formula and the use of minimum standards in education and health. The provinces were to receive a lump sum for the 1997/98 fiscal year that they could spend without restrictions, according to their own priorities (Hudson, 1996:7). The Budget Council and FFC discussed this in September 1996. The outcome of the discussion was that the function committees used in 1994/95, 1995/96 and 1996/97 to determine the criteria used in making budgetary allocations were replaced by the Technical Committees on Finance mentioned in section 5.2.2. The technical committees were to help determine the allocations which were to be discussed in the Budget Council, before submission to the Cabinet. Thus, the 1997/98 allocations were global amounts which gave the provinces discretion in preparing their own budgets departmentally.

By November 1996, budget overruns for 1996/97 were expected in Gauteng, Northern Cape and KwaZulu-Natal (De Villiers, 1996b:13-14). Of the unforeseen and unavoidable expenditure at the end of the 1996/97 fiscal year, R1 421 million was spent by the provinces, mainly on education and welfare (Gumede, 1997:1).

5.8.3 The Budget Council's allocation recommendations

During April 1997 the Budget Council followed up its above mentioned rejection of the FFC's allocation formula with some indicative allocations of its own that it wished to recommend to the Cabinet. The principles for the proposed allocations were discussed at a Finance Lekgotla on 18-20 April 1997. There it was agreed that the indicative allocations will be used as the basis for each province's MTEF as well as for the MTEF of national departments (Budget Council, 1997:1). The macroeconomic framework on which the allocations are based is in essence the same as that of the FFC document. The projections for growth and inflation, as well the fiscal framework, are consistent with conservative projections of the GEAR targets. There are, however, some important differences in the recommendations for the vertical and horizontal division of resources.

The first is that a policy and contingency reserve is top-sliced before the vertical division is made. The reserve is created to cope with the uncertainty surrounding the implementation of the MTEF. The reserve consists of a part of the budget that is not allocated, in order to help facilitate possible reprioritisation of the budget (Budget Council, 1997:3). In addition, the Budget Council recommended that a small unallocated contingency reserve of perhaps R2 billion be created for 1998/99 to deal with emergencies such as natural disasters, that may arise during that year. Overall the recommendation was to allocate up to R3 billion for each of the three years from 1998/99 when the budgets are finalised. Thus the unallocated reserve will be around R2 billion for 1998/99, rising to R4 billion for 2000/01 (Budget Council, 1997:4).

The Budget Council recommended that the amount of resources that will be shared vertically between the national and provincial governments must be calculated by subtracting the following items from total budgeted expenditures:

- "Standing appropriations" which are a legally binding first call on expenditure, such as South Africa's subscription to the IMF,
- projected debt service costs, and
- the policy reserve described above.

Of the amount left to be shared, the provinces were to receive 57.9 percent in 1997/98. The Budget Council recommended that this share should remain constant over the next five years. That means that spending on national services such as defence and housing should grow at the same rate as provincial services like education, health and welfare (Budget Council, 1997:4).

In regard to the vertical division of resources, the Budget Council's recommendations differ from those of the FFC. Section 5.5 discussed the FFC's first proposal for 1996/97 that the proportion of resources going to the national government should not grow in real terms for three years from 1996/97 and that the provinces should absorb the growth in total resources during that period. In its recommendations for 1997/98 fiscal year the FFC changed its initial position in that it recommended that the Budget Council determine the vertical split while taking into account national development planning priorities, constitutionally assigned functions and provincial plans. The FFC did, however, recommend a 0.5 percentage point per annum shift in the vertical split, in favour of the provinces. The differences between the Budget Council's recommendation of a constant share of 42.1 percent to national government and 57.9 percent to the provincial governments and the FFC recommendations can be clearly seen when comparing the constant shares with table 5.1 in section 5.5. It should be noted that the Budget Council did not take provincial own revenue into account in its whole analysis (Budget Council, 1997:3). In contrast, own revenue is important in the FFC's recommendations. For example, table 5.1 in section 5.5 adds the provincial revenues from a surcharge on the national income tax base to the vertical division of revenues collected nationally.

The Budget Council's recommendations for the horizontal division of resources amongst the provinces are separated further from the FFC framework discussed thus far. Section 5.6 discussed the FFC's proposed provincial grants formula, that consisted of a basic grant, national standards grant, tax capacity equalisation grant, spillover grant and institutional grant. The Budget Council proposed that the provinces should receive grants made up of the following components (Budget Council, 1997:6):

- Conditional grants for services that have national benefits, such as academic hospitals and teacher training. By 2000/01 it should make up 11 percent of the finance for provincial spending.
- Unconditional grants for social security. By 2000/01 it should make up 18 percent of the finance for provincial spending.
- An unconditional tax share, related to the size of the tax base in each province. This should be 10 percent of what remains when the first two grants are made and 7 percent of the total of the finance for provincial spending by 2000/01.
- The rest of the horizontal division should then be distributed as an unconditional demographic based grant. By 2000/01 this should make up 64 percent of the finance for provincial spending.

Each of these grants can be examined in more detail to highlight the differences with the FFC's proposals.

5.8.3.1 Conditional grants

Conditional grants are proposed for services that have national benefits. The Budget Council wants to support tertiary and academic health services, vocational education and teacher training colleges, RDP expenditure and intergovernmental grants to local government. The grants or a portion of them will be allocated to the provinces by national departments. The allocations will increase in line with non-interest expenditure (Budget Council, 1997:8). The Budget Council (1997:2) emphasised that the criteria on which the national departments will allocate amounts to the provinces were not yet established.

5.8.3.2 Social security grants

For the funding of social security grants the Budget Council proposed that provinces be given an unconditional grant on the basis of projected expenditure on social grants[75]. The size of the grant is to be based on the cost of existing policies, which is then projected to grow by 2 percent per year in real terms. A provisional formula for distribution is proposed which takes into account the number of elderly people (80 percent) and children (20 percent) that benefit from social grants and then weighing them by the degree of rurality (Budget Council, 1997:8).

5.8.3.3 Tax share

A part of the horizontal division is given on the basis of the tax contributed to each province. The Budget Council proposed that 10 percent of the total amount that is given as unconditional grants is allocated as a tax share. The Gross Geographic Product (GGP) will be used to estimate the tax base for each province (Budget Council, 1997:8). This differs from the FFC's recommendation that was to use an arithmetic average of turnover, payroll and GGP.

5.8.3.4 Equitable share

Finally, the bulk of provincial finance will be allocated as an equitable share grant. This is based on a demographic formula with four components:

- A basic share. In the basic grant component 20 percent of the equitable share is allocated according to the size of the population of the province.
- An education share. It is calculated as the average of the percentage distribution of the population aged 5-19 and the percentage distribution of full-time educational enrolment. 45 percent of the equitable distribution is to be allocated this way.

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[75] The provinces should budget on the basis of expected expenditure, but there will be no additional funds from national government if the allocations are insufficient. They can, however, spend the funds elsewhere if the allocations are too large (Budget Council, 1997:8).

- A health component. The share is calculated in two parts. To favour the population without medical assurance cover, the weighted qualifying population, as estimated by the FFC is used. Taking into account the higher primary health service usage rates of women, infants and the elderly, a composite of the distribution of the population is used. The population over 60 is weighted 0.33, the total number of women by 0.33 and the children under 5 is also weighted with 0.33. 30 percent of the equitable share is to be allocated in this way.
- An institutional allocation. This component is to provide an institutional basis for provincial governments, and is to take into account higher service delivery costs in provinces with smaller, more dispersed populations. It is divided in equal parts between the provinces, and 5 percent of the equitable share is to be allocated in this way.

The most significant difference between the Budget Council's recommendations for the equitable share and that of the FFC, is the population data used. The Budget Council used official CSS population data, where the FFC made its own projections along with the CSS data (Budget Council, 1997:6). The Budget Council sees its proposed formula for equitable shares as more redistributive than the FFC's due to the inclusion of other demographic determinants of service expenditure. The differences are however overshadowed by the differences caused by using the official CSS figures (Budget Council, 1997:7).

The resulting allocations from all the Budget Council's recommendations can be set out in table 5.6.

Table 5.6: Indicative allocations of shares of expenditure

PROVINCES	1997/98	1998/99	1999/00	2000/01
Western Cape	10.90	10.60	10.20	9.80
Eastern Cape	16.90	16.90	16.70	16.60
Northern Cape	2.40	2.30	2.20	2.10
KwaZulu-Natal	19.40	19.60	19.80	20.00
Free State	6.90	6.80	6.80	6.80
North West	8.40	8.20	8.00	7.80
Gauteng	16.00	16.30	16.60	16.80
Mpumalanga	5.90	6.20	6.40	6.60
Northern Province	13.10	13.10	13.20	13.30
South Africa	100.00	100.00	100.00	100.00

(Source: Budget Council table 4, 1997:9)

The shares of expenditure are not significantly different from the FFC's table 20c (see FFC, 1996:34). The Budget Council attributes the difference that does exist to its use of the official CSS population data. The main effect is that more resources are allocated to Mpumalanga, at the expense of Gauteng and North West (Budget Council, 1997:6).

5.8.4 The 1998/99 budget process and the way forward

The 1998/99 budget was the first to reflect South Africa's new constitutional dispensation. The 1997/98 budget (section 5.8.2) was still prepared under the interim Constitution and the Budget Council's recommendations only followed after that. The PRC (1998:11-12) regards the 1998/99 budget as a precursor to the future system. To provide an idea of the way forward for the fiscal system, the budget process is briefly outlined in this section. The PRC (1998:11) identifies eight stages in the budget process.

In stage one, the medium-term fiscal framework is developed by the Department of Finance. Based on the macroeconomic scenario and the calculated maximum expenditure figures, the Cabinet sets objectives and broad priorities. Stage two and stage three overlap. In stage two national and provincial spending agencies submit three-year budget inputs to the Department of State Expenditure. The submissions should reflect two scenarios: One in which the costing of all ongoing and new activities is done from a zero base, and the spending agencies are required to describe line function activities in terms of measurable quantity indicators; the second in which no nominal expenditure growth is assumed for the budget year and maintained at the level in real terms for the subsequent two years, along with an indication of the activities that are to be scaled down. From May to June the Departments of Finance and of State Expenditure evaluate the submissions against the fiscal aggregates and national priorities from stage one. The central departments submit the revised submissions into a draft national MTEF, which is presented to Cabinet early in July. The provincial line departments submit their budget planning inputs to their treasury, where it is evaluated and initial draft provincial MTEF's are prepared for the provincial Executive Councils. The draft MTEF's are forwarded to the national Department of Finance in mid-July.

In the third stage the Minister of Finance takes recommendations from the FFC and Budget Council into account in deciding on the proportions in which nationally collected revenues will be shared in the budget year and in the two subsequent years. The Budget Council recommends the vertical and horizontal division of resources[76]. The total revenue pool is "top-sliced" for mainly debt servicing and provision for a contingency fund. The remaining revenue is split vertically, with the current provincial-national split being 54:46. The provincial share is then divided horizontally. The indicative allocations are used in the MTEF budget input formulation process.

In the fourth stage the national and provincial MTEF's are consolidated. National spending agencies and provinces receive their indicative allocations, and budget cuts are negotiated with the Department of State Expenditure. The MTEF Committee reconciles the revised submissions with the draft MTEF. After MinComBud signals priorities for approval by Cabinet in mid-September, expenditure models are developed for defence, criminal justice system, education, health and welfare to provide an analysis of policy choices and to formulate proposals for conditional grants. The MTEF Committee presents its recommendations to the Minister of Finance, MinComBud and the Budget Council. MinComBud reviews the allocations and Cabinet approves the draft national MTEF in October or November.

Based on the draft consolidated MTEF the Budget Council recommends allocations to national departments and provinces to the extended Cabinet in stage five of the process.

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[76] The PRC (1998:12) states that it is not clear exactly how the Budget Council reaches its decisions.

These are discussed and approved in November and the draft national MTEF is published for parliamentary and public debate in stage six. Stage seven sees the finalisation of the national and provincial MTEF's with consideration by the Budget Council and approval by Cabinet in February. In the last stage the national departments submit their final documents to the Department of State Expenditure in mid-January and the provinces in mid-February. The Minister of Finance makes his budget speech in mid-March and tables the Printed Estimates of Expenditure. The provincial budgets are tabled in the provincial legislatures shortly thereafter.

In summary, the short history of fiscal decentralisation in South Africa is already marked by diverging opinions and official recommendations, and implementing them in practice has lead to a different system than envisaged in the FFC's original framework. Whether this route that fiscal decentralisation has taken, will make it possible for North West Province to face its development challenges will be examined in chapter six.

5.9 Summary

In the light of chapter four's theoretical arguments for and against fiscal decentralisation, chapter five discussed the fiscal system in South Africa.

The Constitutional assignment of functions and finance to the provinces provided the basis of a fiscally decentralised system. In section 5.2 the Constitution's establishment of a unitary state with national, provincial and local levels of government was discussed. The functional areas for which the national and provincial governments are jointly responsible and those for which the provinces have exclusive responsibility were outlined in section 5.2.1. The section also elaborated on the decentralisation of taxing powers, borrowing powers and the provinces' equitable shares of revenue collected nationally, which the Constitution assigned to accompany the responsibilities for the functional areas. In section 5.2.2 it was shown that the FFC is to play a pivotal role in the system of intergovernmental fiscal relations and the commission's overall tasks and functions along with those of the Budget Council and Inter-Governmental Forum were outlined.

During the 1994/95 and 1995/96 fiscal years there was limited implementation of the fiscal system envisaged by the Constitution. The interim measures, where the Department of Finance had the final say in setting provincial budgets, were to be replaced by the FFC's framework document for intergovernmental fiscal relations in June 1995. Section 5.3 discussed the norms that the FFC identified for the system of intergovernmental fiscal relations. The system of intergovernmental fiscal relations was to ensure effective resource use, accountability and transparency, based on fiscal autonomy and certainty of revenue. Equity and development were also to be ensured by the system.

Section 5.4 discussed how the FFC, in accordance with the norms it identified and interpreted the constitutional assignment of functions and finance to the provinces, and identified the provinces' potential revenue sources, minimum standards and revenue sharing as the key components of the system of intergovernmental fiscal relations. With limited decentralisation of taxation powers recommended by the FFC, and the Constitution's provision for the national setting of standards for the rendering of public services, revenue sharing was put forward as the way to ensure that provinces successfully deliver on the functional areas assigned to them. An allocation formula was described as a procedure for dividing the available resources.

Section 5.5 and 5.6 elaborated on the allocation formula the FFC proposed for the vertical and horizontal division of resources. Section 5.5 focussed on the vertical division of revenue between the national and provincial governments. Government activities were categorised as those which are not related to the size of the population and receive a constant share of the vertical split (substantially national) and those that are related to the size of the population and receive the growth in the vertical split (significantly provincial). In the 1995 recommendations the vertical split ratio was determined *ex post*. This was changed in the recommendations for 1996/97 in that the Budget Council was to determine the ratio. Concluding section 5.5 it was discussed that the FFC envisaged the creation of tax room in the formula for the vertical split, to allow for provincial surcharges on the personal income tax base.

Each province's share of the vertical split was discussed in the form of the FFC's proposed provincial grants formula in section 5.6. The horizontal division was proposed to be done through a minimum national standards grant, spillover grant, fiscal capacity equalisation grant, institutional grant and basic grant. The minimum national standards were identified for education and health care with the aim of ensuring that each province can provide for basic human capital. The spillover grant provides finance for academic health training and unique health services in certain provinces. The proposed fiscal capacity equalisation grant links up with provincial taxing powers and the creation of tax room for it. The aim of the grant is to supplement provincial revenue when a province's taxing capacity is below the national average. The institutional grant component of the provincial grants formula proposes to give each province a bottom slice grant for the cost of running a very basic administration. The basic grant is a block grant for general provincial use and distribution to the local authorities.

Where much of the emphasis of the chapter was on the revenue sharing, section 5.7 outlined the provinces' access to loan finance. It was pointed out that the provinces can raise bridging finance to cover current short-term budget shortfall as along as it is redeemed within ten months and do not exceed 5 percent of the total annual budgeted revenue of the province. Longer term loans can be used for approved budgeted capital expenditure shortfalls. The section also explained the role of the loan coordinating committee and that of the Minister of Finance.

Section 5.8 examined the allocations that the FFC proposed on the basis of its vertical and horizontal split recommendations. In practice, the proposed allocations were not realised.

In the 1996/97 fiscal year the same measures were used as in 1994/95 and 1995/96. The Departments of Finance and State Expenditure again projected the provinces' budgetary needs and through the function committees, the national departments had the final say in setting the budgets. This violated the FFC framework document's norm of autonomy.

In the 1997/98 fiscal year the Budget Council rejected the use of the FFC's allocation formula. The provinces received global amounts that they could spend without restrictions, according to their own priorities. The Budget Council followed this up with its own allocation recommendations in April 1997. These recommendations were discussed in section 5.7.3. The Budget Council proposed that before the vertical split was calculated, standing appropriations, debt service costs and a policy reserve should be subtracted from the total budgeted expenditures. Then the vertical division should remain constant at 42.1 percent to national government and 57.9 percent to the provinces for the following five years. The Budget Council's proposal for the horizontal division of resources also differed from the FFC's framework. Conditional grants were proposed for services which have national benefits and unconditional grants for social security. An unconditional tax share, related to the size of the tax base in each province was suggested. The bulk of the provincial finance was to be allocated as an equitable share. That was proposed as a demographic formula with basic share, education, health and institutional components. The final significant difference between the Budget Council's proposals and those of the FFC, was shown to be that the Budget Council used official CSS population data, where the FFC made its own projections along with the CSS data.

Section 5.8.4 briefly outlined the eight steps in the 1998/99 budget process. The 1998/99 budget was the first to reflect South Africa's new constitutional dispensation and provided a possible glimpse of the way forward for the fiscal system.

Chapter six will examine fiscal decentralisation in North West Province. The aim is to determine whether North West Province will be able to address the challenges based on chapter four's arguments for and against decentralisation, and to compare what is theoretically preferable with what is technically feasible in the South African fiscal system, as outlined in chapter five.

Chapter 6: Implications of fiscal decentralisation for North West Province

6.1 Introduction

Given the case for and against fiscal decentralisation and the system of fiscal decentralisation in South Africa, the purpose of this chapter is to outline the implications of fiscal decentralisation for North West Province.

The structure of this chapter is as follows: Section 6.2 attempts to identify how fiscal decentralisation may provide solutions for the development challenges facing North West Province. In section 6.3 the conditions for successful fiscal decentralisation are identified and the likely implications of fiscal decentralisation for North West Province discussed. The chapter concludes in section 6.4 with a summary.

6.2 Fiscal decentralisation and economic development

The economic development challenges facing North West Province were discussed in chapter two. These were established to be due to market and government failure, the nature and causes of which were discussed in chapter three. In chapter four the case for decentralisation to address these failures was examined. In this regard the fragmented localist model and centralist model's theories might be used to shed light on the potential of fiscal decentralisation in South Africa (described in chapter five) to contribute to address the economic development challenges facing North West Province.

6.2.1 Building of the economy

In section 2.3.1 the desired growth scenarios in the "North West 2001" development strategy were set out. It was estimated that a five percent per annum growth rate in the province's GGP is needed to provide jobs for the annual entrants into the labour market.

The broad challenges to building the economy were identified as :

- attracting foreign direct investment,
- structural transformation to focus the economy on tourism and manufacturing,
- small farmer development,
- promoting labour intensiveness, and
- a social accord to improve productivity and keep wage increases below the productivity increases.

Specific output and employment growth targets were also mentioned for certain sectors and the challenges to achieving those, identified. In the mining sector the challenge was seen as successful negotiations between labour, management and government to secure the increases in consumption expenditure, capital investment and exports which are needed to build the economy (section 2.3.1.1). The challenge to output and employment growth in agriculture was identified as small farmer entrepreneurial development (section 2.3.1.2), while in manufacturing the establishment of spatial development initiatives, improvement of labour productivity and enhancement of research and development were seen as the challenges (section 2.3.1.3). For promoting SMME's, the challenges which were outlined included ensuring equal commercial opportunities and providing support to SMMEs through public goods, research and development and public/private partnerships (section 2.3.1.4).

Chapter three's analysis of the perfectly competitive market illustrated that the market may fail to achieve efficient and equitable resource allocation and by corollary, fail to address the development challenges in North West Province. Negotiations between labour, management and government concerning the mining industry may tend to be subject to indeterminancy of bargaining (section 3.3.1.3). The parties have to agree on how to share the gains from their envisaged agreements to, for example, increase investment or productivity. When the bargaining is lengthy and costly the market will fail. The challenges identified by the North West government are subject to information costs, in particular the small farmer entrepreneurial development. Determining the needs and eligibility of small farmers, project implementation and feedback from rural areas may involve information costs that cause market failure (section 3.3.1.2). The challenge of spatial development initiatives, improving research and development and public/private partnerships present positive externality characteristics and may be underprovided by the market (section 3.3.2.3).

Government intervention in the economy may overcome some of the instances of market failure. However, section 3.4 argued that the causes of market failure may also cause government to fail to achieve efficient and equitable resource allocation, and thus to address the development challenges. Government may especially fail to determine the preferences (section 3.4.1) for small farmer development, or for research and development, or for equal commercial opportunities for SMME's. It may also be costly to determine the extent of the positive externalities attached to the former, implying possible inefficient subsidies. Promoting public/private partnerships may encourage rent-seeking behaviour and inefficient allocation of resources (section 3.4.2). Furthermore, because government intervention is subject to social and public choice problems (see section 3.4.3), government failure may be prevalent.

In sections 3.5 and 4.3 fiscal decentralisation was forwarded as a solution to government failure. If fiscal decentralisation can ensure efficient and equitable resource allocation, it may also help to address the development challenges facing North West Province. Arguments which can be made in favour of a fiscally decentralised system to address the challenges are based on (a) the spatial characteristics that may be attached to the challenges and (b) on the possible existence of differential preferences for building the economy.

Spatial characteristic arguments in favour of a fiscally decentralised system were discussed in section 4.3.1. When the costs and benefits of public goods or services are limited to a specific region or locality, the good or service may be provided more efficiently by a fiscally decentralised government. In smaller decentralised groups individuals may be more likely to reveal their preferences for public goods and services and the system of social choice is more stable. In the case of North West Province it may be argued that the costs and benefits from promoting mining, agriculture and SMME's may be limited to the province. Mining and agriculture are immobile resources and the small and localised nature of SMME's means that output and employment growth are obtained for the province and the benefits are not exported to national or multinational corporations.

Differential preferences arguments were discussed in section 4.3.1. When the costs and benefits of public goods and services are regionalised or localised, the preferred amount and type of public goods and services will depend on the tastes and needs of the residents. The section showed that catering for differential preferences may be more efficient than a uniform national approach. It may be argued that fiscal decentralisation may make it possible to focus on needs which are particular to North West Province. Section 2.3.1.1 emphasised the negative implications for growth and employment in the province when mining is not performing. In North West Province mining may require more attention in the building of the economy than may be feasible nationally, or than is needed in other provinces. Another example of possible differential preferences in building the economy is that North West Province is largely a rural province, so that tailoring policy for small farmer development may be more effective. If fiscal decentralisation can contribute to preference revelation for building the subnational economy and reduce information costs, it may in theory contribute to more efficient resource allocation and in that way to development in the province.

Arguments against a fiscally decentralised system to address the challenges of building the provincial economy also refer to the spatial characteristics of development challenges. Such spatial characteristics were discussed in section 4.4.1 in terms of the inefficiency of spillovers. It was shown that spillovers occur when there is a mismatch between the spatial characteristics of public goods and the jurisdiction providing it. This means that residents of other jurisdictions may benefit from subnational programmes or carry some of the cost. In North West Province efforts to build the subnational economy may result in spillover effects. For instance, negotiations between management and labour in the mining industry may have results which have national implications. When an agreement may have implications for mines and workers in the whole country it may be unlikely that the national and international corporations which own the mines, or the national unions which represent the workers will enter into an agreement concerning remuneration, productivity or retrenchments, to build the North West economy. There may also be spillovers in the promotion of agriculture and manufacturing. If the increased agricultural output is processed in agro-industries outside the province or if improved research and development benefit national corporations, subnational government will underprovide such public goods and services which have positive spillovers (section 4.4.1). Furthermore, small, open subnational economies such as North West may find it futile to stimulate their economies, since they may pay the full cost but receive only partial benefits (section 4.4.2). Fiscal decentralisation as solution to government failure and the challenges facing North West Province thus needs to be tempered in a cooperative localist model framework (section 4.5). Intergovernmental fiscal instruments may be used to compensate for the inefficiency of the spillovers (section 4.5.4).

The theoretical arguments either for or against a decentralised fiscal system to build the provincial economy, are not conclusive. There are no significant arguments against a greater degree of decentralisation in a cooperative localist model. The decentralised measures allowed for in the Constitution and the FFC's recommendations need to be examined.

The constitutional framework adopted for provincial governments in South Africa (section 5.2.1) does not explicitly mention building the economy. Schedule 4 part A lists agriculture, industrial promotion, and regional planning and development as areas of joint national and provincial responsibility. The FFC's recommendations do not mention the degrees of decentralisation or centralisation envisaged for building a provincial economy. A possible national influence on a fiscally decentralised system may be the development norm that is to be applied to the system of intergovernmental fiscal relations. Section 5.3.7 stated that the norm means that fiscal transfers may be used to encourage regional development and employment. There is, however, no indication that building a provincial economy is a national concern, or that the effort requires uniformity or equity. On the strength of the arguments in favour of fiscal decentralisation and with little restriction in practice it seems possible that the provincial government may face the challenge of building the provincial economy. Section 6.4 will outline the conditions for successful fiscally decentralised building of the economy.

6.2.2 Physical services delivery

In section 2.3.2 it was stated that infrastructure is essential for alleviating poverty and making North West Province accessible to investment and growth. The challenges which were identified include providing access to clean drinking water and sanitation, the provision of electricity, postal and telephone services, along with roads and transportation services.

These challenges have significant public goods characteristics and the market may fail to allocate resources efficiently and equitably for them. Though not typically non-rival and non-excludable in consumption, the cost of adding another consumer to water provision or the sanitation system, or to electricity, telephones or roads, tends to be low and marginal cost pricing inefficient (section 3.3.2.2). The absence of property rights to roads or the sanitation system and the large number of participants in the province mean that voluntary payments are unlikely to be forthcoming. Individuals will misrepresent their preferences and act as free riders to receive the physical services without paying for it. Private cooperation to provide physical services will be subject to information costs and indeterminancy of bargaining (sections 3.3.1.2 and 3.3.1.3). The result is that the market will under-provide physical services, or not provide it at all.

As solution to market failure, government intervention may be proposed to provide a political process to reveal preferences and furnish the fiscal resources needed to pay for physical services delivery. However, in section 3.4.1 it was shown that government may fail to determine preferences for public goods. The social and public choice problems described in section 3.4.2 also showed that the nature of government as a system of collective decision making may cause it to fail to achieve efficient and equitable resource allocation.

In sections 3.5 and 4.3 fiscal decentralisation was forwarded as a solution to government failure and the concomitant challenges facing North West Province. Arguments in favour of a fiscally decentralised system to address the challenges of physical services delivery may be based on spatial characteristics and differential preferences.

In section 4.3.1 the fragmented localist model was outlined and shown to argue that spatial characteristics may be attached to the costs and benefits of public goods and services. When the costs or benefits are regionalised or localised it may be possible for a fiscally decentralised system to provide the public good or service more efficiently. In North West Province the provision of water and sanitation, electricity, postal and telephone services and to a lesser extent roads, has such local or regional public goods characteristics. The costs and benefits will be limited to the province and may thus benefit from fiscally decentralised provision.

In addition to spatial characteristics, the reasoning behind the differential preferences arguments in section 4.3.1 may also be applied to physical services delivery. The fragmented localist model argues that catering for differential preferences for public goods and services in different jurisdictions may be efficient. In smaller decentralised groups individuals may reveal their preferences because if they do not, the public good or service may not be provided at all. In theory they may also vote with their feet by moving to jurisdictions which best satisfy their preferences. In North West Province the importance of adequate sanitation, as identified in the development profile, may represent a preference pattern that differs from other provinces and which a fiscally decentralised system can cater for. The preference for sanitation stems from the fact that underground water is the primary source of water supply in a large portion of the province and adequate sanitation is necessary to prevent contamination (section 2.2.3). The preferences for roads and transport services in North West Province may also differ from those in other provinces and thus benefit from fiscally decentralised provision. Sections 2.2.3 and 2.3.2 emphasised that the location of the North West Province makes it possible for the province to be a through-traffic hub to the rest of Southern Africa. A fiscally decentralised system may facilitate the implementation of the recommendations of the province's Trade and Industrial Strategy, to develop intermodal transfer points and specialised transport infrastructure services (Naudé, 1998a). If fiscal decentralisation can contribute to preference revelation for physical services delivery in the province, it may in theory contribute to more efficient and equitable resource allocation and in that way to development in the province.

Arguments against a fiscally decentralised system to address the challenges of physical services delivery, may also be based on the spatial characteristics attached to the challenges. Although the arguments in favour of fiscal decentralisation imply that there is a perfect correspondence between the individuals who consume public goods and services and the jurisdiction that provides it, in practice spillovers occur. Though the arguments that spillovers may exist in the cases of water and sanitation are weak, they are stronger for transport services. An example is the North West Star bus service which is subsidised by the province, but provides services across its borders. Section 4.4.1 showed that a subnational government will only provide such public goods and services to the extent that a tax-price or user charge reflects the preferences and benefits of local residents and the benefits that non-residents receive are not taken into account. The result is that the public goods and services with positive spillovers will be systematically under-provided.

The efficiency of fiscally decentralised physical services delivery to satisfy differential preferences may be argued against if it causes differences in net fiscal benefits across jurisdictions. When the benefits received from public goods and services, along with the tax price paid, differ between jurisdictions, residents will move in response to these fiscal considerations to jurisdictions where they receive positive net fiscal benefits. Such migration is inefficient as it may generate fiscal externalities (section 4.4.1).

Physical services delivery is seen as essential for alleviating poverty. As far as physical services delivery has a distributional aspect, arguments can be made for equity in provision. As in section 4.4.3, it may be claimed that in South Africa the lack of physical services in certain communities is the result of the previous apartheid government's policies and improving the situation is a national concern. Only national government may be able to ensure that all people receive the same benefits, regardless of where they reside.

The arguments in favour of a fiscally decentralised system to address the challenges of physical services delivery, and those against, are not decisive. As in the previous section it may be argued that a cooperative localist model is required to realise the efficiency of decentralisation, but mitigates the possible spillovers and inequity (section 4.5). Intergovernmental fiscal instruments may encourage provincial governments to internalise the spillover effects into its decision making, or to ensure that national equity objectives are achieved in the provision of physical services. The degree of decentralisation or centralisation that is allowed for in the Constitution and in the FFC's recommendations will determine whether the emphasis of a cooperative localist model is to be on the efficiency benefits of catering for differential preferences for these regional and local public goods, or whether the focus is to be one of national equity.

The degree of decentralisation or centralisation that is allowed for in the constitution was described in section 5.2.1. Section 4 part A lists public works as an area of joint responsibility, but only in so far as provincial government departments administer functions specifically assigned to them. Thus, the constitutional assignment seems to propose a lesser degree of fiscal decentralisation. This is backed by the FFC's equity norm. In the system of intergovernmental fiscal relations the equity norm is aimed to ensure fiscal fairness in the provision of public services to all households. Section 5.3.6 discussed how fiscal fairness is interpreted to mean that each individual should have equal access to publicly provided services such as water or sanitation, and that each household should receive equal or similar public services for an equivalent tax effort. In implementation the equity norm takes the form of RDP minimum standards for the provision of water and sanitation, as described in section 2.3.2. Thus, though the theoretical arguments in favour of fiscally decentralised physical services delivery exist, the South African fiscal system tends to favour the equity arguments against fiscal decentralisation. The system of intergovernmental fiscal relations proposes only administrative decentralisation to the provinces and minimum standards to ensure national equity in provision of physical services. Section 6.4 will examine whether this precludes fiscal decentralisation and will outline the conditions for fiscally decentralised physical services delivery to exist, as applicable in a system of shared functions.

6.2.3 Social services delivery

In section 2.3.3 the need for the extension of health, welfare and housing services in North West Province was discussed. Regarding health care it was shown that North West Province has the fewest medical officials and nurses per thousand of the population and the second lowest health funding per capita of the provinces. The main challenge that North West 2001 identified for addressing these needs is to foster public/private cooperation in the health system. In welfare, the challenge was also seen as increasing private sector cooperation in order to extend welfare services. In section 2.3.3 it was shown that the housing component of social services has been characterised by delays in housing delivery. For provincial government the challenge is to facilitate delivery by encouraging *bulk* service delivery and efficient local government planning.

The market may fail to provide and extend social services efficiently and equitably. Section 3.3.2.2 identified social services as a typical public good. Exclusion may be problematic and free riders may represent their preferences. Improved health care, welfare and housing services may also be seen as having positive external effects (section 3.3.2.3) which may cause market failure.

To some measure the nature of public services presupposes a role for government. However, section 3.4.1 showed that as in the cases of the market system and voluntary agreements, government may fail to determine the preferences for such public goods. The problems associated with social choice (section 3.4.3.1) may cause government failure to provide an appropriate system of collective decision making, and the problems of public choice (section 3.4.3.2) may thwart attempts at efficient supply of public goods.

Sections 3.5 and 4.3 proposed fiscal decentralisation as a solution to government failure. If fiscal decentralisation can ensure efficient and equitable resource allocation, it may also help to overcome the development challenges facing North West Province. Arguments in favour of a fiscally decentralised system to address the challenges of social services delivery may be based on spatial characteristics and differential preferences. In section 4.3.1 the fragmented localist model argued in favour of decentralised allocation on the basis of the spatial dimensions that may be attached to the costs and benefits of public goods and services. The costs and benefits of health, welfare and housing services were seen to be sufficiently regionalised or localised to recommend that it should be a subnational responsibility (section 4.3.4).

Though the spatial characteristics arguments concerning the costs and benefits of social services may not be as strong as in the case of physical services, there are also spatial dimension arguments concerning the redistributive character of social services. Fiscally decentralised provision of health, welfare and housing services may be based on Pauly's (1973) assertion of a spatial dimension of concern about the poor. In section 4.3.3 it was stated that a higher value is placed on redistribution to the local poor, based on altruism and the desire to minimise the undesirable manifestations of poverty. Tailoring social services delivery to reflect the diverse attitudes and preferences of residents in different jurisdictions may link up with the spatial dimension for concern about the poor. In North West Province health services may, for example, focus on rural clinics. From an allocation point of view that would reflect the preferences of the large rural population and from a distribution function point of view, reflect the spatial dimensions for concern about the poor - who are predominantly rural. If fiscal decentralisation can cater for decentralised differential preferences for social services in North West, it may in theory also contribute to efficient and equitable resource allocation, and in that way to development in the province.

Arguments against a fiscally decentralised system to address the challenges of social services delivery may in the first place again be based on the spatial characteristics attached to the costs and benefits of the services. Significant spillovers may exist in health care services. In the case where institutions provide unique health care services patients from other provinces may be referred to them. That means that North West Province's residents carry the cost, but do not exclusively receive the benefits. As already stated, such public goods and services with positive spillovers will be systematically under-provided.

Catering for differential preferences in health, welfare and housing services may cause differences in net fiscal benefits across jurisdictions. In the case of health and welfare services, the inefficient re-allocation of people in response to net fiscal benefit differentials may be exacerbated by the mobility of the poor (section 4.4.1). This relates to the arguments against decentralised redistribution, which takes place when provinces provide social services.

As social services are redistributive in character, arguments were presented in section 4.4.3 which favour national redistributive equity objectives. The first is that the inequality and poverty which the province wants to address through improved health, welfare and housing services, is the result of the previous political dispensation and of national economic conditions and should thus be addressed by the national government.

Secondly, section 4.4.3 presented counter-arguments to Pauly's (1973) spatial dimension for concern about the poor. It was argued that there may not be such an exclusive concern for the local poor as Pauly (1973) suggested, since television and advanced communication make people aware of the plight of the poor, wherever they are. Exclusive concern for the local poor may also be reduced when there may be romanticism about the distant poor and where people may want to reduce the worst obvious cases of poverty in the whole country. These arguments favour national provision of social services. Based on the redistributive character of social services, the third argument in favour of national provision is that of the mobility of the poor. Should one province provide extended health, welfare and housing services (in accordance with decentralised differential preferences) the poor may move to that province. Section 4.4.3 showed the increases in the number of the poor may increase the cost to the non-poor to render the social services and will reduce the non-poor residents' levels of utility and the redistribution. The threat of mobility may lead to the provinces' levels of social services delivery to converge, with a decrease in the average level across jurisdictions. Mobility of the poor is thus a significant argument against fiscally decentralised provision of social services.

The arguments for and against a fiscally decentralised system to address the challenges of social services delivery may weigh more heavily against fiscal decentralisation and in favour of national provision of social services. Any mix of decentralised and centralised measures in the system of intergovernmental fiscal relations will require a value judgement, either for efficiency through catering for decentralised differential preferences, or for equity through national provision.

In section 5.2.1 the constitutional assignment listed health, welfare and housing services as areas of joint responsibility between national and provincial governments. In the FFC's recommendations, the equity norm governs the degree of decentralisation or centralisation that is allowed for. As described in the previous section, with the equity norm applicable to the system of intergovernmental fiscal relations, each individual should have equal access to publicly provided services and receive equal or similar public services for an equivalent tax effort (section 5.3.6). In addition to the equity norm there are further restrictions on fiscal decentralisation. The provision of health services must adhere to RDP minimum standards, as noted in section 2.3.3. Welfare benefits are determined nationally and the provinces' share of the joint responsibility is to administer the welfare services. Housing services are the domain of the national Department of Housing and the National Housing Board. Thus, both the theory and the South African fiscal system put significant equity arguments forward against fiscally decentralised social services delivery.

With joint responsibilities for health, welfare and housing services the intergovernmental fiscal relations system is again characterised by a cooperative localist model (section 4.5) solution. There is administrative decentralisation to the provinces, and minimum standards and national policy to ensure fiscal fairness. Section 6.4 will outline the conditions for fiscally decentralised social services delivery to exist, as applicable to a system of shared functions.

6.2.4 Human resource development

In section 2.3.4 it was shown that in North West Province the aim of human resource development is to improve education attainment. The challenges to be faced included extending primary and secondary education in the province, improving school attendance rates, ensuring that education is relevant in the job market and encouraging private sector participation in training.

Though the specific challenges differ, human resource development and social services delivery are alike in character. The same arguments used in the case of social services delivery (section 6.2.3) also describe why the market may fail to extend primary and secondary education, or to encourage private sector participation in training. As in the social services case government may also fail to determine the preferences for human resource development and to provide such public goods efficiently. Fiscal decentralisation may again be forwarded as solution to the government failure and development challenges. The same arguments as in section 6.2.3 may be used for and against a fiscally decentralised system to address the challenges of human resource development.

Arguments in favour of a fiscally decentralised system to address the development challenges are based on the spatial characteristics of the costs and benefits and the efficiency of catering for decentralised differential preferences described in section 4.3.1.

In the case of education, these arguments tend to be weak.

The mobility of the population makes education subject to substantial spillover effects (section 4.4.1). This is related to possible equity arguments against fiscally decentralised human resource development. In as far as the low levels of education attainment are seen as the result of the previous political structure and thus as a national concern, national government needs to face the human resource development challenges (section 4.4.3).

The theoretical arguments seem on balance not to favour a fiscally decentralised system to face the challenges of extending education, improving school attendance, or ensuring that education is relevant for the job market.

The degrees of decentralisation or centralisation that are provided for in the constitutional assignment of functions were described in section 5.2.1. Section 4 part A listed education and population development as areas of joint responsibility between the national and provincial governments. The FFC's proposals discussed in sections 5.3 and 5.6 bias the system of intergovernmental fiscal relations in favour of a more centralised approach, through the equity norm and the minimum standards applicable to education. Fiscally decentralised human resource development may further be thwarted by the fact that teachers' conditions of service and for example retrenchments are negotiated at national level (see also section 6.3.4). Thus, in another area of provincial challenges, the South African fiscal system allows limited opportunities for a fiscally decentralised system to face the challenges. There is administrative decentralisation to the provinces within an intergovernmental fiscal relations system of national equity objectives and minimum standards. Section 6.4 will outline the conditions for fiscally decentralised human resource development to exist, as applicable in a system of shared functions.

6.2.5 Safety and security

In section 2.3.5 it was discussed how the North West provincial government aims to act as a facilitator in promoting a general awareness of crime and in a drive against crime. A number of challenges were outlined in the North West 2001 development strategy, which included greater control over the ownership and use of firearms and establishing safehouses and referral services to deal with crime against women and children. Improving investigative services, making the police service more user friendly, introducing crime prevention approaches and sensitising the community to bribery and corruption were also identified as challenges.

As in the case of the other challenges facing North West Province the market may fail to ensure that safety and security is provided efficiently and equitably. A drive against crime may generate significant positive externalities which are non-excludable and non-rival in consumption (section 3.3.2.3). The market may tend to underprovide safety and security. The absence of property rights to the positive external effects of a safer society may also provide incentive for citizens to misrepresent their preferences for safety and security and to free ride, which causes market failure.

Where government intervention was proposed as solution to market failure, section 3.4.1 showed that government too may fail to determine the preferences for safety and security. Government intervention was also shown to possibly fail due to problems associated with social choice (section 3.4.3.1) and public choice (section 3.4.3.2).

In sections 3.5 and 4.3 fiscal decentralisation was forwarded as possible solution to government failure and the concomitant development challenges facing North West Province. The arguments for a fiscally decentralised system to face the challenges of ensuring safety and security may be based on spatial characteristics and differential preferences. Based on the theory of the fragmented localist model set out in section 4.3.1, it may be argued that the costs and benefits of, for example, crime prevention approaches, greater control over firearms, or establishing the safehouses and referral services will be limited to the region. This would make for efficient decentralised provision. There is also the possibility that differential decentralised preferences may exist for safety and security. As North West Province has a large rural and agricultural component, stopping farm attacks and rural protection may be an example of a differential preference. In comparison, a more urban Gauteng may want to address car hijacking or the Western Cape may want to stamp out the problems of gang related violence.

The arguments against a fiscally decentralised system to face the challenges of ensuring safety and security are largely based on possible spillovers. Provinces may not be able to deal with the challenges of safety and security when faced with for example, national crime syndicates or international narcotics or endangered species smuggling rings. Such cases call for national coordination.

The arguments for and against a fiscally decentralised system to face the challenges of ensuring safety and security are not unambiguous. Though the spatial characteristics and differential preferences arguments may favour fiscal decentralisation, national government may view uniform policy and provision of safety and security services as more important. Balancing the arguments, a cooperative localist model is required to realise the efficiency of catering for decentralised differential preferences for safety and security, while compensating for possible spillovers (section 4.5). The decentralised measures which are allowed for in the constitution and the FFC's recommendations thus need to be examined.

The constitutional assignment discussed in section 5.2.1 listed police as an area of joint responsibility in schedule 4 part A. This joint responsibility of the national and provincial governments is, however, only to the extent of the provisions of chapter 11 of the constitution, which are limited. National government seems to favour uniform policy and provision of safety and security services. With limited decentralisation of policing responsibilities, North West Province is practically unable to face the safety and security challenges in any other than a facilitation role. The FFC has no direct recommendations concerning safety and security. Section 6.4 will outline the conditions, if any, for fiscally decentralised provision of safety and security.

6.2.6 Optimal governance

The challenge of achieving optimal governance in North West Province will not be discussed in this section. Institutional capacity will be discussed in section 6.3.4 as part of the conditions for successful fiscal decentralisation.

The following sections will discuss the requirements for the South African fiscal system to realise the advantages of fiscal decentralisation and face the development challenges in North West Province.

6.3 Realising the benefits of fiscal decentralisation

Against the theoretical background of chapter four and the characteristics of the South African fiscal system presented in chapter five this section's aim is to examine whether fiscal decentralisation can contribute towards development in North West Province.

If a fiscally decentralised system is to face the development challenges in North West Province, it will need to comply with certain requirements. There are conditions which have to be satisfied in order to realise the theoretical benefits of decentralisation and in that way overcome the development challenges.

In section 4.3 the potential benefits of fiscal decentralisation were identified. The fragmented localist model proposed fiscal decentralisation as a possible solution to government failure to ensure efficient and equitable resource allocation outcomes. Fiscal decentralisation was shown to reduce the problems of aggregating preferences and demand revelation for public goods and services, to reduce the possibility of inefficiency in the social choice process and to constrain vote or budget maximising behaviour by politicians or bureaucrats. Achieving efficient and equitable resource allocation in this way may make it possible to overcome the challenges of building the economy, of providing physical and social services, to ensure human resource development, safety and security and optimal governance in North West Province.

To realise the benefits of fiscal decentralisation, the key lies in the efficiency of catering for differential preferences for public goods and services, based on the spatial characteristics of the costs and benefits of those public goods and services. The ability to cater for differential preferences forms the basis for the requirements or conditions which a fiscally decentralised system has to comply with. That ability depends on the province's access to own revenue, the certainty of allocated revenue and the discretion over it, the composition of expenditure and the institutional capacity in the province. Each of these determinants will be examined in turn to outline North West Province's ability to cater for differential preferences, to realise the benefits of decentralisation and to overcome the development challenges facing it.

6.3.1 Access to own revenue

In section 4.3.5 it was emphasised that access to own revenue is essential to ensure the degree of autonomy that will enable the province to cater for differential preferences and capture the benefits of fiscal decentralisation. In section 5.2.1 it was shown that the interim and final Constitution gives provincial legislatures the competence to raise taxes, levies and duties. The FFC framework document for the system of intergovernmental fiscal relations also subscribes to the norm of fiscal autonomy (section 5.3). The decentralised assignment of taxation is, however, counter-weighed by equity considerations. The provinces are prohibited from raising income tax, value-added tax and sales tax. The FFC framework document also points out the disadvantages of decentralising taxes on equity, macroeconomic policy and administrative efficiency grounds (sections 4.4.6, 5.2.1 and 5.4.1). Revenue sharing is forwarded as an alternative to tax devolution (section 5.4.3). Thus, for own revenue the provinces are left with only taxes, levies or duties on casinos, gambling, wagering, lotteries and betting and also user charges. The user charges are mostly licences and fees and departmental revenues, such as hospital fees. To adhere to the norm of fiscal autonomy the FFC proposed in its May 1996 recommendations for the 1997/98 fiscal year that the provinces levy a surcharge on the personal income tax base and that tax room should be created for it (sections 5.5 and 5.6.3).

The implementation of the Constitution and the FFC's framework provided little own revenue for the provinces. North West's 1995/96 budget provided for total revenue of R5.943 billion. Of that, only R408 million was own revenue. The own revenue represented 6.5% of the financing requirement. The balance was a R5.443 billion transfer from national government and R92 million from Development Bank of Southern Africa (DBSA) loans. The main contributions to the limited own revenue base were from casino tax, motor vehicle licenses, departmental revenue such as traffic fines, hospital fees and boarding fees and from property rentals and other miscellaneous revenue (Kuscus, 1997a).

In 1996/97 the budgeted own revenue amounted to R456.04 million, which was R1.64 million more than the revised estimate for 1995/96. Still this represented only 6.7% of total revenue. Funds transferred from national government for 1996/97 was budgeted at R6.31

billion (Kuscus, 1997b).

The already limited amount of own revenue was reduced when national government introduced VAT on gambling from 1 October 1996. This reduced North West's levies from 15% to 3%. The result was that in the 1997/98 budget own revenue amounted to only R321.22 million. That was R123.36 million, or 38.4%, less than the 1996/97 final amount of R444.58 million. In 1997/98 own revenue represented only 4.58% of total revenue. The share of national revenue was budgeted at R6.692 billion (Kuscus, 1997c).

The FFC's recommendation for a provincial surcharge on the personal income tax base was included in the final Constitution (see section 5.5.4), but has to date not come into law. The use of a Transitionally Assigned Surcharge to serve as a proxy for the provincial revenue from a surcharge was never implemented.

North West Province has very limited own revenue to use to realise its own priorities and cater for differential preferences. It is dependent on transfers from national government. In addition, the ability to cater for differential preferences is not only constrained by the revenue adequacy aspects when the province has limited access to own revenue. Fiscally decentralised revenue raising is also supposed to provide a pricing mechanism. When access to raising own revenue is limited, the efficiency and accountability (responsiveness) of having the beneficiaries pay for services consumed, are also lost (sections 4.3.1, 4.3.5 and 5.3.1).

In South Africa a vertical imbalance is created in the system of intergovernmental fiscal relations as taxation authority is centralised and provinces have limited access to own revenue while many expenditure responsibilities are decentralised. The vertical imbalance increases the importance of a revenue sharing process. The following sub-section examines the certainty of allocated revenue and discretion over it, as indicators of North West's ability to cater for differential preferences and thus of the success of achieving the advantages of fiscal decentralisation and facing the development challenges.

6.3.2 Certainty of allocated revenue and discretion over it

The previous section showed that North West Province depends on national government for between 93 percent and 95 percent of its revenue. The PRC (1998:1) sees the provinces as substantially reliant on revenues that are levied and collected by national government and views the constitutional division of these resources as an additional step to budgeting. The certainty of the shared revenue and the discretion that the province has over it are thus important determinants of North West's ability to cater for differential preferences.

The certainty of the shared revenue is guaranteed by the interim and final Constitution which provides that each province is entitled to an equitable share of revenue collected nationally (section 5.2.1). Certainty of shared revenue was described as the FFC's fourth norm for the system of intergovernmental fiscal relations in section 5.3.4. It was stated that a province must be able to rely on the predictability of its revenue flows in order to plan its activities. Predictability requires transparency. The transparency norm states that the method of calculating the equitable shares of shared revenue should be transparent and understandable to promote credibility and stability (section 5.3.5). To ensure certainty of revenue and predictability, the FFC proposed an allocation formula for sharing the available revenue. The formula proposed for 1996/97 and later additions to it for 1997/98, was explained in section 5.6.

The discretion that the province has over shared revenue is outlined in the Constitution and the FFC's proposals for the system of intergovernmental fiscal relations. The discretion over shared revenue is influenced by the revenue sharing process' emphasis on equity. The Constitution's proposed equitable share of revenue is related to the FFC's equity norm (section 5.3.6). The Constitution and the FFC reason that as own resources are limited, an equitable share of nationally collected revenue may help to ensure that households receive similar public services for an equitable tax effort. This equity emphasis on shared revenue was taken up in the revenue sharing formula, for example sections 5.4.2 and 5.4.3 described how minimum standards were to form the basic parameters within the allocation formula.

The discretion that the province has over shared revenue from the allocation formula was outlined under the horizontal division of resources in section 5.6. The grants for education and health care were to be governed by set minimum standards. With the minimum standards the revenue was allocated to provide only the minimum level of service. In many cases the grants for education, health and welfare would have had to have been supplemented from the basic grant in order to provide the minimum level of service. In addition, the spillover grant and institutional grant were also conditional in character. Thus, the provinces had only the basic grant amount for financing their own priority expenditures. For 1997/98 the basic grant was to make up approximately 47 percent of North West's total grant from the revenue sharing formula (Kuscus, 1997c).

Thus, the allocation formula ensured certainty of revenue, but limited discretion over the spending of the funds, because the Constitution and FFC's placed emphasis on equity. Section 4.3.5 emphasised that fiscal autonomy is compromised when using transfers grants and other central monies. The ability to cater for differential preferences is severely limited by the minimum standards conditions attached to the education, health care, spillover and institutional grants. The unconditional basic grant improves autonomy, but it does break the beneficiary pays accountability link. The implementation of this framework provided extremes of national influence and provincial discretion.

In section 5.2.2 it was showed that in the 1994/95 and 1995/96 fiscal years no fiscal decentralisation existed. With the help of function committees the national Department of Finance set the provincial budgets. In section 5.7.1 it was shown that in the 1996/97 fiscal year the FFC's recommendations, which included the above-mentioned revenue sharing formula, were not implemented. The same system as in the previous two years was used. The provinces' budgetary needs were projected and the national departments, through the function committees, had the final input in the budgets. The PRC (1998:9) emphasises that provincial legislatures were asked to approve provincial budgets which were totals of predetermined allocations from the function committees, to the detriment of accountability. From 1994/95 to 1996/97 North West Province had no ability to cater for differential preferences. This changed in 1997/98. Section 5.7.2 explained that the Budget Council rejected the FFC's recommendations for 1997/98 and instead the provinces were allocated a lump sum that they could spend without restrictions according to their own preferences.

Thus, from the time of the implementation of the new system of fiscal decentralisation, the provinces' access to own revenue has been limited. The system of revenue sharing left the provincial government with little discretion over revenue from 1994/95 to 1996/97. Only in 1997/98 was their ability to cater for differential preferences enhanced when an unconditional global allocation was made to the provinces.

The following sub-section examines the composition of provincial expenditure, as it could constrain the provinces' ability to cater for differential preferences, even when the shared revenue is unconditional.

6.3.3 Composition of provincial expenditure and the discretion that it leaves

Even when a province is relatively autonomous in terms of access to revenue, its ability to cater for the differential preferences of its people may be constrained by the nature of its expenditure. Personnel and other committed expenditure cannot be reduced easily when it is necessary to reprioritise. High levels of committed current expenditure will leave little room for new capital expenditure. This sub-section examines the expenditure side of the budget in North West Province.

Examining of North West's budget shows that it is dominated by four large votes, namely Education, Health, Welfare, Housing and Public Works. In the 1995/96 budget they represented almost 75 percent of total expenditure. Of those, Education amounted to 29 percent of total expenditure, Health to 14.7 percent and Welfare to 13.9 percent. Housing took up 5.5 percent of total expenditure and Public Works 11.2 percent. Of the total expenditure for the fiscal year an estimated 45 percent was personnel costs and 60 percent of the expenditure was regarded as committed expenditure.

During the 1996/97 and 1997/98 the concentration of expenditure in these votes increased.

In 1996/97 Education's share had increased to 33.7 percent of total expenditure. Health and Welfare's shares increased respectively to 17.1 percent and 14.8 percent of total expenditure. Housing took up 6.6 percent and there was a decline in the Public Works share to 9.7 percent. In 1996/97 personnel costs amounted to 45.3 percent of total spending. Of total spending 88.46 percent was towards current expenditure. Of the remainder, 7.05 percent was towards development spending and 4.49 percent towards capital spending.

The 1997/98 year enforced the trend shown thus far. The aforementioned votes resulted in 86.6 percent of total expenditure. Education's share increased to 38.6 percent of the total. The trade-off was in Health, Housing and Public Works that took up 16.7 percent, 6.4 percent and 9.5 percent shares respectively. Welfare's share increased to 15.4 percent of total spending. In 1997/98 personnel costs increased significantly to 52.6 percent of total expenditures. Current expenditures amounted to 89.3 percent of total expenditure. There was some reprioritisation towards capital spending which took up 8 percent, whereas development spending totalled 2.7 percent of total expenditure.

A significant portion of spending in North West Province is aimed at the areas in which the development challenges were outlined. In 1997/98, spending on the Education, Health, Welfare and Public Works votes amounted to approximately 86 percent of total spending in the province. However, during the three financial years increases were shown in the share of personnel costs in total spending. The personnel costs and current spending may limit the province's ability to reprioritise to face the development challenges, for example to finance the spending needed to fund small farmer entrepreneurial development (section 2.3.1). The significant shares of current and committed expenditure also help to illustrate the budget constraints to expanding infrastructure, health care, welfare or education, which were mentioned in sections 2.3.2 to 2.3.4.

To provide an idea of how spending is being prioritised to face the development challenges, North West's 1997/98 budget document (North West Province, 1997) indicated the spending in priority areas as linked to the budget. The votes in the provincial budget and the spending in the priority focus areas are shown in table 6.1. The table shows significant spending in the areas of promoting investment and jobs (R899.659 million), SMME development (R352.609 million) and Agricultural support services (R257.963 million). The Education, Sports, Arts and Culture vote's contribution to the R303.097 million spending on human resource development consisted of R80 million for classrooms and R118 million for life skills education. Spending on local level focus areas totalled R319.330 million. Health and Welfare contributed towards local government support and the Transport and Civil Aviation vote towards local economic development. The Local government and Housing vote's spending on local level focus areas consisted of R38 million for urban development and R66.5 million for rural development. Of the R280.317 million spent on infrastructure the Public Works and Roads vote targeted R84.916 million for infrastructure development and R163.701 million for maintenance of infrastructure (North West Government, 1997). Although the targeting of spending in priority focus areas is encouraging, there is no indication of the personnel and current expenditure nature of the spending. It may be expected to be in line with that of the budget as a whole, which implies limited discretion and ability to cater for differential preferences.

With limited access to own revenue, limited discretion over shared revenue and the composition of expenditure such that it leaves little discretion, institutional capacity is to be examined as being the final determinant of North West Province's ability to cater for differential preferences.

6.3.4 Institutional capacity

In section 2.3.6 the restructuring of the public sector in North West Province since 1994 was described and the challenge of optimal governance outlined. As provincial budget constraints hamper North West Province's efforts to address its development challenges, public/private partnerships were put forward as a first step to ensuring optimal governance.

Table 6.1: Spending in priority focus areas linked to the budget

Priority focus areas	Promote investment and jobs	SMME development	Corridor develop-ment	Eco-tourism	Agriculture support services	Infra-structure	Community support services	Local level	Human resource develoment	Health and welfare
Budget Votes (R)										
Premier		9 753 000							5 000 000	
Provincial Services Commision									24 812 000	
Health and Welfare	739 000 000	55 664 000					142 997 000	40 600 000		
Safety and Security	105 000		295 000				251 000			60 000
Finance and Economic Affairs		35 000 000								
Education, Sports, Arts and Culture	1 000 000	3 000 000		30 000 000			6 000 000		198 000 000	4 000 000
Local government and Housing		5 500 000				31 700 000		104 500 000	5 500 000	
Transport and Cilvil Aviation		2 000 000	730 000					174 230 000	250 000	
Public Works and Roads	138 504 000	107 692 000				248 617 000			69 535 000	
Agriculture	20 000 000	134 000 000			257 963 000					
Total	899 659 000	352 609 000	1 025 000	30 000 000	257 963 000	280 317 000	149 248 000	319 330 000	303 097 000	4 606 000

(Source: North West Province, 1997)

The second proposed step was to promote excellence in the public sector through cooperative government and right-sizing. The third step listed in section 2.3.6 to overcome the challenge of optimal governance is to promote excellence in the public service. The aim is to put a dynamic and efficient structure of government in place.

Arguments concerning the possible institutional advantages of fiscal decentralisation were discussed in section 4.3.1. It was suggested that mobility and competition to draw mobile citizens to jurisdictions may limit the maximising behaviour of politicians and bureaucrats. At subnational level, citizens are closer to government, and agency and monitoring costs are likely to be lower. Responsive and responsible government decision making may also be enforced if decentralised services are financed at that level (section 4.3.1). If the North West Province is to realise these theoretical institutional advantages of fiscal decentralisation, it may rise to the challenge of optimal governance.

Section 4.4.4 discussed the possible institutional shortcomings of fiscally decentralised systems, which might hamper North West Province's ability to ensure optimal governance. The institutional advantages of fiscal decentralisation can only be realised if the citizens are mobile and interjurisdictional competition takes place. The South African system of intergovernmental fiscal relations subscribes to this in the form of the accountability norms described in sections 5.3.2 and 5.3.5. In contrast, section 5.3.6's equity norm and the discussions in sections 6.2.1 to 6.2.5 showed that the South African fiscal system has a significant focus on equity, which may eliminate much of the opportunity for interjurisdictional competition. Without interjurisdictional competition a fiscally decentralised system loses some of the ability to limit the maximising behaviour of politicians and bureaucrats.

Without significant mobility and interjusrisdictional competition less information is revealed about decentralised preferences. Tanzi (1995), Wildasin (1995) and Prud'homme (1995b) question the responsiveness and accountability of subnational governments on the grounds of their decision making mechanisms (section 4.4.4). The arguments may be relevant to North West Province. Decentralised preferences may not be determined accurately as provincial elections take place along with national elections and are decided on the basis of tribal or political party loyalties. The provincial electoral mandate is weak and provincial politicians know that their re-election will not depend much on their performance.

In the South African context a number of issues concerning governance in all the provinces is highlighted in the Skweylya Commission's Provincial Review Report (1997) regarding public service and administration.

The report examines issues for national government and transversal issues, and conclude that the provinces lack the flexibility to respond effectively to local conditions (Skweylya, 1997:4). The issues for national government explained the provinces' inflexibility to respond to local conditions in terms of national constraints placed on provincial service delivery, legislative impediments, administrative blockages and the relationships between national and provincial governments (Skweylya, 1997:8). The blockages and constraints which national administration are to overcome are in the first place confusion in national departments over the management of key functions of the public service in the provinces. Some of the problem areas mentioned are the following:

- National departments have not supported the development of their provincial partner departments to enable them to administer effectively.
- New policies are set at national level without consideration to the organisational, financial and service delivery implications in provinces.
- Mandates for negotiations with employee representatives are decided by national government although the mandates are binding upon the provinces (see also section 6.2.4). National departments often do not take the financial implications for the provinces into account.

Budgets and financial management issues are also mentioned for national government. Those include:

- National budget formats do not allow provincial managers to take decisions on how to best use their financial resources. The formats do not provide sufficiently detailed information to control costs and guide reprioritisation.

- National guidelines for buying goods and services do not establish value for money as the key principle.
- National guidelines on purchasing are restrictive and lead to long delays, because purchases have to go through the formal provincial tender process.
- Staff are confused as to the levels of financial authority that the provinces have. As each provincial administration is treated as a government department, the accountability of the Provincial Director-General may not be delegated to their heads of department.
- The national and provincial governments do not monitor service delivery performance effectively. The quality of the service delivery is not determined and there is little feedback to managers in order to improve performance.
- The Financial Management System (FMS) and the Personnel/Salary System (PERSAL) do not provide adequate support to the provinces.

There are also human resource management blockages and constraints which national administration is to overcome. Those blockages and constraints include:

- National human resource policies are poorly communicated to the provinces and few guidelines are given for interpretation of what the policy means in practice. The misinterpretation of what the Voluntary Severance Package was designed to achieve serves as an example.
- Provinces are forced to accept the number of posts of particular grades assigned to them by the Public Service Commission and are unable to re-organise their structures to be more efficient within the budget allocated.
- The redeployment of staff has not been well managed and no provision is made for reallocation expenses.
- National regulations like the Public Service Staff Code (PSSC) do not enhance managers' accountability for their performance. There is only limited performance-based evaluation and no culture of accountability for individual actions.
- The PSSC and Personnel Administration Standards do not recognise experience and competency enough and have frustrated many appointments.

- The procedures used to deal with staff misconduct are unwieldy and lengthy and inhibit good management and discipline.
- National departments require provincial staff to attend many meetings and as a result they spend too much time away from their primary jobs.

The transversal issues identified by the Provincial Review Report are of concern to the national and provincial departments. These issues represent the challenges and constraints affecting the functioning of service delivery of the provincial administration as a whole, or the majority of its departments (Skweylya, 1997:13). The challenges and constraints can be discussed with reference to the following themes.

The first is that of leadership, management and strategic planning. The Provincial Review Report states that political interference by MECs undermines the role of the Heads of Department and hampers the administration of provincial departments. Another form of the problem occurs when Heads of Departments bypass the Director-General and refer administrative issues and decisions to the political leadership (see also section 4.4.4). The absence of effective leadership paralyses the administrative system and results in uncertainty, indecisiveness and low morale amongst staff. It also means that there is little strategic direction and guidance. The report finds that strategic planning at provincial level is often weak and poorly implemented. Strategic plans are also poorly coordinated and communicated, which compromises the ownership of the plans and undermines effective implementation (Skweylya, 1997:4, 13-14).

The second theme of challenges and constraints concerns organisational arrangements. The Provincial Review Report noted that some provinces still need to create departmental structures in line with their functions and activities (Skweylya, 1997:4). Many departments have created an amalgamated structure from components from the previous dispensation. The structures then do not reflect the functions currently performed by the departments and this fact has caused duplication of functions within and between departments. The original structures were also not aligned to the current strategic vision and plans, and may be inefficient and unstable. In addition, the lack of clear delineation of functions creates confusion and uncertainty amongst staff. The Provincial Review Report also states that some structures have marginalised key activities of government when they have been placed within major spending departments (Skweylya, 1997:4). The examples included the apparent neglect of Arts and Culture as a component of the Department of Education and the lack of focus on Welfare issues in the Department of Health and Welfare. In the last instance, provincial departments mainly have to use their Public Works departments for maintenance, which the report found not to be optimal for service delivery (Skweylya, 1997:4, 17).

Human resource capacity also poses a challenge in the provinces. The Provincial Review Report estimates that almost half of the provinces have not completed the staffing of their new structures (Skweylya, 1997:17). In general, there is a lack of personnel with appropriate technical and professional skills and experience to perform the jobs required. The result is that skilled staff have been over-burdened, which has a negative impact on service delivery (see also section 4.4.4). In cases where the staffing has not been completed, provinces hold large numbers of staff additional to those in the posts. Where the process is finished, there are large numbers of excess staff which the provinces cannot redeploy. The problems of excess staff point towards the failure of the Voluntary Severance Package (VSP) to sufficiently reduce the numbers in the public service. The report shows that skilled staff left the public service with VSPs but management is unable to retrench staff who are not productively employed, due to the moratorium on employer-initiated retrenchment (Skweylya, 1997:18) (see also section 6.2.4). The other major human resource challenge in many provincial departments is the lack of discipline and occurrence of misconduct. There is a shortage of staff that can manage misconduct cases and the procedures of the Public Service Act and Public Service Staff Code are time-consuming. When misconduct is not effectively dealt with it causes service delays, excessive costs and demoralises other staff. Finally, throughout the country ghost workers still remain on the payroll of some provinces (Skweylya, 1997:5, 17-18).

Financial management challenges and constraints are grouped together by the Provincial Review Report (Skweylya, 1997). It was found that there is a shortage of qualified and trained financial management staff in most of the provinces. Staff do not have sufficient skills or understanding of the importance of financial management to oversee provincial departments funds appropriately. In addition to the human resource shortage, financial management systems are not adequate to meet the challenges of the decentralised system. In many provinces there is a lack of understanding of the budgetary system, programmes are not prioritised and budgets do not assess the costs of implementing planned programmes. Furthermore, when budget cuts are made, they are done in an arbitrary manner, without consideration of the effects on service delivery. Weak budgetary systems and inadequate financial control is perpetuated by inadequate financial information and management systems (see also section 4.4.4). The report found that financial information systems are not user-friendly and do not produce reports that managers can sufficiently understand. Information entered into the systems is often incomplete and the reports are generally not trusted (Skweylya, 1997:5). Financial management is hampered further by incomplete and uncoordinated personnel and salary information. The financial system and PERSAL often have difficulties in interfacing. Another challenge and constraint to financial management is the problems with Provincial Tender Boards. Cases are mentioned of a five month delay from a department's decision to make a purchase to the placing of the order. Such delays may have serious effects on service delivery (Skweylya, 1997:21). Finally, the report found that the state's assets, especially vehicles, are not well managed.

The final theme of challenges and constraints affecting the functioning and service delivery of provincial administration is that of information systems and technology. The Provincial Review Report found that most provinces lacks a strategy for the management and employment of information technology. More than half the provinces do not have complete networks for the basic administrative systems (Skweylya, 1997:22).

Although these issues concern all the provinces and are not specific to North West Province, the Provincial Review Report does present an idea of the immensity of the challenges of optimal governance.

The quality of the bureaucracy may be related to arguments about corruption (section 4.4.4) and many of these may apply to North West Province. In section 2.3.6 the Platinum SDI document (Naudé *et al.*,1998b:48) was cited as contending that North West Province has not seen the same degree of maladministration and corruption as the other provinces. However, from the end of 1997 and in early 1998 several cases of corruption and mismanagement surfaced and tainted the province's image.

In November 1997 the provincial auditor revealed irregularities in the Department of Education, Arts, Sports and Culture. That led to the dismissal of the then MEC of the department Me. Mamokoena Gaoretelelwe (Anon., 1998b:2). As a result of the irregularities the Provincial Public Accounts Committee called for an investigation into the department's financial affairs, particularly the allegations of fraud and corruption concerning the purchase of textbooks and stationery during the 1995/96/97 financial years (Du Preez, 1998:2). The forensic auditing firm of Gobodo Incorporated Chartered Accountants undertook the investigation. Early in February 1998 fraudulent activities involving in excess of R38 million were revealed.

In the Department of Sports, Arts and Culture (now separated from the Department of Education) some of the money allegedly misused were said to have been claimed for the Bophuthatswana National Soccer League (Bopsol) (Anon., 1998a:8). Bopsol wound up on 31 December 1994 but a relationship continued with North West government. Expenses were claimed on Bopsol's behalf and were paid out through the Department of Sports, Arts and Culture (Mfoloe, 1998a:1). There were claims that the fraudulent use of the funds included:

- The use of government order forms to purchase private goods.
- Eleven Bopsol petrol credit cards were still being used after the league disbanded.
- Clothing was bought for 16 non-existent Bopsol "soccer coaches".
- More than R45 000 was claimed for repairs to a Bopsol minibus, which the league never owned.
- Inflated claims for services rendered by a catering company in Mafikeng.
- At least 15 percent of revenue raised by Odi Stadium in Mabopane could not be accounted for.

In the follow-up of these corruption allegations 10 officials were suspended, including the province's director of sport (Mfoloe, 1998b:1).

The Education department textbook fraud of more than R30 million came to light after Portfolio Committees on Public Expenditure probed the issue at a budget hearing in the legislature (Anon., 1998a:8). The Gobodo investigation followed up and revealed a much larger scale of corruption and mismanagement, which culminated to a R74 million scandal in the Department of Education. It was found that in 1995 there was an oversupply of textbooks at a cost of R13.835 million (Du Preez, 1998:2). In 1997 the Tender Board approved expenditure for the procurement of stationery valued at R23 million, but the Department's records showed approved expenditure of R30 million. The most significant case in the scandal was that in the 1995/96/97 financial years the Education department made payments of R74.4 million for textbooks, stationery and other items for which no, or inadequate proof of delivery, or doubtful proof of delivery could be provided (Nkomo and Mfoloe, 1998a:1). Mismanagement in the department was evident in the setting up of the North West Reconstruction and Development Culture of Learning Project (RDP COL). The Department of Education deviated from the original business plan and it resulted in the required funding being close to R40 million, when only R9 million was allocated for it (Nkomo & Mfoloe, 1998b:2). The Gobodo report stated that Education department officials disregarded the principles of financial control in the payment cycle. Such mismanagement included the following (Nkomo & Mfoloe[77], 1998a:1 and Anon., 1998b:2):

- Payments were not reconciled to order amounts.
- Proof of delivery was often ignored and orders were improperly completed.
- Expenditure was not controlled against approved tender amounts.
- Payments were made, based on photocopies of invoices.
- There was no evidence of adequate supervision of officials in relevant line functions.
- The same payment was made to different companies
- Payments were made against differing measuring values.

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[77] Nkomo and Mfoloe (1998c:2) provide details of the roles of the ten officials implicated in the irregularities. The officials were suspended.

In the follow-up of the Gobodo investigation it was found that eight of the suppliers of books to the North West government were not registered for VAT. The companies charged VAT to the Education department but did not remit it to the Receiver of Revenue (Nkomo & Mfoloe, 1998d:2). This was estimated to have cost the state close to R3 million in uncollected VAT (Anon., 1998b:2). In addition, the department also made a R1.275 million VAT payment to a supplier that was not included in a tender (Du Preez, 1998:2).

In conjunction with the alleged corruption in the Education department the role of the North West Tender Board also came under scrutiny in the investigations. The report of the Gobodo investigation stated that the controls, procedures and practices in both the procurement and payment cycle of the department and the Tender Board were inadequate (Nkomo & Mfoloe, 1998e:5). According to the report, members of the Tender Board also had interests in some of the companies which were allocated tenders to supply books and stationery (Sentle, 1998:4).

In addition to the high profile investigations into corruption and mismanagement at Bopsol and in the Department of Education, relatively smaller cases were also uncovered by the anti-corruption drive. The cases included suspects defrauding Agribank of R3 million, the Health department of R2 million and R1.5 million's worth of goods from the government store (Mfoloe, 1998b:1). Attempted fraud involving R1.6 million in the Finance department was also investigated, along with cheque fraud of R100 000 in that department and of R564 000 in the Transport department (Anon., 1998a:8).

In response to the corruption and mismanagement that was uncovered, the North West government instituted several corrective and preventative measures. The State Attorney was instructed to recover all monies where books were not delivered. Book suppliers suspected of unethical conduct regarding government tenders and contracts were blacklisted. Cases of possible criminal nature were referred to the South African Police Service (SAPS) and disciplinary action in terms of the public service act were taken in line with the recommendations of the Gobodo report (Mfoloe, 1998b:6). In all, twenty officials were suspended, nine arrested and four dismissed (Van der Westhuizen, 1998:10). In the Department of Arts, Culture and Sport the preventative measures included a review of the positioning of staff in the procurement and payment system (Dhlamini, 1998:6). In the Finance department a cheque clearing system was established, which must approve all cheques of more than R5000. The department also trained fourteen internal auditors to assist with financial controls and the SAPS commercial branch has a number of members attached to the department (O'Grady, 1998:2). The boldest step to prevent corruption and mismanagement was envisaged as the commercialisation of certain functions, for example credit control and management of the motor fleet will not be handled by government officials and the distribution of food and medicine may be done by outside organisations (Van der Westhuizen, 1998:10).

Even with the positive steps to counter corruption and maladministration, North West Province still has some way to go to put a dynamic and efficient structure of government in place.

In conclusion, it may be said that although fiscal decentralisation may in theory offer a solution to the development challenges facing North West Province, the possibility of realising the advantages in practice may be limited. In order to overcome government failure to allocate resources efficiently and equitably, and in that way to master the market failure inherent to the challenges, North West Province needs to realise the advantages of fiscal decentralisation through the efficiency of catering for decentralised differential preferences. The ability to do that is, however, constrained by a number of factors. The centralist nature of the South African fiscal system implies only administrative decentralisation to the province. Minimum standards and national policies are to ensure fiscal fairness and national equity in addressing the challenges facing the province. The functioning and operation of the fiscal system also constrains a decentralised solution to North West's challenges. The province has limited access to own revenue and limited discretion over allocated revenue with which to cater for decentralised differential preferences. The composition of expenditure leaves little room for discretion and reprioritisation and limited institutional capacity hampers the ability to realise the advantages of fiscal decentralisation. A fiscally decentralised system may thus not in itself contribute to development and to overcoming the challenges facing North West Province.

6.4 Summary

This chapter identified the implications of fiscal decentralisation for North West Province.

Section 6.2 reiterated the development challenges facing North West Province and related these to the problems of market and government failure. Subsequently the fragmented localist and centralist models of fiscal federalism were used to evaluate the potential of a fiscally decentralised system to contribute towards resolving the development challenges. Consequently, the findings on the degree of decentralisation or centralisation which is theoretically preferable were measured against what is feasible in the South African fiscal system.

Section 6.2.1 briefly outlined the challenges to building the North West economy. The challenges to achieving the output and employment growth targets set to ensure jobs for all new work seekers, include successful negotiations in the mining sector, small farmer entrepreneurial development, improved labour productivity, research and development and spatial development initiatives in manufacturing, as well as promoting SMME development. It was argued that the market may fail to allocate resources efficiently and equitably and by corollary fail to overcome the challenges. Small farmer entrepreneurial development may be subject to information costs, which may cause market failure. Spatial development initiatives or research and development may present positive externality characteristics and may be underprovided by the market. Government intervention was shown to provide little reprieve from the problems of market failure. Government may also fail to determine the preference for small farmer entrepreneurial development and is subject to costs in determining the extent of, and regulating the aforementioned positive externalities. Government intervention is subject to social and public choice problems (section 3.4.3) which may cause government to fail to ensure efficient and equitable resource allocation. As solution to the government failure and the challenges of building the North West economy, fiscal decentralisation was proposed. Spatial characteristics and differential preferences provide arguments to propose that the costs and benefits of building the North West economy may be limited to its geographical area and that differential preferences for building the economy exists. In smaller decentralised groups individuals are more likely to reveal their preferences and the system of social choice is more stable. Catering for differential preferences may be more efficient than a uniform national approach. In theory, fiscal decentralisation may contribute to more efficient resource allocation and in that way to development in the province. Arguments against a fiscally decentralised system to build the provincial economy, were based on the inefficiency of spillovers. These arguments for and against a fiscally decentralised system were regarded to be inconclusive and a cooperative localist model was proposed to realise the advantages of fiscal decentralisation and compensate for the inefficiency of possible spillovers. The theoretically preferable degree of fiscal decentralisation was then compared to what is feasible in the South African fiscal system. The challenges of building the provincial economy were shown to be areas of joint national and provincial responsibility and the FFC makes no explicit mention of the degree of fiscal decentralisation envisaged for building the provincial economy. It was concluded that it may be possible for the provincial government to face the challenge of building the provincial economy.

In section 6.2.2, providing access to clean drinking water and sanitation, the provision of electricity, postal and telephone services, along with roads and transportation services were identified as the challenges to physical services delivery and alleviating poverty and inequality in North West. The absence of property rights and non-revelation of preferences, along with inefficient marginal cost pricing, were reasoned to cause market and government failure to efficiently allocate resources for physical services delivery. The arguments for a possible decentralised solution were that the spatial characteristics of the costs and benefits are regional and local and that differential preferences exist, whereby physical services delivery may benefit from decentralised provision. The arguments against a fiscally decentralised system emphasised spillovers and when taking the distributional aspect of physical services into account, argued in favour of equity in provision. Neither side's arguments were seen as decisive and, again a cooperative localist model was proposed. However, in examining the degree of decentralisation allowed for in the South African fiscal system the constitutional assignment was shown to propose a more centralised system. The FFC's equity norm implies only administrative decentralisation to the provinces and the system of intergovernmental relations is governed by minimum standards to ensure national equity in provision of physical services.

In sections 6.2.3 and 6.2.4 similar arguments for social services delivery and human resource development were provided. Market failure, was argued, occur as the challenges are typical public goods, where exclusion may be problematic and free riders may misrepresent their preferences. Improved health, welfare, housing and education may also be regarded as having positive external effects, which may cause market failure to allocate resources efficiently and equitably. As the causes of market failure were shown to also cause government to fail, fiscal decentralisation was again proposed as possible solution. In this case the spatial characteristics and differential preferences arguments in favour of decentralisation tended to be weak. Stronger arguments were presented against decentralisation, based on the inefficiency that spillovers and net fiscal benefit differentials have. The redistributive character of social services and human resource development also favoured national equity objectives. As the theoretical arguments weighed against fiscal decentralisation, a cooperative model may tend to be centralised and the benefits from fiscal decentralisation limited. The degree of decentralisation of social services delivery and human resource development that is allowed for in the South African fiscal system reflected the theory and is governed by the FFC's equity norm. There are only administrative decentralisation to the provinces and minimum standards and national policy to ensure fiscal fairness.

In section 6.2.5 the challenges to ensuring safety and security in North West Province were briefly outlined. As in the cases of the other development challenges the market was shown failing to allocate resources efficiently and equitably. A drive against crime may generate significant positive externalities which are non-excludable and non-rival in consumption. Such an absence of property rights to a safer society perpetuates non-revelation of preferences and free-rider behaviour, which causes market failure. Government was argued to fail to determine the preferences and its intervention to be subject to the problems of social and public choice. The arguments for a possible decentralised solution were based on spatial characteristics and differential preferences, and the arguments against, on spillovers. To balance the arguments, a cooperative localist model was proposed. The mix of decentralised and centralised measures which is allowed for in the South African fiscal system envisaged a more centralised structure than the theory accommodated. Uniform policy and provision of safety and security services are favoured, with the province only in a facilitation role.

It was concluded in section 6.2 that the theory favours a more fiscally decentralised cooperative localist model to face the challenges of building the economy, physical services delivery and safety and security. In the cases of social services delivery, the arguments are weaker, but not insignificant. The South African system, however, favours a more centralised cooperative localist model, with the emphasis on equity and administrative decentralisation of physical and social services delivery, human resource development and safety and security. Minimum standards and national policies are proposed to ensure fiscal fairness and national equity in addressing the challenges facing North West Province.

In section 6.3 the requirements for the South African system to realise the advantages of fiscal decentralisation and face the development challenges in North West Province were determined. It was argued that the challenges can be faced if the benefits of fiscal decentralisation can be realised. The benefits exist in overcoming government failure to allocate resources efficiently and equitably, and in that way to master the market failure inherent to the challenges. Realising the benefits of fiscal decentralisation depends on the efficiency of catering for differential preferences for public goods and services, based on the spatial characteristics of the costs and benefits of those public goods and services. The ability to cater for differential preferences constituted the requirements against which the South African system's ability to face the development challenges in North West was measured.

In section 6.3.1 North West Province's access to own revenue was examined. Own revenue was argued to be essential to ensure the degree of autonomy that will enable the province to cater for differential preferences and capture the benefits of fiscal decentralisation. The Constitution does provide for provinces to raise taxes, levies and duties, but this is argued against in the FFC's framework document on equity, macroeconomic policy and administrative efficiency grounds. The provinces are left with user charges like vehicle licences and hospital fees, and with levies and duties on casinos and gambling. It was shown that in the 1995/96, 1996/97 and 1997/98 fiscal years North West Province's own revenue represented 6.5 percent, 6.7 percent and 4.6 percent respectively of its total revenue. The balance consisted of transfers from national government. Limited access to own revenue constrains the ability to cater for differential preferences and to realise the benefits of decentralisation, and in that way the ability to overcome the development challenges facing North West Province.

The limited access to own revenue increase the significance of shared and allocated revenue. Section 6.3.2 examined the certainty of allocated revenue and the province's discretion over it. It was shown that the use of an allocation formula ensures certainty and transparency of shared revenue. The discretion over shared revenue is, however, limited by the Constitution and the FFC's emphasis on equity. Resources are to be shared equitably between provinces, to ensure that households receive similar public services for an equivalent tax effort. Minimum standards form parameters within the allocation formula of mainly conditional grants. Subsequently, it was shown that in practice the provinces had no ability to cater for differential preferences in the 1994/95, 1995/96 and 1996/97 fiscal years. National departments determined the provinces' budgets through function committees. Only in 1997/98 were the provinces allocated a lump sum that they could spend without restrictions. However, even though such an unconditional grant improves autonomy, it breaks the beneficiary pays accountability link and compromises the advantages of fiscal decentralisation.

The composition of provincial expenditure was also shown to influence North West's ability to realise the advantages of fiscal decentralisation and overcome its development challenges. Section 6.3.3 illustrated that the province's budget is dominated by the education, health and welfare, housing and public works votes. The significant proportions of personnel costs and current expenditure limit North West Province's ability to reprioritise to address the development challenges.

Finally, institutional capacity was discussed as a requirement to realising the advantages of fiscal decentralisation and facing the development challenges in North West Province. Section 6.3.4 discussed the arguments for and against a fiscally decentralised system's ability to ensure optimal governance. The issues concerning governance from the Skweylya Commission's Provincial Review Report (1997) were discussed. It was shown that South African provinces face significant blockages and constraints in their leadership, management and strategic planning, in organisational arrangements, human resource capacity and financial management. For North West Province specifically, the quality of the bureaucracy was related to the incidence of corruption and mismanagement. The allegations of corruption and mismanagement in the Departments of Sports, Arts and Culture and Education were examined along with the corrective and preventative measures taken by the provincial government. It was concluded that North West still has some way to go to ensure optimal governance in order to realise the advantages of fiscal decentralisation and overcome the development challenges facing the province.

It was concluded from the discussion in this chapter that a fiscally decentralised system may not in itself contribute to development in South Africa or overcome the challenges facing North West Province.

Chapter 7: Summary, conclusions and recommendations

South Africa, and in particular the North West Province, face significant economic development challenges. The purpose of this study was to evaluate the potential contribution of fiscal decentralisation to economic development in South Africa. This was done through consideration of the case of North West Province.

As a conclusion to the study, section 7.1 provides a summary of what has been done, why and how it was done. In section 7.2, the conclusions concerning the potential of fiscal decentralisation to address the development challenges in North West Province are set out. Section 7.3 contains recommendations pertaining to the system of fiscal decentralisation and the scope for further research.

7.1 Summary

To identify the contribution of fiscal decentralisation to economic development in South Africa, North West Province's development profile was put forward as representative of the economic development challenges facing the country.

Chapter two showed the province to be characterised by poverty, inequality, economic under-performance and unemployment. The North West economy is dependent on mining and agriculture, which have been shedding jobs (sections 2.2.1.1 and 2.2.1.2). Manufacturing produces low technology, medium wage and resource intensive products (section 2.2.1.3). The province's problems in the formal sectors are reflected in the expansion of the informal sector and the significant number of subsistence farmers (section 2.2.1.4). It was shown that 57 percent of the population can be regarded as poor and the unemployment rate was estimated at 36 percent in 1996. High population growth rates, high infant mortality rates and low levels of education attainment suggested lower than national average human development levels in North West (section 2.2.2). In many cases infrastructure is outdated and deteriorating and access to clean drinking water, sanitation, electricity, telephones and postal services are inadequate. The provision of health, welfare and housing services were shown to be lacking (section 2.2.3).

To address the poverty, inequality and economic under-performance in the province, the *North West 2001* growth and development strategy identified six strategic focus areas.

The first is that of building the economy (section 2.3.1). To ensure that an adequate overall economic growth rate is realised, growth and employment targets were set for the mining, agriculture and manufacturing sectors. The challenges to achieving the targets included small farmer entrepreneurial development, increased productivity, competition and improved research and development in manufacturing, as well as promotion of SMME development. It was, however, argued that the basic level of economic growth to build the economy will not be achieved without success in the other focus areas.

The second strategic focus area in North West 2001 is physical services delivery (section 2.3.2). Priority is given to providing access to clean drinking water and sanitation in the province. Emphasis is also placed on transport infrastructure to unlock North West's economic potential as a through-traffic hub in Southern Africa. The provision of electricity, postal and telephone services were shown to be critical needs in addressing poverty and inequality in the province.

Social services delivery is a further strategic focus area (section 2.3.3) due to the importance of primary health care services and welfare nets in addressing poverty and inequality. The challenge identified by North West 2001 is to extend social services through fostering public/private cooperation in social services delivery. In housing delivery the challenge was shown to be to ensure appropriate bulk service delivery and efficient local government planning and management of housing related services.

The fourth strategic focus area is human resource development (section 2.3.4). Literacy rates, school attendance and the matriculation pass rate in North West need to be improved. Adult education, life skills education and vocational and technical training need to be extended. North West 2001 argues that, in order to achieve these ends, education should be relevant for the job market and private sector involvement in training should be encouraged.

North West 2001 identified safety and security as a further focus area (section 2.3.5). Crime is recognised to have negative implications for tourism, investment and rural development. In addition, to ensure success in the other focus areas, crime prevention approaches and sensitising the community to bribery and corruption are seen as essential.

The final focus area in North West 2001 is that of optimal governance (section 2.3.6). To address poverty, inequality and economic underperformance in the province through a strategy of integrated planning and delivery, North West 2001 requires a fundamental qualitative change in the way government organises and manages itself. To ensure optimal governance, public/private partnerships may be needed in areas like physical and social services delivery and human resource development. Excellence in the public sector and public service also have to be ensured.

The economic development challenges outlined in chapter two were argued to represent instances of market failure in chapter three. Subsequently, government intervention in the economy and government's possible role in overcoming the economic development challenges were outlined in chapter three.

The causes of inefficiency and inequity in a market economy were categorized in chapter three as (a) the absence of property rights, (b) information costs and (c) indeterminancy of bargaining (section 3.3.1). The instances of market failure which were discussed included the cases of (a) common property resources, (b) public goods, (c) externalities, (d) imperfect competition and (e) inequity (section 3.3.2). Market failure provided a rationale for government intervention in the economy. In order to ensure efficient and equitable resource allocation it was argued that government needs to fulfil allocation, stabilisation and distribution functions. However, government may also fail to achieve the goals of efficient and equitable resource allocation. Public collective action was shown to be subject to the same shortcomings as private collective action. Government may fail to aggregate individual preferences for public goods into a collective outcome, as it is also subject to the problems of the prisoners' dilemma and free-riding. Government intervention may thus fail to produce a Pareto efficient supply of public goods (section 3.4.1). Government regulation of external effects is also subject to information costs (section 3.4.2). From an institutional point of view it was shown that the nature of social and public choice in government could in itself may lead to government failure. The social choice discussion showed that the outcome of a majority voting process may be intransitive and where individual preferences are double peaked a unique social choice equilibrium is not stable, or does not exist. In such a case government may not be able to determine the efficient provision of public goods (section 3.4.3.1). It was also illustrated that the behaviour of vote maximising politicians and budget maximising bureaucrats may cause government to fail to achieve an efficient and equitable resource allocation (section 3.4.3.2). By implication, government failure implies that government may have problems solving the development challenges in North West Province.

Chapter three concluded by arguing that a decentralised fiscal system may minimise government failure and bring society closer to ensuring Pareto efficient and equitable resource allocation outcomes.

Chapter four put forward the arguments in favour of fiscal decentralisation. Where government was shown to fail to determine individual preferences for public goods and services the fragmented localist model of fiscal federalism contends that decentralised allocation may be efficient (section 4.3.1). The arguments in favour of decentralised allocation are based on the spatial characteristics of public goods and services. When the costs and benefits of public goods and services are limited to a particular region or locality it is possible that residents of different localities may have different preferences for those public goods and services. In smaller, decentralised groups individuals are more likely to reveal their preferences for public goods and services, because misrepresentation could mean that the public good or service is not provided at all. With reference to the Tiebout model it was argued that individuals will reveal their preferences through their mobility between jurisdictions. The consumer-voter will move to and settle in a jurisdiction that best satisfies his or her preferences for public goods and services. In addition to the advantages of demand revelation, smaller decentralised groups were argued to be more homogeneous and the difference in the intensity of preferences less. As a consequence, majority voting may be more stable and that may reduce the possibility of government failure due to the nature of the system of social choice. Fiscal decentralisation was also argued to address the public choice sources of government failure. Citizens are closer to the government, which may reduce agency and monitoring costs, and they can also move in response to vote or budget maximising behaviour.

The efficiency of catering for decentralised differential preferences was used to argue in favour of decentralised stabilisation (section 4.3.2) and redistribution (section 4.3.3). The fragmented localist model contended that efficient stabilisation or an equitable distribution should reflect the diverse attitudes and preferences of residents in different jurisdictions. In the case of redistribution, it was argued that a spatial dimension of concern about the poor may exist and that decentralised distribution will favour equitable income redistribution.

With decentralised allocation, stabilisation and redistribution, the assignment of expenditure responsibilities made subnational government responsible for all public goods and services, where the benefits accrue mainly regionally or locally. The only centralised expenditure responsibilities were argued to be those (a) for which there are no difference in demand in various localities, (b) where the benefits of the public good or service are public in nature and uniform provision is necessary, or where decentralisation results in significant spillovers to other localities and those (c) for which the additional costs of decentralising administration are sufficiently high to outweigh the advantages (section 4.3.4). The consequent decentralisation of taxation responsibilities should provide a correspondence between expenditure needs and revenue means. The importance of own revenue, in order to realise the advantages of decentralisation, was emphasised. Subnational governments were reasoned to require a certain degree of revenue autonomy from central government to be able to cater for differential preferences. A subnational tax effort further functions as a pricing instrument and benefit taxes may increase subnational governments' accountability (section 4.3.5). It was concluded that the decentralisation of functions to lower levels of government should be favoured.

The arguments against fiscal decentralisation were set out in the form of the centralist model of fiscal federalism (section 4.4). Arguments against decentralised allocation were based on the possible inefficiency of spillovers and interjurisdictional competition (section 4.4.1). It was shown that a mismatch may occur between the spatial characteristics of the costs and benefits of public goods and services and the responsible jurisdiction. Subnational govemments may have no incentive to take the spillover benefits or costs that they generate for non-residents into account. It was argued that they may underprovide those public goods and services that have positive spillovers and overprovide those with negative spillovers. Decentralised decision making will in such cases be inefficient and justify a role for central government. The mobility of residents and competition between jurisdictions was also shown to be a possible cause of inefficiency and inequity. When individuals move they create fiscal externalities as they do not take into account that they consume the decentralised public goods jointly with other residents in their locality and that they reduce one another's tax burden. The moving of individuals causes changes in the net fiscal benefits all receive, and net fiscal benefit differences may lead to further inefficient factor movements in response to fiscal considerations. It was shown that the mobility of citizens and resources lead to tax competition, which results in sub-optimal budgets on the tax and expenditure side. Inefficient decentralised decision making may provide a role for more centralised government.

The arguments against decentralised stabilisation were based on institutional and practical considerations (section 4.4.2). The first was that decentralised subnational economies are open to leakage and will pay the full cost of stabilisation with only partial benefits. The second reason forwarded for stabilisation to be a function of central government was that in practice subnational governments have tended to exacerbate macroeconomic instability. It was argued that a centralised stabilisation policy may better deal with subnational deficits and debt before it leads to instability.

The centralist model's arguments against decentralised distribution emphasised equitable distribution as defined in terms of a social welfare function that the central government seeks to maximise (section 4.4.3). The focus was that all jurisdictions should have the same tax price for various activities. On this basis a number of arguments were forwarded in favour of national redistributive equity objectives. The first was that income inequality and poverty are primarily due to national economic conditions and policies. Poverty can thus be viewed as a national concern and distribution as a national public good. It was shown that in the case of decentralised distribution on the basis of differential preferences, mobility makes it possible for the poor to move to jurisdictions where distribution policies are more pronounced. This may increase the cost to the non-poor to render the assistance and reduce the non-poor residents' utility levels and subsequently the redistribution. The result may be a uniform distribution policy amongst various jurisdictions, without optimal distribution - which was seen to provide a role for central government. Economies of scale and capacity arguments were in favour of centralised administration of redistribution.

The centralist model highlighted the possible institutional shortcomings of fiscal decentralisation (section 4.4.4). It was argued that the efficiency of subnational decision making mechanisms may be constrained when elections are decided on the basis of personal, tribal or political party loyalties and do not reflect decentralised preferences. Elected officials may face a vague or inconsistent electoral mandate, along with a mismatch between spending and resources and a principle-agent relationship with their bureaucrats. Decentralised bureaucracies may lack the human resources and technology to be efficient. Corruption was furthermore argued to be more prevalent at local and decentralised levels than at national level. These institutional shortcomings were seen as further arguments in favour of centralisation.

With centralised allocation, stabilisation and redistribution, expenditure responsibilities were assigned to national government (section 4.4.5). The economic principles of assigning taxes to lower levels of government were discussed and it was recommended that progressive taxes, taxes on mobile bases and taxes on unequally distributed bases be centralised (sections 4.4.6.1 to 4.4.6.3). Only user taxes, fees and property taxes were found to be suitable for decentralisation (section 4.4.6.4). It was concluded that fiscal decentralisation may not always ensure efficient and equitable resource allocation.

From the apparent trade-off between decentralised efficiency and centralised equity it was argued that society can come closer to ensuring efficient and equitable resource allocation outcomes in a cooperative localist model (section 4.5). Some expenditure responsibilities may be decentralised to capture some of the efficiency benefits of decentralised allocation, while others can be centralised to compensate for spillovers and inequities which may occur under decentralisation (section 4.5.1). The theoretical model proposed only limited decentralisation of taxation responsibilities, but it was stated that the more expenditure responsibilities that are decentralised, the more tax authority ought to be decentralised (section 4.5.2). Subsequently, intergovernmental fiscal relations can be used to refine the fiscal system and compensate for the inefficiencies and inequities created by the combination of decentralising and centralising functions. Conditional grants, unconditional grants, tax and revenue sharing and mandates and regulation were the types of intergovernmental fiscal instruments which were discussed (section 4.5.4.2).

To outline the degrees of decentralisation or centralisation which might bring society closer to ensuring Pareto efficient and equitable resource allocation outcomes, and address the development challenges facing North West Province, the South African fiscal system was discussed in chapter five.

The South African fiscal system was shown to implicitly suggest a cooperative localist model, which aims to realise the benefits of fiscal decentralisation, while compensating for possible inefficiencies and inequities. The constitutional assignment of functions and finance to the provinces provided the basis of a fiscally decentralised system. Expenditure in major functional areas such as agriculture, education, health services, welfare, housing, industrial promotion, police, public transport and public works was shown to be decentralised and the joint responsibility of national and provincial government (section 5.2.1). In this regard, the FFC's norms applicable to the system of intergovernmental fiscal relations emphasised effective resource use, accountability and transparency, based on fiscal autonomy (section 5.3). Taxation was shown to be much more centralised (section 5.4). The constitution gives provincial legislatures the competence to raise taxes, levies and duties, but income tax, value-added tax and sales taxes are excluded (section 5.2.1). The FFC also argued against decentralisation of taxation on equity, macroeconomic policy and administrative efficiency grounds (section 5.4.1). Revenue sharing and grant allocations were proposed as alternatives, which are related to the Constitution's provision that provinces are entitled to an equitable share of revenue collected nationally (section 5.4.3). The notion of an equitable share of allocated revenue and the FFC's equity norm suggest a more centralised cooperative localist model. The aim of the system was shown to be to ensure fiscal fairness in the provision of public goods or services, where individuals should receive equal or similar public goods or services for an equivalent tax effort (section 5.3.6). Subsequently, an allocation formula was described as a procedure for dividing available fiscal resources (sections 5.5 and 5.6). The formula reflected the system's emphasis on national equity objectives. Minimum standards formed the parameters of formula allocations, and the proposed national minimum standards grant, spillover grant, fiscal capacity equalisation grant and institutional grant were all contended to be conditional in nature (sections 5.6.1 to 5.6.4). Only the basic grant was proposed for general provincial use (section 5.6.5).

During the 1994/95 and 1995/96 fiscal years there was limited implementation of the fiscal system envisaged by the Constitution (section 5.2.2). As interim measure, the Department of Finance had the final say in setting provincial budgets. In the 1996/97 fiscal year the same measures were used as in 1994/95 and 1995/96. The Departments of Finance and State Expenditure again projected the provinces' budgetary needs. Through the function committees the national departments had the final say in setting the budgets (section 5.8.1). This was shown to violate the FFC framework document's norm of autonomy. In the 1997/98 fiscal year the Budget Council rejected the use of the FFC's allocation formula. The provinces received global amounts that could be spent without restrictions, according to provincial priorities (section 5.8.2). The Budget Council followed this up with its own allocation recommendations in April 1997 (section 5.7.3). Section 5.8.4 briefly outlined the eight steps in the 1998/99 budget process. The 1998/99 budget was the first to reflect South Africa's new constitutional dispensation and provided a possible glimpse of the way forward for the fiscal system.

Thus it was argued that in its short history fiscal decentralisation in South Africa has been marked by diverging opinions and official recommendations and implementation has lead to a different fiscal system than envisaged in the FFC's original framework. The final step in the study was to examine whether the South African fiscal system may contribute to address the development challenges facing North West Province. This evaluation, given the arguments forwarded in chapters two to five, was done in chapter six. Specifically, the fragmented localist and centralist models of fiscal federalism were used to evaluate the potential of a fiscally decentralised system to contribute towards resolving the economic development challenges. The degrees of decentralisation or centralisation which were found to be theoretically preferable were then measured against what is feasible in the South African system.

It was determined in chapter six that the market may fail to ensure efficient and equitable resource allocation for the challenges of building the North West economy. It was argued that small farmer entrepreneurial development is subject to information costs which may cause market failure. The challenges of spatial development initiatives or improving research and development present positive externality characteristics and may be under-provided by the market (section 6.2.1). The market may also fail in the case of physical services delivery. The challenges in this regard have significant public goods characteristics. Though not typically non-rival and non-excludable in consumption, the cost of adding another consumer to water provision or the sanitation system, or to electricity, telephones or roads tends to be low, and marginal cost pricing inefficient. The absence of property rights to roads or the sanitation system and the large number of participants all over the province mean that voluntary payments are unlikely to be forthcoming. Individuals will misrepresent their preferences and were shown to act as free-riders to receive the physical services without paying for it. Private cooperation to provide physical services will be subject to information costs and indeterminancy of bargaining. The result is that the market will under-provide physical services, or not provide them at all (section 6.2.2). Similar instances of market failure were also argued to occur in the cases of social services (section 6.2.3) and human resource development (section 6.2.4) challenges. Those are typical public goods where exclusion may be problematic and free-riders may misrepresent their preferences. Along with safety and security (section 6.2.5), improved health, welfare, housing or education were also seen to have positive external effects, which may cause market failure to allocate resources efficiently and equitably.

Market failure may provide a rationale for government intervention in North West, but given the arguments put forward in section 3.4, government may also fail to ensure efficient and equitable resource allocation, and may thus have difficulty solving the development challenges in North West. The arguments in favour of fiscal decentralisation were therefore evaluated, given the particular economic development challenges facing North West Province.

It was argued that fiscal decentralisation may address the challenges of building the provincial economy as the costs and benefits have regional or local spatial characteristics, and differential preferences exist. The costs and benefits from promoting especially mining, agriculture and SMME's may be limited to the province. Mining and agriculture are immobile resources and the small and localised nature of SMME's means that output and employment growth are obtained for the province and the benefits are not exported to national or multi-national corporations. Fiscal decentralisation may also make it possible to focus on needs in building the economy, which are particular to North West Province. The negative implications for growth and employment in the province when mining is not performing, were emphasised as an example. It was argued that in North West, mining needs more attention when building the economy than can be given nationally, or than is needed for example in Northern Province, or the Eastern Cape. Another example of possible differential preferences in building the economy, was that North West Province is a rural province, which may make tailoring policy for small farmer development more significant. If fiscal decentralisation can contribute to preference revelation for building the subnational economy and reduce information costs, it may in theory contribute to more efficient resource allocation, and in that way to development in the province (section 6.2.1).

Spatial characteristics of costs and benefits were also forwarded as part of a decentralised solution to the challenges of physical services delivery and safety and security. In North West Province the provision of water and sanitation, electricity, postal and telephone services and to a lesser extent roads, were argued to have local or regional public goods characteristics. The costs and benefits will be limited to the province and thus it may benefit from fiscally decentralised provision (section 6.2.2). The costs and benefits of crime prevention approaches, greater control over firearms, or establishing safehouses and referral services were also argued to be limited to the region, which would make for efficient decentralised provision (section 6.2.5). In the cases of social services delivery (section 6.2.3) and human resource development (section 6.2.4), these arguments were, however, weaker.

The reasoning behind the differential preferences arguments was applied to the physical services and safety and security challenges. The importance of adequate sanitation, as identified in the development profile, was presented as a preference pattern for physical services that may differ from other provinces and which a fiscally decentralised system can cater for. The preference for sanitation stems from the fact that underground water is the primary source of water supply in a large portion of the province and adequate sanitation is necessary to prevent contamination. The preferences for roads and transport services in North West Province were also shown to possibly differ from those in other provinces and thus stand to benefit from fiscally decentralised provision. The location of the North West Province makes it possible for the province to be a through-traffic hub to the rest of Southern Africa. A fiscally decentralised system may facilitate the implementation of the recommendations of the province's Trade and Industrial Strategy, to develop intermodal transfer points and specialised transport infrastructure services (section 6.2.2). In the same fashion it was reasoned that since North West Province has a large rural and agricultural component, stopping farm attacks and rural protection may be an example of a differential preference for safety and security. In comparison, a more urban Gauteng may want to address vehicle hijacking or the Western Cape may want to stamp out the problems of gang related violence (section 6.2.5). The differential preferences arguments were once again weaker in the cases of social services delivery (section 6.2.3) and human resource development (section 6.2.4). In terms of the redistributive character of social services, it was stated that in North West Province, health services may, for example, focus on rural clinics. From an allocation point of view that would reflect the preferences of the large rural population and from a distribution function point of view, reflect the spatial dimensions for concern about the poor - who are predominantly rural (section 6.2.3). If fiscal decentralisation can cater for differential preferences for physical services, safety and security, social services or human resource development in North West, it may in theory also contribute to efficient and equitable resource allocation, and in that way to development in the province.

Fiscal decentralisation may not always ensure efficient and equitable resource allocation. The arguments against fiscal decentralisation (from chapter four, section 4.4) were subsequently evaluated given the development challenges facing North West Province. These are based on the inefficiencies of spillovers and interjurisdictional competition, along with national equity concerns.

In North West some of the challenges of building the subnational economy were contented to be subject to spillover effects. The challenge of negotiations between management and labour in the mining industry in the province may have results which are highly public in nature. When an agreement may have implications for mines and workers in the whole country it may be unlikely that the national and international corporations which own the mines or the national unions which represent the workers will, in order to build the North West economy, enter into an agreement concerning remuneration, productivity or retrenchments. Spillovers were also shown to possibly occur in the promotion of agriculture and manufacturing. If the increased agricultural output is processed in agro-industries outside the province or if improved research and development benefits national corporations, provincial government was reasoned to under-provide such public goods and services which have positive spillovers. In as far as building the economy was seen as a stabilisation function it was argued that the province may incur the full cost of stimulating a small open economy, but receive only partial benefits (section 6.2.1).

In the cases of physical services, social services, human resource development and safety and security, fiscal decentralisation was opposed on spillover grounds. In transport services, North West Star bus services were cited as a possible example of the inefficiency of spillovers. North West Star bus services are subsidised by the province, but provides services across its borders. It was argued that the provincial government will provide the subsidy to the extent that it reflects the preferences and benefits of the province's residents and will not take into account the benefits that non-residents receive (section 6.2.2). In the case of institutions providing unique health care services, patients from other provinces may be referred to them. That means that North West Province's residents carry the cost, but do not exclusively receive the benefits (section 6.2.3). Such public goods and services with positive spillovers were argued to be systematically under-provided. Catering for decentralised differential preferences for public goods and services was also argued against if it causes differences in net fiscal benefits across jurisdictions. When the benefits received from public goods and services, along with the tax price paid, differs between jurisdictions, residents will move in response to these fiscal considerations to jurisdictions where they receive positive net fiscal benefits. Such migration is inefficient as it may generate fiscal externalities. Fiscal decentralisation of physical and social services delivery and human resource development were also argued against on distributional grounds (sections 6.2.2, 6.2.3 and 6.2.4). The lack of these services in certain communities was seen as the result of the previous political structure and the improvement of the situation as a national concern. Only national government may be able to ensure that all people receive the same benefits, regardless of where they reside.

Thus, also in North West Province, fiscal decentralisation may not always ensure efficient and equitable resource allocation.

The evaluation of fiscal decentralisation, given the economic development challenges facing North West Province, illustrated that a combination of decentralised and centralised measures may be required to address the challenges. What is theoretically preferable needed, however, to be measured against what is feasible, given the emerging South African fiscal system.

The framework that the South African fiscal system provides for addressing the economic development challenges facing North West Province was shown to imply a centralist cooperative localist model. Building the provincial economy was shown as an area of joint national and provincial responsibility and the FFC made no mention of the degree of decentralisation envisaged for building the provincial economy (section 6.2.1). The other challenges, namely physical (section 6.2.2) and social (section 6.2.3) services delivery, human resource development (section 6.2.4) and safety and security (section 6.2.5) were, however, shown to be governed by the FFC's equity norm. For the province to ensure equal or similar public goods and services for an equivalent tax effort implies only administrative decentralisation. Minimum standards and national policies were proposed to ensure fiscal fairness and national equity in addressing the challenges facing North West Province.

Finally, despite the apparent centralist focus of the South African fiscal system, the study set out to determine the prerequisites for the South African system to realise the advantages of fiscal decentralisation and face the development challenges in North West Province (section 6.3). It was argued that the challenges can be surmounted if the benefits of fiscal decentralisation can be realised. The benefits exist in avoiding government failure to allocate resources efficiently and equitably, and in that way to overcome the market failure inherent to the challenges. Realising the benefits of fiscal decentralisation depends on the efficiency of catering for differential preferences for public goods and services, based on the spatial characteristics of the costs and benefits of those public goods and services. Thus, the ability to cater for differential preferences constituted the condition against which the South African system's ability to face the development challenges in North West was measured.

Firstly, North West Province's access to own revenue was examined (section 6.3.1). Own revenue was argued to be essential to ensure the degree of autonomy that will enable the province to cater for differential preferences and capture the benefits of fiscal decentralisation. It was shown that in the 1995/96, 1996/97 and 1997/98 fiscal years North West Province's own revenue represented 6.5%, 6.7% and 4.6% respectively, of its total revenue. The balance was transfers from national government.

The limited access to own revenue was argued to increase the significance of shared and allocated revenue. Secondly, the certainty of allocated revenue and the province's discretion over it was examined (section 6.3.2). It was shown that the use of an allocation formula ensures certainty and transparency of shared revenue. The discretion over shared revenue is however limited by the Constitution and the FFC's emphasis on equity. Resources are to be shared equitably between provinces, to ensure that households receive similar public goods and services for an equivalent tax effort. Minimum standards form parameters within the allocation formula of mainly conditional grants. Subsequently, it was shown that in practice the provinces had no ability to cater for differential preferences in the 1994/95, 1995/96 and 1996/97 fiscal years. National departments determined the provinces' budgets through function committees. Only in 1997/98 were the provinces allocated a lump sum that they could spend without restrictions. However, even though such an unconditional grant improves autonomy, it was argued to break the beneficiary pays accountability link and to compromise the advantages of fiscal decentralisation.

The composition of provincial expenditure was also shown to influence North West's ability to realise the advantages of fiscal decentralisation and overcome its development challenges (section 6.3.3). It was illustrated that the province's budget is dominated by the education, health and welfare, housing and public works votes. The significant proportions of personnel costs and current expenditure limit North West Province's ability to reprioritise for addressing the development challenges.

In the last instance, institutional capacity was discussed as a requirement to realising the advantages of fiscal decentralisation and facing the development challenges in North West Province (section 6.2.4). The arguments for and against a fiscally decentralised system's ability to ensure optimal governance were discussed. The fragmented localist model forwarded greater transparency and accountability at subnational level, where the centralist model emphasised a possible lack of institutional capacity at that level. Subsequently the issues from the Skweylya Commission's Provincial Review Report concerning governance, were discussed and it was shown that South African provinces face significant blockages and constraints in their leadership, management and strategic planning, in organisational arrangements, human resource capacity and financial management. For North West Province specifically, the quality of the bureaucracy was related to the incidence of corruption and mismanagement. The allegations of corruption and mismanagement in especially the Departments of Sports, Arts and Culture and Education were examined along with the corrective and preventative measures taken by the provincial government. It was concluded that North West still has some way to go to ensure optimal governance in order to realise the advantages of fiscal decentralisation and address the economic development challenges facing the province.

7.2 Conclusions

From chapter two it was clear that North West Province faces significant economic development challenges. The provincial economy is fragile and under-developed and its people poor. A basic level of economic growth is needed to build the economy and create employment. The growth may help facilitate improved physical services delivery, social services delivery and human resource development.

The economic development challenges facing North West Province may, however, present instances of market and government failure to allocate resources efficiently and equitably. On the basis of the nature and causes of market failure chapter three concluded that there is a role for government in the economy, but government may also fail to ensure efficient and equitable resource allocation.

Chapter four examined fiscal decentralisation as a possible solution to the problems of government failure and as a way to ensure efficient and equitable resource allocation. When considering the arguments against fiscal decentralisation the chapter concluded that the question is not whether to decentralise or centralise, but it is rather about finding the suitable balance of both. The conclusion is that it is the degree of decentralisation and centralisation, along with the system of intergovernmental fiscal relations, in a cooperative localist model which determines the fiscal system's ability to ensure efficient and equitable resource allocation.

The South African fiscal system was examined in chapter five and shown to be in essence a cooperative localist model, as proposed in the theory. It was concluded that the South African system has a significant centralist focus. The emphasis on equity results in only administrative decentralisation.

Chapter six synthesised the development challenges, the theory of government's role and of fiscal decentralisation, along with the South African fiscal system. When taking into account the nature, functioning and operation of the South African fiscal system, the study concluded that a fiscally decentralised system may not in itself contribute to development, or overcome the challenges facing North West Province.

7.3 Recommendations

For the fiscal system described in the constitution to overcome the economic development challenges facing North West Province, requires a fundamental value judgement. The centralist nature of the South African fiscal system and its implementation, have been shown to preclude much of the advantages of fiscal decentralisation. If the emphasis on equity and fiscal fairness is to remain, a solution to North West's challenges may require technical efficiency in administrative decentralisation. For this, building provincial administrative capacity should be the overriding concern. Should a more decentralised solution to the challenges be sought, the constitutional assignment of functions and finance and its implementation ought to provide for provincial ability to cater for differential preferences and for realising the benefits of fiscal decentralisation. Provinces will require greater access to own revenue and more discretion over allocated revenue. Unfunded mandates created by national policies will have to be limited. Greater clarity is needed on the role of the FFC and its recommendations in the system of intergovernmental fiscal relations. For this, even more emphasis have to be placed on developing provincial institutional capacity.

A greater degree of fiscal decentralisation in South Africa in future will have to be supported by research on the following issues:

- the spatial characteristics of the costs and benefits of public goods and services provided by provinces,
- the existence of differential preferences for public goods and services on a spatial level in South Africa,
- the mobility of consumer-voters and their ability to reveal their preferences for the public goods and services in that way, and
- the political process for revealing preferences in provinces and the responsiveness of provincial government to those preferences.

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