Fiscal Decentralization in East and Southern Africa: A Selective Review of Experience and Thoughts on Moving Forward

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I. INTRODUCTION

The last decade has witnessed an extraordinary proliferation of decentralization and local government reform around the world, including in East and Southern Africa. Disappointing progress in meeting national goals through centralized processes has induced many developing countries to think beyond top-down development strategies more seriously than they have in the past. Rapid political, economic, and technological changes have fueled the trend to rely more heavily on lower levels of government.

Fiscal decentralization may seem, on the surface, to be the “easiest” dimension of decentralization because it is not particularly difficult to assign additional powers and revenues to sub-national governments. The reality, however, is more complex. Even if a formal decision is made to decentralize, reluctant central agencies may be able to slow the process down. In addition, giving additional resources to sub-national governments that are not politically, managerially and technically prepared to use them responsibly can create enormous problems. Finally and perhaps most important, the degree to which fiscal decentralization should be pursued is not obvious. Empirical evidence to justify or discredit the pursuit of fiscal decentralization in developing countries is scant and mixed. None of the claims on either extreme—that fiscal decentralization retards economic development and has a variety of undesirable macroeconomic effects; or that it improves local service delivery and enhances government accountability to local citizens—has been adequately tested.

The main reason for the lack of solid evidence on fiscal decentralization is clear—the great variety of context across developing countries complicates meaningful comparative research and development of general rules. First, systems differ in the number of levels of government that exist and the constitutionally and legislatively mandated relationships among them. Second, they also vary in degree of political decentralization and grassroots legitimacy. Some have significant political power and are popularly elected, while others are appointed and follow directives of a more centralized level of government. Third, sub-national authorities differ in their degree of autonomy in revenue-raising and expenditure decision-making. Even in supposedly decentralized systems, the central government continues to exert a degree of control that effectively undermines local autonomy. Finally, there are great differences in sub-national government managerial and fiscal capacity both across and within countries. These enormous differences in the way public sectors are structured and the way they share functions and resources across levels of government, combined with a lack of reliable data, have precluded a clearer understanding of how to approach fiscal decentralization.


Although substantial contextual variation complicates broad generalization, it is possible to outline the basic elements of a beneficial decentralized system and some of the key factors that affect whether it can be realized. These elements would have to be considered in the context of each country to analyze the advantages and disadvantages of fiscal decentralization in a particular case. The real issue is probably not whether there should be fiscal decentralization—it is happening and will continue to happen in many countries; rather, the issue is how to structure an appropriate balance between local autonomy and central control that will allow the potential benefits of fiscal decentralization to be realized without undermining national objectives.

This paper considers fiscal decentralization in the Republic of South Africa and in less detail in a number of rather different cases in East Africa—Ethiopia, Kenya and Uganda. The next section briefly outlines the elements of a good decentralization program. The third section focuses on South Africa, considering the achievements and problems of fiscal decentralization in that country. The fourth section reviews the selected East African cases. Finally, we conclude with a number of broad lessons and recommendations about the pursuit of fiscal decentralization in Africa.

II. THE ELEMENTS OF FISCAL DECENTRALIZATION: WHAT DO WE KNOW?

The basic elements of an effective decentralized fiscal system include at least the following: an adequate legislative and institutional enabling environment; assignment of an appropriate set of functions to sub-national governments; assignment of an appropriate set of local own-source revenues to sub-national governments; the establishment of an adequate intergovernmental fiscal transfer system; and the establishment of adequate access of sub-national governments to development capital. Each of these is very briefly discussed in turn, first outlining a few principles, and then turning to a few commonly encountered problems and possible ways to reduce them.

A. An Adequate Enabling Environment

An enabling environment for fiscal decentralization can begin with constitutional or legal mandates for some minimum level of autonomy, rights and responsibilities for sub-national governments. This provides a foundation on which to build decentralization, but it does not by any means guarantee successful fiscal decentralization. There are many countries with constitutional clauses and laws on sub-national government that have not managed to decentralize successfully.3

A number of elements appear to be critical in establishing a sustainable enabling environment for fiscal decentralization. The first is an adequate political will to

decentralize. International or central budgetary pressures have sometimes fueled decentralization programs in the absence of genuine national commitment. The second is a set of robust and clearly defined constitutional and/or legal provisions to support decentralization and the strengthening of decentralized levels of government. The third is an appropriately empowered mechanism for coordinating the complex activities typically associated with decentralization. Without this, competing and reluctant central agencies can work against each other. Finally, the center must recognize that effective sub-national governments need adequate resources and capacity to meet their responsibilities under decentralization. This has often not been the case where the impetus for fiscal decentralization has been a national budgetary crisis that generated a movement for offloading functions to sub-national governments.

B. Assignment of Appropriate Functions to Sub-national Governments

The principles for assignment of services to sub-national governments as developed in the fiscal federalism literature are fairly clear, and there is no need to elaborate on them here. Many countries generally do in fact follow these principles in a broad way. The problems with fiscal decentralization on the expenditure side appear to be related more to a lack of attention to implementation than to decentralizing inappropriate services. Two aspects are particularly worth noting. First, no matter what a constitution or enabling law says, central government agencies rarely have a desire to decentralize services they have been providing, particularly if decentralization involves a loss of prestige and resources to these agencies and they perceive each other as competitors. Under this condition, they should be expected to try to slow the process down. Second, if too many sectors are decentralized too rapidly and sub-national governments do not have the capacity to handle these new responsibilities, they are likely to perform poorly. If this happens, central agencies hostile to decentralization can use poor local performance as an excuse for keeping the services centralized.

This common scenario is directly linked to common concerns about the effects of sub-national government fiscal behavior on central government deficits and macroeconomic stability. Although poor fiscal performance of sub-national governments is often a genuine problem, this does not necessarily prove that fiscal decentralization is inappropriate. It may simply mean that the fiscal decentralization or sub-national government reform program is giving sub-national governments too much

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functional responsibility too rapidly and without appropriate capacity building and local governance development support from the central government.

C. Assignment of Appropriate Revenues to Sub-national Governments

The fiscal federalism principles for assignment of revenues to sub-national governments, like the service assignment principles discussed above, are well defined and generally appropriate. Many developing countries basically follow these principles, with a few prominent exceptions, such as the infamous South Asian octroi.\(^7\) Thus, central governments generally attempt to assign sub-national governments revenue bases that are relatively immobile and should therefore not lead to serious spatial efficiency effects, that do not compete seriously with central tax bases, etc.

Three particularly problematic concerns remain on the revenue side. First, assigned revenues are almost never adequate to meet the local expenditure requirements. This means that central government transfer programs are inevitably required. Second, sub-national governments often use too many unproductive revenue sources that barely cover the costs of collecting them. Third, individual local revenue sources suffer from some serious design problems, such as stagnant bases, overly complex structures, and ineffective collection mechanisms.

While building local revenue systems is important, care must be taken to approach reform strategically. Attempts to implement too many reforms at once can overwhelm the tolerance of local residents and the capacity of sub-national governments. One of the most critical international lessons of local tax reform is that sub-national governments should focus their energies on systematic development of a few local sources of revenue that can provide substantial yields and establish a better link between the taxes local residents pay and the benefits they receive.\(^8\)

D. Developing an Appropriate Intergovernmental Transfer System

Intergovernmental transfer programs serve multiple often-interrelated purposes. First, they help to cover sub-national government fiscal imbalances, supplementing inadequate local own-source revenues to improve the ability of sub-national governments to meet their expenditure responsibilities. Second, they can be used to meet national redistributional objectives, helping to offset fiscal capacity differences among sub-national governments. Third, they can be used to encourage local expenditures on particular goods and services that exhibit positive externalities or are considered to be basic needs that should be distributed less unequally than the ability to pay for them. Most transfer systems are intended, at least officially, to meet these objectives, and they use a variety of types of mechanisms to do so.\(^9\)

\(^7\) Bahl and Linn (1992); Shah (1994).

\(^8\) Bahl and Linn (1992); Shah (1994); Litvack, Ahmad and Bird (1998).

\(^9\) Much of the literature on this topic is reviewed in: L. Schroeder (1988) "Intergovernmental Grants in
There are several typical issues and problems involved in designing transfer programs. First, no one type of transfer meets all desired objectives. Unconditional grants, for example, are best for income redistribution purposes, while conditional grants are a more efficient way of encouraging expenditures on particular types of target services. Second, fiscal equalization grants are often considered important, but they are very difficult to design because of the technical and political complexities involved in defining an "optimal" distribution of income across decentralized jurisdictions and in determining a fair way to raise the revenues to be redistributed. Third, macroeconomic problems can be created if too large a percentage of central resources are guaranteed to sub-national governments each year. The potential dangers, however, must be balanced against the value of providing sub-national governments a stable revenue base and the potential microeconomic gains of decentralized service delivery. Fourth, transfer programs may have conflicting objectives or unintended results. For example, an equalizing grant may be offset by conditional grants that go to wealthier areas, or grants may substitute for rather than stimulate local tax effort. Fifth, too many transfer programs with different allocation criteria create an administrative burden for local officials and provide incentives for unproductive competition and strategic behavior. Finally, many transfer systems—by design or by manipulation—are allocated with a degree of subjectivity that undermines basic economic objectives.

In the final analysis, it is difficult to make generalizable prescriptions about the appropriate structure of an intergovernmental transfer system, which should be expected to vary across country depending on national objectives, the extent of service and revenue functions assigned to sub-national governments, the fiscal capacity of sub-national governments, the extent of inequalities across sub-national governments, and the political environment. Common reforms include carefully selecting the overall package of transfer programs to balance key objectives, moving towards consolidated programs with more transparent allocation mechanisms, building incentives for good fiscal behavior into the access criteria and distribution formulae, and starting new programs incrementally, increasing available resources as sub-national governments develop capacity to behave in a fiscally responsible manner. In spite of the challenges involved, transfer programs can generally be designed to improve on the status quo.

E. Developing Adequate Local Access to Investment Capital

Sub-national governments in many developing countries get much of their capital budget from intergovernmental transfers, but some decentralized governments, typically states, provinces, and large cities, are able to borrow in some countries.10


Where local borrowing occurs, often through some type of municipal credit institution, loans are often allocated at least partially according to political criteria, interest rates may be subsidized, and loan repayment is often inadequate. Substantial dependence on grants and subsidized loans developed during a period when funds for infrastructure were abundant and developing countries faced fewer internal or external pressures for good fiscal performance than at present. Moreover, many analysts long believed that subsidization would improve equity in service delivery. Recent economic and fiscal changes, however, as well as increasing evidence that subsidization does not primarily benefit those in need, have stimulated reforms. Many countries are adopting objective appraisal techniques, charging closer-to-market interest rates, and enforcing repayment, often through municipal development funds. Some central governments, particularly in Latin America, but also in India, South Africa, and a few other countries, are trying to develop a municipal bond market.

A good fiscal decentralization program requires the development of an appropriate spectrum of options to finance capital investment, from grants and subsidized loans for poorer sub-national governments and non-self-financing projects, to various types of loans and bonds for fiscally sound sub-national governments and self-financing projects. As with grants, the approach that a central government takes towards enhancing sub-national government access to loans depends on the fiscal context. In cases where decentralized governments are relatively strong, efforts to develop direct access to capital markets make sense, but the central government must regulate municipal bond markets, develop and enforce credit limits, and stop bailing out sub-national governments that default on their debt. In more typical cases, where sub-national government investment responsibilities are smaller and they are fiscally weak, some type of municipal development fund will generally be the correct approach. Municipal credit institutions are initially regulated or managed and substantially capitalized by central governments, either with their own resources or donor loans. This approach gives central fiscal authorities considerable control over borrowing activities of sub-national governments, although this power must be structured to minimize abuse. In addition, such institutions are likely to be increasingly privatized as sub-national governments develop greater creditworthiness, which will help to limit the extension of non-viable loans. Serious impacts of local debt on the broader economy can generally

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be avoided if municipal credit markets are properly structured, managed, and developed over time.\textsuperscript{12}

Perhaps the most critical challenge in more advanced fiscal decentralization is how to “graduate” sub-national governments from extreme dependence on grants and subsidized loans to greater use of credit markets. This requires proper development and definition of both grant and loan options. It is critical to ensure that wealthy municipalities cannot use grants for self-financing projects, thereby diverting scarce resources from projects with weak revenue potential and from poorer sub-national governments unable to borrow. At the same time, grants and subsidized lending mechanisms must create incentives for weaker sub-national governments to improve their fiscal discipline and begin to borrow for appropriate projects. A multi-faceted system that incorporates these critical elements could help to prevent the type of sub-national government debt crisis feared by those suspicious of fiscal decentralization.

III. FISCAL DECENTRALIZATION IN SOUTH AFRICA

Having reviewed basic elements of fiscal decentralization, we now turn to a review of the evolving intergovernmental fiscal system in South Africa. We start with some basic background, and then proceed to consideration of the elements of the system.\textsuperscript{13}

A. The Context of Reform and the Evolving Government System

The South African Constitution of 1996 provides for three spheres of government—national, provincial and local—that are, in the words of the Constitution, “distinctive, interdependent, and interrelated.” All three spheres are evolving, and the role of both provinces and local governments has increased significantly in recent years.

Even prior to the election of Nelson Mandela as president in 1994 and the subsequent dismantling of apartheid, the Republic of South Africa (RSA) had begun to

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\textsuperscript{12} Peterson (2000).

decentralize its public sector, but the government faced a special challenge. In addition to transferring responsibilities to lower levels of government, politicians and policymakers were faced with the formidable task of redressing enormous disparities—both political and economic—among jurisdictions that had long been subject to strict racial segregation.

Regional governments were originally given a strong role by the Constitution that created the Union of South Africa in 1910. The 1986 Provincial Government Act, however, abolished provincial legislatures and replaced them with appointed executive authorities. New powers, such as health services, were subsequently given to provincial administrations, but provincial budgets still required ratification by the national Parliament. The 1996 Constitution empowered provincial legislatures, more clearly defined the role of provincial governments, and allowed them some degree of autonomy.

On the local government side, non-white areas were managed during much of the apartheid era by local bodies that had had few powers and resources, even after they were elected in later periods. The most recent were the Black Local Authorities (BLAs), which were established in 1982 but never enjoyed political legitimacy. They were commonly seen as a desperate attempt by the regime to provide a façade of local democracy for blacks, while essentially reinforcing segregation and keeping apartheid intact. They were never able to develop reasonable tax bases, largely because of apartheid restrictions on economic development in the BLAs, and service levels typically lagged far behind the White Local Authorities (WLAs). Poor service levels and attempts to impose rents and service charges in the BLAs angered local communities and led to the infamous rent boycotts, fueling the drive by civic organizations and activists to topple apartheid.

In the late 1980s, the national government tried to defuse escalating tensions and to salvage the system. They established a substantial intergovernmental grants program to channel resources to poor black areas through newly created decentralized umbrella institutions call Regional Services Councils (RSCs) and Joint Service Boards (JSBs). In the end, these late interventions were ineffective, and the situation continued to worsen.

In response to the severity of the crisis, a Local Government Negotiating Forum was established in 1990 to develop a new local government system that would be more widely accepted as legitimate. This resulted in the Local Government Transition Act of 1993, which provided for a three-stage transition process. During the pre-interim phase, local forums were established to negotiate appointment of temporary councils to govern until local elections were held. Municipal elections marked the start of the interim phase, which is essentially ending with the definition of a new local government system. In the final phase, the newly defined system will be implemented and developed.

One of the greatest institutional challenges involved in implementing the government’s transitional reform program is how to amalgamate fiscally disparate former WLAs and BLAs located in proximity. The national government established a “one-city” concept, under which it established unified local governments that are supposed to offer

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14 The Local Government Transition Act was most recently amended in 1996.
all citizens basic services and standardize the types of public revenue collected from them. Progress has been very mixed, and the situation has been further complicated by the creation of new municipal boundaries by the Municipal Demarcation Board in 2000, to which we shall return. This action consolidates more than 800 local governments into less than 300.

**B. Basic Institutional Structures and Functions**

Although it is not possible to provide a thorough analysis of the intergovernmental system in this paper, a brief review of the present structure and functions of local government is important to set the stage for a review of the fiscal system. The specific powers of each level of government are assigned in the Constitution. Some functions are defined as the exclusive sphere of one level of government, while others are concurrently assigned to more than one level.

The nine provincial governments have responsibility for a wide range of functions. Most important among them are elementary and secondary education, health care, social welfare, and public transportation. The Constitution allows provincial governments to impose taxes on any base except personal and corporate income, general sales, value-added, customs, and property. The provinces are given authority to levy a flat-rate surcharge on personal income subject to approval of the Parliament, which has not been granted yet. Provincial governments are also entitled to an “equitable share” of national revenue, and there is a framework in which they are allowed to borrow.

The Local Government Municipal Structures Act (No. 117 of 1998) consolidated a complex system of urban and rural transitional governments into three basic categories of municipalities. Metropolitan councils (Category A) cover the largest urban areas. Local municipal councils (Category B) cover smaller and medium-size localities, primarily urban. District municipal councils cover areas not served by Category A and B councils and have responsibility to coordinate integrated development planning for the district as a whole. The districts not infrequently provide services on behalf of weak local councils situated in the district council area.

Local governments in South Africa are given substantial powers and functions by the 1996 Constitution, which mandates the creation of elected municipal councils to make decisions regarding the exercise of these powers and functions. The most important

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15 These structures are detailed in Department of Constitutional Development (1998).

16 Schedules 4 and 5.

17 Metropolitan councils (MCs) were originally established as umbrella governments in six of the largest urban areas. Until recently, a number of smaller metropolitan local councils (MLCs) operated under each of them. Others urban areas were governed by transitional local councils (TLCs), but these councils were typically at least partially dependent on broader-area district councils (DCs), which evolved from the old RSCs and JSBs established during the apartheid era. There have been various types of rural local councils, but many have relied on the district councils for various services and assistance.
municipal services include water, sanitation (including solid waste), roads, storm water drainage, and electricity. A few functions are assigned through legislation. The actual distribution of responsibilities, however, varies widely within and across types of local governments. Some municipalities, particularly in larger urban areas, take responsibility for a significant range of functions and services, while other local governments, particularly but not exclusively in rural areas, provide few services independently.

Local governments are granted a number of sources of revenue by the Constitution, and they are also given the right to borrow, except to finance a recurrent deficit. The main sources of revenue cited are rates on property and surcharges on fees for services provided by on or behalf of the municipality. Other sources may be allowed by national legislation, but local governments are excluded from imposing income tax, value-added tax, general sales tax, and customs duties. The Constitution also entitles the local governments to an "equitable share" of national revenues. Local governments may also receive additional grants from either the central or provincial governments on either a conditional or an unconditional basis.

The Constitution gives higher levels of government considerable oversight and control powers over decentralized governments. The assignment of some powers and revenues to local governments is at the discretion of the center and, to an extent, the provinces. The center must take the lead on developing national objectives and guidelines and in ensuring adequate coordination among all levels. The center also designs and administers the intergovernmental transfer program.

Finally, the national and provincial levels have a variety of responsibilities to monitor—and to intervene as necessary—in local government affairs to ensure that basic standards of good governance, service provision, and financial discipline are being met. The Department of Provincial and Local Government (DPLG, formerly the Department of Constitutional Development) is the major national institution involved in local government reform, supervision, and assistance, but other key national ministries, such as the National Treasury (formerly the Department of Finance) and various sectoral departments, also play important roles.

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18 For example, the Local Government Transition Act (Second Amendment) assigns local governments the responsibility for integrated development planning.

19 Sections 229 and 230 of Chapter 13.

20 Section 227 of Chapter 13.
C. Provincial and Local Government Expenditures

Provincial and local government service expenditures are significant and together far exceed national level expenditures (excluding transfers, grants-in-kind, and debt servicing). Expenditure budget estimates for 2000/01 are 70 billion rands (29 percent of total expenditures) for the national level, 110 billion rands (46 percent) for the provincial level, and 60 billion rands (25 percent) for the local level. Provincial budgets differ in size, however, and local budgets vary enormously from large metropolitan areas with huge budgets to small rural councils with negligible budgets. In 1998/99, the ten largest municipalities accounted for 65 percent of total local government expenditures.

Provincial expenditures in 1999/00 amounted to R97 billion, which represents a negative growth in real terms compared to the 1996/97 level of R91.2 billion. Education accounted for the largest share at 41 percent, while health accounted for 25 percent and welfare for 20 percent. More than 90 percent went to operating expenditures, but a significant amount of capital expenditures are made as agency payments or off budget. Nearly 60 percent of the total was used for personnel and another 22 percent for transfers.

Provincial spending patterns vary significantly. Northern Province and Mpumalanga spend more than average on education, while Western Cape, Northern Cape, and KwaZulu-Natal spend less. Gauteng and Western Cape spend more than 30 percent on health, while five of the other provinces spent in the range of 16-22 percent on health. Northern Cape and Eastern Cape spend more than 23 percent on welfare, while Gauteng spends only 15 percent. Per capita spending in every category also varies greatly across provinces. Northern Province, for instance, spends 16 percent more than the average per capita on education, while Gauteng and KwaZulu-Natal spend 14 percent less. Per capita health expenditure showed particularly great variations, with Western Cape and Gauteng spending 30-40 percent more than average, and North West and Mpumalanga 27-28 percent less. Welfare also shows large variations, as Northern Cape spends 63 percent more than the average province and Gauteng spends 34 percent less.

Provincial expenditure variations reflect not only demographic profiles and income levels but also historical national decisions. Per capita spending on education tends to be higher in poorer provinces, such as Northern Province, because these often have larger populations of school going age and large numbers of repeaters due to inherited poor school systems. Per capita spending on health is higher in provinces such as Gauteng and Western Cape, which inherited major health responsibilities, such as the Central Hospitals. Per capita spending on welfare tends to be higher in provinces with sizable poor populations, such as Eastern Cape and Northern Cape.

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Due to substantially different budget formats and completeness of reporting across municipalities, detailed local government expenditure data are harder to come by, but a few trends are known. Operating expenditures dominate the budget (81 percent average in 1999-2000), and expenditure composition differs dramatically across councils, with large municipalities providing a variety of services and smaller ones often spending most or all of their budget on basic administration. In 1996/97, the major operating expenditure line item in metropolitan areas was salaries--accounting for 25 percent of total operating expenditure--followed by trading services\(^{22}\)--22 percent. These accounted for 30 percent and 29 percent, respectively, of total operating expenditure in other urban areas. District council budgets, which are not broken down into operating and capital, components, were dominated by local functions (45 percent), followed by regional functions (34 percent) and administration (11 percent).

It is important to note that provincial governments are highly dependent on the national government to finance their expenditures. In 1999/2000, for example, provincial governments raised on average only 4 percent of their revenues, ranging from around six percent in Gauteng to less than two percent in Northern Province. On the other hand, municipalities are in the aggregate substantially independent from the center on the recurrent side of the budget, raising 92 percent of their total revenues in 1999/2000.

These aggregate figures, however, hide variations. Some small rural local governments have few or no own-sources of revenue, and even the dependence of metropolitan areas varies across provinces. Local governments are substantially more dependent on the center for capital expenditures (30 percent average in metropolitan areas, 55 percent in other urban areas, and essentially 100 percent in rural areas). Again, there are large variations among the provinces, ranging, for example, from more than 40 percent in KwaZulu Natal and the Western Cape to only 15 percent in Gauteng.

The heavy role of the center in financing sub-national, particularly provincial expenditures is a result of decisions regarding national priorities and provisions in the 1996 Constitution. The equitable share provisions of the Constitution are particularly important. The share of national resources that goes to each level of government is supposed to be determined after consideration of a variety of national needs and interests reflected in the Constitution and legislation, the fiscal capacity and ability to perform of each sphere, and the need to redress historical inequities. Taking full account of these considerations would, of course, require data that are difficult to obtain as well as a number of value judgments. In 1999/2000, the national, provincial and local government allocations of national revenues are, respectively, 41.1, 57.3, and 1.5 percent.

\(^{22}\) Electricity, water, sanitation, and refuse removal are referred to as trading services in South Africa.
C. Provincial and Local Own-Source Revenues

Provincial governments, as noted above, are heavily dependent on the national government. Own revenue collections, with some fluctuations, have generally declined in recent years, despite the passing of a regulatory framework that allows provinces to impose new taxes with national approval and efforts to promote revenue generation. The estimated 2000/01 own revenue is R3.6 billion, 12% below the 1996/97 level.

The main provincial own-source revenue is road traffic fees, including motor vehicle licenses and registrations and driver’s licenses and learner’s permits. These accounted for nearly 38 percent of the total in 1999/2000. Other important provincial sources include gambling (15 percent), interest (7 percent) and hospital fees (8 percent). Road traffic fees are buoyant, as are gambling revenues. The buoyancy of hospital fees has been declining recent years, but is expected to rise in the medium term.

The average per capita provincial own revenue is R96, but there is significant variation. Western Cape and Gauteng collect R176 and R134 per capita, whereas Eastern Cape and KwaZulu-Natal collect only R51 and R68 per capita. Differences reflect a combination of varying fiscal capacity and fiscal effort. For instance, Gauteng’s high level of own revenue reflects not only strong fiscal capacity, but also a strong fiscal effort in the form of relatively high tax rates. There is a negative correlation (-0.71) between poverty incidence and own revenue per capita in the provinces, suggesting that fiscal capacity is important in explaining low own revenue generation.

Local governments rely primarily on user charges, property rates, and the RSC levy, a combination payroll and turnover tax. The RSC levy, which was originally introduced by the apartheid regime to support the Regional Service Councils and Joint Service Boards, is only available to metropolitan and district councils. The balance of local revenues comes from a variety of minor sources that will not be considered here.

Given the focus on local governments here and the relatively greater importance of local taxes as a source of revenue, each of the three major municipal sources will be considered in more detail. The figures used here are not always the latest aggregates, but they are the most recent for which the level of detail provided is available. Thorough analysis of local revenue sources in South Africa is hindered by a lack of reliable comparative data, but we are able to consider the way each of the major sources is structured and administered, reporting whatever summary data are available, and noting some key issues regarding each source.

**User Charges**

The major source of urban and metropolitan revenue on the operating account is own-source revenue from trading services—electricity water, sanitation, and solid waste.

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23 The data and information used here come primarily from Department of Constitutional Development (1997b), Vaz (1999), and National Treasury (2000).
These charges constitute the largest single source, generally accounting for more than 60 percent of local revenue in 1996/97. Metropolitan local governments raise 54 percent of their revenue from this source, slightly more at 65 percent in other urban areas. Local governments also charge for other services, such as public transport, clinics, recreation facilities, etc., but these typically raise less than one percent of total revenues.

Available data are far from comprehensive, but some recent information is available to characterize the use of charges. A survey of a sample of 12 municipalities in 1999 showed significant variations across local governments. The charge for 1000 units of electricity, for example, ranged from around R200 in Bloomfontein to more than R300 in Louis Trichard municipality. Similarly, charges for 30 kilolitres of water ranged from R60 in Reddersberg to R107 in Carolina. An earlier analysis of 15 municipalities in 1997 found cost recovery ratios ranging from 94 percent to 146 percent for water, 65 percent to 128 percent for electricity, 79 percent to 213 percent for sanitation, and 65 percent to 100 percent for solid waste. Thus, limited evidence suggests that user charges are used as taxes in some local authorities, while in other cases they do not even cover the costs of the service. Beyond a few modest sectoral studies, there is little information on how charges are set and their efficiency and equity effects.

There are two main concerns regarding possible reform of local user charges. First, as noted above, the government does not know enough about the structure and effects of most types of user charges across local governments, so that it is difficult to determine if the current structure is generally appropriate for balancing efficiency and equity goals and if the revenues derived from this source are being used in an appropriate way. There may be some services for which charges are being “overused” and others for which “underuse” is a problem.

Second, there have been in recent years some proposals made to regionalize or privatize a number of the services that generate surplus revenues for the municipalities, particularly electricity. Having the highest electricity user charges among the sample of municipalities discussed above, for example, allows Louis Trichard municipality to have the lowest property taxes. As noted earlier, many local governments employ user charges as taxes to fund general expenses. Whether this is considered desirable or not, reforms that take surplus-generating services away from local governments could have profound impacts on their financial viability. Such decisions require careful analysis and crafting of policies to offset any serious revenue effects of changes in service responsibilities.


More recent aggregate numbers are available, but they do not show the differences among different types of local governments. The more recent numbers suggest a modestly declining reliance on user charges. This is probably due to increases in transfer, increased productivity of the RSC levy, and perhaps a set of issues related to the way user charges are set and the possibility that local governments are preparing for a potential loss of some trading services that generate significant charge revenue.
The reality is that user charges are currently the backbone of urban government finance in South Africa, and they are likely to remain important no matter what types of reforms are adopted. More detailed and systematic study of user charges and the services for which they are collected is required before judgment can be passed on the current situation and recommendations made for the future, including the possibility of developing service-specific standards for cost recovery and tariff setting.

**Property Rates**

Property rates have historically been an important revenue source and the single most important local tax in South Africa, accounting for 20.34 percent of local revenues in 1996/97. There is, however, considerable variation across provinces, ranging from 13.11 percent in North West Province to 22.3 percent in KwaZulu-Natal, and this source has been available only in urban areas. Property rates are moderately more important in the largest cities, accounting for 22 percent in metropolitan areas compared to 17 percent in other urban areas in 1996/97. There are also wide variations in per capita terms. In 1998/99, for example, monthly rates charges in a sample of 12 municipalities ranged from R27 in Louis Trichard to around R250 in Durban, Cape Town and Johannesburg.

The structure of the tax is not easily summarized because there is considerable variation in use across local governments. In some provinces, such as Western Cape, Northern Cape and Eastern Cape, the base is the market value of land. In other cases, both land and buildings are assessed, but sometimes on different bases. In Free State, for example, land is assessed at market value, but improvements are assessed at replacement cost less depreciation. In a few cases, some local discretion is allowed. In KwaZulu-Natal, for example, land must be assessed at market value, but local officials can decide whether to assess structures at market value or replacement cost less depreciation.

There are similarly wide variations across provinces in the definition of exemptions, valuation periods, rebates, rate-setting conventions, etc. In some cases, local governments are given discretion, while in other cases they are not. The reason for these variations is that property rates have been governed historically by individual provincial laws rather than national legislation. A case can be made for this diversity on local autonomy grounds, but it obviously greatly hinders the development of an understanding of local government tax capacity and effort. This, in turn, makes it difficult for the center to determine the ability and willingness of the local governments to meet constitutional mandates regarding service provision and the alleviation of historical inequities discussed earlier. The lack of uniformity also complicates government efforts to design an intergovernmental transfer system that adequately helps to meet national objectives.

There has been some research conducted on property rates, but these studies have resulted in inconclusive or conflicting conclusions and policy recommendations.

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26 Most of the information here is summarized from Department of Constitutional Development (1997b), Vaz (1999); National Treasury (2000).
regarding the equity and efficiency effects of the tax and the need for some national standards in defining and administering the tax. There is, however, broad agreement that property rates will remain the principal municipal own-source tax. Their importance is underscored by the fact that the national government’s efforts to improve local own-source revenues place first priority on rates reform.

Two prominent issues need to be resolved with respect to property rates. First, the tax has been levied only in urban areas and principally in the former all-white areas. New legislation expected to pass the Parliament in 2001 opens the door to expand the net, but this is both politically contentious and complex. Getting areas covered by former black local authorities to pay rates is constrained by a number of factors. Habits developed during the rent boycott—the “culture of nonpayment”—are not going to disappear overnight. Newly elected local governments under demarcation will have to earn the trust of their constituents before payments will be readily forthcoming. In addition, some people hold the expectation that the relatively wealthy former WLAs should compensate for apartheid-era inequities by footing a major local share of the bill for extending services to former BLAs. Astronomical property tax burdens levied for this purpose are precisely what many residents of the former all-white areas fear will be a consequence of decentralization. In addition to these concerns in urban areas, there is a debate about the extension of property rates to rural areas. Proponents argue that bringing untaxed rural areas into the tax net will improve inter-jurisdictional equity and reduce inter-jurisdictional efficiency effects. Opponents maintain that there will be negative impacts on agricultural production and land use, as well as a detrimental effect on the rural poor.

Second, the new legislation provides for greater uniformity in property rates in South Africa, including a uniform land and improvements base. How this will be implemented and the effects of implementation in a country where there is considerable variation in the structure of the property tax across provinces and local governments remain to be seen.

Property rates is the most “locally controlled” and productive tax in the South African system. Its major failings are the difficulty of administration, the arbitrariness that sometimes results from poor administration, and the difficulty in making revenue growth from the property tax keep up with growth in the economy. The issue of the future of property rates is critical to the financial viability of local governments in South Africa. The ultimate decisions about how to proceed with reform will also have a significant effect on the future design of intergovernmental transfers in terms of both redistributional goals and local revenue incentive mechanisms.

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**RSC Levy**

The RSC levy, as noted above, was introduced by the apartheid regime in the late 1980s to help redress imbalances between black and white local governments. The levy is a combination payroll and turnover tax that falls primarily on the formal sector. The RSC levy accounted for about 5 percent of aggregate local government revenues in 1996/97. This figure, however, masks the great importance of this source to district councils, which received 39 percent of their total income from the RSC levy in 1996/97.

The structure of both components of the RSC levy is defined by national legislation, and the setting of rates is subject to nationally mandated maximums. Thus, local governments have little control over the levy, especially since the National Treasury froze rates a few years ago. There has been little study of the levy’s efficiency and equity effects, and it is considered a complex and politically contentious tax to collect. Although a productive source of revenue in the districts, data on the tax base are not readily available. Lack of better information on the base and other factors hinders understanding exactly what comparative yield figures capture—differences across local governments in fiscal capacity, administrative structures and procedures, staff capacity, willingness to pay of council constituents based on perceptions of local government performance, etc.

There are several concerns about the RSC levy, the most obvious of which is that it has become an important local revenue source. This means that it is neither practical nor desirable to abolish the levy unless it can be replaced with a revenue source that provides a comparable yield. This is particularly true in the emerging environment of decentralization in which local governments are expected to receive more responsibilities while their dedicated sources of revenue remain fairly limited, particularly in the districts.

A second important issue regarding the RSC levy is that the potential effects of its two components, a payroll tax and a turnover tax, are controversial. Although these forms of taxation are used internationally, they are widely criticized. Payroll taxes raise the relative cost of labor, which may have employment effects. This is particularly important given the high cost of labor in South Africa. Turnover taxes cascade through stages of production and raise prices that are also subject to the VAT. Both payroll and turnover taxes primarily affect the formal sector (which may be considered either a positive or negative feature), and both, but particularly the latter, can be difficult and/or expensive to administer. Finally, equity effects are not entirely clear, both with respect to the structure of the component taxes and the way they are administered. A payroll tax

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29 The figure rose to seven percent in 1998/99, but data for different categories of municipalities are not available for that year.

falls primarily on formal sector employees, who are relatively well off within the national income distribution. It is, however, a flat rate tax, so it is not progressive within the group on which the tax is levied. Turnover taxes are partially exported to other jurisdictions and are likely to be passed forward in the form of higher consumer prices, and consumption taxes tend to fall more heavily on low-income people. Thus, regressivity, at least on the revenue side, is a potential concern here. Poor administration, which is anecdotally documented and alleged to be widespread, can cause horizontal inequities with either tax.

A third set of issues regarding the RSC levy concern local autonomy. Generally speaking, the tax as currently structured is more like a grant than a local tax. The central government defines the bases, effectively sets a ceiling on the tax rates, and does not give local governments legal recourse. On the other hand, there are some rate variations, and some local governments are said to be more active than others are in collection and enforcement. The extent and nature of variations in the RSC levy across local governments must be better understood, and the potential implications of giving local governments greater autonomy in the administration of the RSC more fully documented.

A fourth set issues, linked to the three already discussed, relate to the way the RSC levy affects broader policy objectives. It is possible, for example, that greater local autonomy could lead to higher and possibly geographically differentiated rates, greater overall tax burdens, and various types of efficiency effects. These effects could have a negative impact on the economy and reinforce or exacerbate existing inter-jurisdictional inequalities. On the other hand, heavy central control may undermine the ability of local governments to meet important responsibilities at a time when they are facing increasing pressures to perform. These pressures come both from the national government as it expands local functions under decentralization programs and from increasingly aware citizens who want local governments to redress public service shortfalls and inequities. Regarding redistribution, if the RSC levy is to be formulated essentially as a grant, then its effects relative to the rest of the intergovernmental transfer system must be analyzed. Even if it is conceived as a local tax, its differential yield across councils should be taken into consideration when defining redistributational components of the grant system.

In summary, the RSC levy has strong revenue benefits and seems to be politically acceptable in its present form. The major question is whether these benefits and the low rate of taxation outweigh the considerable negative aspects of the tax. Before RSC levy reform options and their implications can be explored more fully, additional data and analysis would be required. More information is needed about the levy effects and the yield, efficiency, equity, and administrative effects of various possible options to replace it. Without access to such information, policy prescriptions on the RSC levy are largely normative and subjective. A detailed research program on the RSC levy to fill in some of the existing knowledge gaps, both quantitative and qualitative, is currently underway.  

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E. Intergovernmental Transfers

As noted above, provinces provide major services but have few sources of revenue. Most urban municipalities raise substantial amounts of revenue and provide a number of key services. In contrast, most rural jurisdictions provide few services and have weak revenue capacity. Given the limited amount of own-source revenue raised by many provincial and local governments, the constitutional mandate to provide basic public services, and the extremely unequal income jurisdiction, intergovernmental revenues must play an important role in financing provincial and local governments.

Existing Transfer Systems

The provincial government transfer system has been evolving since the 1996 Constitution empowered the provinces. The original equitable share system, as developed from recommendations by the Financial and Fiscal Commission, included five separate formulas with a variety of components. The National Treasury later simplified the formulas, which are now based largely on population and previous levels of provincial spending. In addition, there are a number of conditional grants and agency payments (essentially a payment to a sub-national government for delivering services on behalf of a national department), most of which are for health, finance, housing and transport.

Government transfers in 1999/00 provided 96% of the provincial revenue, with 83% from the unconditional equitable share and 13% as conditional grants. The averages mask major variations across provinces. Eastern Cape and Northern Province, for example, receive 88.7 and 88.3 percent from the equitable share, while Gauteng and Western Cape receive only 76.6 and 75.7 percent. In contrast, conditional grants are less important in Eastern Cape, Mpumalanga, North West, and Northern Province, providing between 8.6-9.9 percent of revenues, but relatively more important in Gauteng and Western Cape, where they supply 17.1 and 17.6 percent. The Department of Health administers the largest share of the conditional grant. In 2000/01, this Department will transfer R5.7 billion to the provinces, corresponding to 43% of the total. The grants mainly fund the Central Hospitals responsible for research and professional training, as well as specialized health facilities and national nutritional programs. Since the Central Hospitals were established in Gauteng and Western Cape, these provinces receive the lion share of the health grants. Support to administrative capacity building and infrastructure development is directed to poorer, rural provinces, such as Free State.

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There are also significant variations between provinces in the per capita revenue by source. The average per capita revenue available from equitable shares and conditional grants are respectively R2004 and R292. But while Northern Cape and Eastern Cape receive R2341 and R2189 per capita from the equitable share, Gauteng and KwaZulu-Natal receive only R1640 and R1856 per capita from this source. With respect to conditional grants, Western Cape, Gauteng, and Free State receive R461, R366, and R334 per capita, but Mpumalanga and North West receive only R189 and R215.

There are three categories of transfers (including agency payments) to the local governments. The first is the equitable share of nationally collected revenues, primarily intended to enable municipalities to provide basic services to poor residents. The equitable share accounts for 29 percent of total transfers to local governments in 1999/2000. The formula for distributing the equitable share between municipalities comprises a municipal basic services transfer (S component) and a municipal institutional transfer (I component). The S component is intended to finance poorer municipalities to deliver basic municipal services to households, while the I component provides support to those municipalities that lack administrative capacity.

The second is a set of conditional grants, accounting for 11 percent of transfers. These have a variety of purposes. One type goes to towns in the former Bantustans for staff salaries, while others subsidize electricity and water services. There is also a grant to fund management support and capacity-building initiatives in small municipalities, and a financial management grant to assist metropolitan, district, and large Category B municipalities to build capacity for financial planning and budgeting. Another important type is the restructuring grant that assists eligible municipalities whose financial difficulties, as determined by the National Treasury, pose a significant threat to national economic development.

Finally, agency payments from national departments account for 60 percent of transfers to local governments. They include grants made through the Consolidated Municipal Infrastructure Program (CMIP) for basic infrastructure, the community based public works program for job creation and the ‘grant-in-kind payments’ for the community water supply and sanitation program for rural areas and bus subsidies to assist low-income commuters.

How does the existing transfer system perform in terms of its objective? This is a very difficult question to answer definitively because of a lack of data, but there are some positive features to consider. The very existence of the equitable share and capital grants programs recognizes vertical imbalances. The equitable share is redistributive, and the capital transfer programs largely target basic services for disadvantaged citizens. Some services create spillovers that transfers can help to correct. Thus, the system is designed to meet some of the key objectives noted above, but empirical evidence is limited.
**Fiscal Imbalance**

The extent to which the fiscal imbalance is alleviated by the present transfer system is unclear. Certainly the large amount of resources transferred by the national government to the provinces suggests a serious effort to deal with the resource problem. Some analysts suggest that the municipal vertical imbalance is small because local own-source revenues cover 90 percent of operating expenditures in major municipalities. Neither of these realities, however, tells the full story. It is, in fact, inappropriate to use actual expenditures and actual revenues to determine the size of the fiscal imbalance. The correct approach is to develop a normative indicator of fiscal need that measures the gap between local expenditures required to provide mandated services at a minimum standard and local revenue-raising capacity. Although various capital and recurrent transfers help to fund sub-national services that would otherwise not be provided, the extent to which needs are being met cannot be determined without better data. On the municipal side, the documented lack of local services and the small size of the equitable shares program, suggest that more needs to be done to alleviate vertical fiscal imbalance, but there is little information about how much more revenue could be locally raised.

It must also be recognized that the demand for services will grow in the future. As the economy develops and local capacity increases, there will be increased pressure for provincial and local governments to provide a broader range and higher level of services. Provincial and local revenue-raising capacity will also be growing, but it will almost invariably lag behind the growth of expenditure needs because the institutional capacity of many provincial and local governments to raise own-source revenue is limited and will take time to develop. In addition, some key local taxes tend to grow slowly or require political and/or administrative action to keep buoyant, and there are limits on the development of local taxes and user fees. Raising them too high would be politically difficult, may place a heavy burden on residents, in some cases especially the poor, and may discourage local economic development. Finally, the national government does not seem inclined at present to provide new sources of sub-national revenue.

These arguments—which require further documentation—suggest that the aggregate need-capacity gap of sub-national governments could grow in the future and that their vertical share of national revenues, at least at the local level, probably needs to increase. At the same time, the restrictions National Treasury wishes to place on the overall size of the public sector will limit the local share. In addition, the National Treasury and DPLG understand that local governments must have adequate capacity, financial discipline, and local accountability to use resources provided to them responsibly. Ultimately, the decisions about how to vertically divide nationally-raised revenue and how this should evolve over time requires weighing the capacities and competing demands of the three levels of government.

**Alleviating Inequities**

The equitable share is intended as a redistributive mechanism, enabling provinces and local governments to meet the social service demands of their populations. The
provincial equitable share formula is designed to capture provincial differences in relevant variables, such as poverty levels, numbers of learners, non-insured persons, land area etc. Provinces with higher incidences of poverty, such as Eastern Cape, do receive higher per capita transfers from the equitable share than “rich” provinces, such as Gauteng. On the other hand, the specification of some other allocation formulae is questionable. For example, the formula for the welfare component uses population on the assumption that the distribution of the disabled population follows that of the total population, which is not true. More generally, there has not been adequate study of the degree to which the formulas are properly specified to meet their intended goals or whether they in fact meet those goals, and there are not clear norms and standards for the basic services the equitable share is supposed to finance. Costs to meet specified norms might vary across provinces for a variety of reasons, and this should ideally be taken into account when making allocations. In addition, without norms and a monitoring system, it is not possible to know if grants are used as intended. This situation has led to calls by the Financial and Fiscal Commission for a “costed-norms” approach to the allocation of the equitable share, such that each province’s allocation should be set to meet the minimum amount of resources needed to meet the nationally defined output goals.

Recent research compared the equitable share grants to local governments in 1997-98, the year before the first equitable share allocation, to an estimate of the grants that will occur when the S grants are fully phased in and the historical allocations are completely phased out. With the exception of Gauteng, where rural incomes are relatively high, the horizontal distribution of the equitable share results in large grant increases to rural jurisdictions and decreases to urban jurisdictions. In the poorest local authorities, equitable share revenue dominates the budget, while this revenue is relatively trivial in the wealthier local governments. Thus, there is some genuine redistribution occurring. If own-source revenues cannot be substantially increased, however, there will be growing pressure to distribute the equitable share in a way more favorable to urban and metropolitan jurisdictions.

Conditional grants are provided for the provinces and municipalities to implement national priorities, and to maintain national standards, particularly with respect to infrastructure and provincial administrative capacity. Conditional infrastructure grants appear to generally go to intended sectors and poorer provinces, but there has been a

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33 It should be noted that the equitable share formula will not be fully phased in before 2003/04, and the current per capita transfers will change. Western Cape’s per capita transfer will for instance decrease, while KwaZulu-Natal’s per capita share will increase.

34 Chernick and Reschovsky (2000).

35 The intention is actually that the recipient sub-national government can spend the transferred resources as it wishes, as long as they fulfill their constitutional responsibility to provide basic services.


37 This is discussed in more detail in Reschovsky and Smoke (1999).
problem with failure on the part of some national departments to make these transfers in full and a failure on the part of the some sub-national governments to spend them in full. These delays have been attributed both to micromanagement by mistrustful national departments (sometimes with underdeveloped policy frameworks) and weak capacity on the part of sub-national governments. A set of provincial transitional grants, which is being phased out over time, is intended to fund financial management improvement programs and to provide general budgetary support to provinces faced with significant restructuring. These grants have tended to flow to the poorer provinces and those that had to incorporate former tribal homelands. 38

There is little information available about the success of local government capital grants in meeting their objectives. It can be presumed that these programs do target priority sectors, but the there is a great variety of programs and conditions for accessing funds and reporting on their use. These allocation mechanisms are highly fragmented, and the disbursement mechanisms are typically project-based and centralized. The many different programs targeting job creation, water, roads, housing electricity, transport, and various other sectors, create serious planning and budgeting challenges for national department and local government managers. In addition, some recent but limited work conducted for the National Treasury raises concerns that the distribution of some municipal infrastructure transfers has been inequitable. The National Treasury is proposing the consolidation of all capital grants into an unconditional transfer. This is a good idea in principle, but it may take a long time to implement across all municipalities. Greater local control over capital resources is most appropriate for the larger and more capable local governments, while others may need to evolve towards this situation from a more conditional system as their capacity is developed.

Spillovers

The South African system of intergovernmental transfers is primarily directed towards redistribution and basic service provision. Some of these basic services may generate spillover benefits, but correcting for externalities has not been a major direct objective of transfer programs. Over time, as sub-national governments in South Africa become more fully established and take on larger service roles, residents will play an increasingly more important role in determining the level of services, particularly at the local level. This is desirable in certain respects, but it can lead to the under-provision of some services from the national perspective if voters fail to take account of the benefits they confer neighboring communities, particularly in metropolitan areas where local governments are in close proximity. A solution would be for national or provincial governments to design matching grants for local services with benefit spillovers, where the matching rate is set to encourage the appropriate expenditure levels. The role that such grants might play in the future requires further consideration.

38 National Treasury (2000).
E. Sub-national Government Borrowing

Provincial governments are empowered by the Constitution to borrow, but they have not yet done so except to secure bridging finance. On the other hand, loans have historically accounted for a substantial portion of the capital budget of South African metropolitan and some other urban municipalities. The largest source of loans has been government institutions. In addition, South Africa has a financial sector that is capable of raising and allocating capital to projects involving known risks. With the advent of the municipal amalgamation process (in some cases, rich with less well-endowed ones), investors however, have become more doubtful about the borrowing capacity of municipalities. In fact, recent growth in municipal borrowing in South Africa has been increasingly for short-term debt, and the long-term municipal debt market has, according to National Treasury, “all but dried up.”

A well-developed capital market is a desirable source of municipal revenue, especially where there is a large backlog of infrastructure needs and the potential for some local governments to borrow is considerable. In order to revitalize the local debt market, proper budgeting and sound financial management procedures, including firm credit-control measures, are needed. The Department of Finance has released a municipal finance management bill for comment. This document states that municipalities should determine their own debt levels, but cannot borrow to fund current deficits. It also states that national government will not establish municipal credit limits and will not act as a guarantor or lender of last resort. The extent of borrowing will be the decision of the municipality. Short-term borrowing will be limited to the amount required to bridge operating cash shortfalls and long-term borrowing will be limited to funding capital investment in property, plant and equipment. Full disclosure will be enforced to ensure that investors can fairly assess risk.

As efforts are made to improve local government creditworthiness and access to loan financing, it is critical that the linkages to the rest of the intergovernmental fiscal system are recognized. Improved generation of local own-source revenues (to enhance repayment capacity) is a prerequisite to local borrowing (the purpose of which should be for long-term investments), and intergovernmental transfer mechanisms should not be designed in a way that undermines local government incentives to borrow.

F. Overall Financial Condition

Neither provincial nor local governments in South Africa are in strong financial shape, but there are some signs of improvement, particularly at the provincial level. Provinces had an aggregate deficit of R5.5 billion in 1997/98, but they managed


to realize an aggregate surplus of R549 million in 1998/98.\footnote{National Treasury (2000), p. 8.} Wages and salaries as a share of provincial expenditures have stabilized after some rapid increases following a 1996 salary agreement. On the other hand, as noted above, provincial own-source revenues have declined and there have been some problems with the disbursement and management of intergovernmental transfers. There is clearly more work to be done in improving provincial financial performance.

The local government situation is even sketchier. Larger municipalities are substantially financially independent, but some have been running into fiscal difficulties in recent years, to the extent that their ability to borrow has been curtailed. Many smaller municipalities have been financially weak and have had little capacity. The Department of Provincial and Local Government’s Project Viability has identified a large number of local governments as being in financial trouble. The National Treasury has a Budget Reform Pilot Program to help local governments put their financial house in order, and the new municipal demarcation is expected to deal with the problem of non-viable municipalities. Despite these developments, substantial capacity building will be required to ensure that the new municipalities can behave in a fiscally responsible way.

\section*{G. Key Issues in Fiscal Decentralization in South Africa}

South Africa’s intergovernmental fiscal system fares reasonably well in terms of many of the desirable features outlined earlier in this paper. There is a reasonable constitutional and legal intergovernmental framework in place that is constantly evolving with new legislation and guidelines. The recent development of the Municipal Structures Act, the Public Finance Management Act, the Municipal Systems Bill, the Municipal Finance Management Bill, and a variety of service- and revenue-specific legislation, such as the Property Rating Bill, together constitute an increasingly solid framework for the development of a mature intergovernmental fiscal system, although many follow-up regulations will have to be issued to implement the provisions of these laws. In addition, a variety of procedural reforms, such as the adoption of the Generally Accepted Municipal Accounting Practice (GAMAP) and budget format standards, also improve the overall system.

The assignment of functions and revenues is basically sound. It is possible to argue for greater clarity in some areas and to make the case that certain expenditures should be further decentralized and that additional revenue sources could be assigned to provincial and local governments. The national government, however, would be quite reasonable in arguing that they should move gradually until the significant capacity constraints that plague many provincial and local governments are alleviated and performance of existing functions is improved.

The intergovernmental transfer system deserves a mixed review. On the one hand, there has been a genuine effort to share national resources with provincial and local
governments in a fair way that meets basic constitutional objectives. On the other hand, it is not at all clear that the share of resources going to lower levels of government is commensurate with the major responsibilities they have been assigned, particularly at the municipal level, and the complex system of conditional and agency transfers, while partially justified by capacity constraints, substantially complicates provincial and local government management. Perhaps the greatest issue with intergovernmental transfers is the lack of information. Before serious steps can be taken to improve the overall system, more work needs to be done on how to define needs and costs and how to measure sub-national fiscal capacity and differences across jurisdictions in South Africa.

Provincial government borrowing is presently minor, largely for bridging finance, but a case can be made to develop provincial capacity to borrow for capital investments. Municipal borrowing in South Africa has eroded in recent years, but there is significant potential to develop it if local government capacity and fiscal discipline can be increased. A municipal borrowing policy framework has been developed as part of the Municipal Finance Management Bill. The Bill seeks to restore municipal access to credit markets by clarifying the legal process for borrowing as well as clarifying the rights and obligations of borrowers and lenders. The Bill also provides for intervention measures in the case of a municipal financial emergency.

In order to move forward with the further development of the intergovernmental fiscal system in South Africa, a number of key concerns will have to be dealt with. Among the most important are determining appropriate vertical revenue sharing arrangements; making some difficult decisions on how to balance local autonomy and macroeconomic considerations; building provincial and municipal capacity and financial discipline; dealing with the shifting institutional structure of local governments; and improving some problems caused by fragmented actions by key national government institutions.

Determining Vertical Shares

Perhaps the most difficult challenge facing national government in the intergovernmental fiscal relations arena relates to the vertical division of nationally collected revenue. The international literature on intergovernmental fiscal relations indicates that the share should match expenditure assignment and some notion of minimum expenditure standards. It is also vital that the process of determining the vertical share is transparent. If provincial and local governments do not know what to expect on a regular basis, it will be difficult for them to plan their budgets or maintain a fiscal balance. In South Africa, a number of factors discussed above suggest the likelihood of a growing gap between expenditure requirements based on assignment and revenues, particularly at the municipal level. The national government faces the challenge of trying to better understand the extent of the fiscal gap and try to bridge it based on the internationally accepted principle that finance should follow function.

At the same time, it must be recognized that the national government is facing other challenges. The National Treasury wishes to keep the public sector under 26 percent of
GDP, and the sub-national government sector is only one of the numerous competing demands the National Treasury must balance. More information on the revenue needs of sub-national governments to meet their functional responsibilities is one important input into the vertical share decision, but other concerns also need to be carefully weighed.

**Balancing Local Autonomy and Central Control**

Intimately related to the issue of vertical shares is the somewhat ambiguous view of the national government on the autonomy of sub-national governments. Despite the strength of the Constitution on provincial and local government roles, there remains at the central level a lack of clear consensus on intergovernmental fiscal reform. Some analysts feel the need to maintain significant centralization to support macroeconomic growth, to redress inequities, and to protect the integrity of service delivery by maintaining service standards. Others prefer greater fiscal decentralization in the belief that it will improve allocative efficiency and accountability. This lack of consensus, while understandable, negatively influences the direction, strength and consistency of local fiscal reforms.

The local autonomy-central control balance is a difficult matter. On the one hand, the various alleged benefits of decentralization should not be expected in the absence of adequate local autonomy. At the same time, these benefits cannot be realized without adequate sub-national capacity and some genuine accountability of sub-national governments to their constituents. At the same time, all national governments need some control over major instruments of tax and expenditure policy in order to have the flexibility to shape macro-stabilization policy.

In the South African context, the provincial governments provide basic services that serve national goals and use a very large share of national resources, so a degree of central control and standards is essential. While undisciplined local governments can add to macroeconomic instability problems, this is probably not a big concern given present levels of local fiscal activity. Moreover, if national government were to develop local capacity (below) and to impose a hard budget constraint, such concerns could be further alleviated. There is, however, a tension between local autonomy and central control. The national government needs to take a clearer stand on this issue, but in the context of a pragmatic program designed to build better systems and capacity in order to minimize the risks and maximize the benefits of greater local autonomy.

Only when a clearer stand is taken on how far decentralization should go and the form it should take can the national government move forward with a coherent system of reforms that will build the system over time. Basic decisions on this matter will affect, for example, how the national government decides to reform the problematic RSC levy. They will also influence how to define the balance between redistribution and local autonomy in the use of transfers and the desire to encourage local spending on services that meet national priority objectives and/or involve inter-jurisdictional spillovers.
Securing and Analyzing Information

As emphasized throughout this discussion, information is lacking on many aspects of intergovernmental fiscal issues. The National Treasury has been moving forward in this regard with respect to the provinces, but there is still a lot of work to do. Knowledge about municipal characteristics is less developed and more uneven. There is a need to better document the size of the vertical fiscal imbalance, the nature and extent of inter-jurisdictional fiscal disparities, and the overall effects of the present set of local revenues and intergovernmental transfers. Particularly lacking is information on the wide variety of capital grant programs, which have not been extensively studied. Such information and analysis would not only provide a more solid basis for designing reforms, but also a baseline against which to monitor and evaluate future performance relative to the goals of a reform program and the expectations of citizens.

Building Capacity and Fiscal Discipline

Moving forward with fiscal decentralization requires considerable capacity. While substantial capacity exists at the national government level, specific skills required to define and implement sub-national reform are somewhat short in supply. Provincial governments vary in capacity and needs. At the local level, there are very wide disparities among municipalities in terms of their capacity to deliver services and administer taxes, their fiscal capacity, and the degree of accountability to and the political sophistication of their citizens. These disparities exist across and within types of local governments, such that uniform devolution of fiscal powers to all local governments or all councils of a particular type is likely to result in uneven fiscal performance.

Given this reality, it would be useful to differentiate among local governments on a more objective basis than is currently the case. Improved local information would help to do this and would allow local financial and other decentralization reforms to be better tailored to the specific circumstances of individual local governments. This system could also serve as the basis for targeting of technical and financial support and creating incentives for local performance from higher levels, as well as continued monitoring of local government circumstances and performance. This would provide the system with information to respond in an appropriate manner as local governments become ready for additional responsibilities or fall into financial trouble and require assistance.

The Shifting Institutional Structure of Municipal Governments

As noted earlier, the Municipal Demarcation of 2000 consolidates the local authorities into a much smaller number, leading to further challenges in municipal reform. The overarching issue is how creation of presumably more fiscally viable and capable larger local governments might compromise the likely better political connection with communities in smaller jurisdictions. On another level is the nuts-and-bolts challenge of transition—how amalgamations will take place, how resources (human and financial) and assets will be shared, etc. In addition, the government needs to think about how the demarcation will affect own-source revenue reforms, as well as the need for
transfers and how they should be distributed. The new (larger) local authorities should be more fiscally viable, which may, for example, improve the potential for own-source revenue generation, allow for the institutional component of the equitable share to be discontinued, and improve prospects for local government borrowing. Supporting reforms will need to be phased in as the new municipal boundaries take effect.

The local government situation is further complicated by a recent amendment to the Municipal Structures Act. This reform assigns all service responsibilities (except in Category A municipalities) to the districts (Category C municipalities) unless the Minister for Provincial and Local Government specifically assigns responsibility to a Category B municipality. The problem with this arrangement is that there are some Category B municipalities that are providing services adequately, and it makes no sense to disempower them. There is not space to detail the possibilities and complications here, but the national government clearly faces a challenging set of decisions about how to interpret and implement this new assignment provision.

National Government Institutional Concerns

Several central departments with different agendas and inadequate cross-departmental channels of communication have a role to play in provincial and local government fiscal reform. To date, coordination and conflict resolution have been ad hoc and bi-departmental. The principal focus of the “coordinating” ministries, the National Treasury and DPLG, has been on the revenue side, particularly with respect to local governments. In fact, there has been only modest attention by these departments to sectoral decentralization activities and detailed municipal expenditure requirements. These coordinating departments and their sub-departments have pursued various reforms to local government own-source revenues, the intergovernmental transfer system, and local government credit mechanisms. It is, however, not always clear that the various aspects of the system—own-source revenues, transfers, and loans—are being considered in an integrated way or dealt with consistently. Individual sectoral departments have pursued service-specific reforms independently, sometimes without regard to the financial capacity of local governments. Some of these reforms have been only marginally related and coordinated, raising concerns that such reforms might work at cross-purposes and/or overwhelm the capacity of some weaker local governments.

South Africa needs a more developed and coordinated approach to reform of finance and other aspects of the intergovernmental system. An inter-ministerial process/mechanism could provide a vehicle for developing this approach. As many types of reforms cannot be implemented in all local governments at once, this mechanism could determine, based on recommendations of research on local capacity and performance, how to proceed. The involvement of a coordinating body in implementation design and oversight would help to improve the consistency of central departmental activities and to ensure that basic reforms that are a prerequisite to more advanced reforms in local finance will be undertaken first.
An Overall Strategy for Reform

Consolidating a strategy for intergovernmental fiscal reform is difficult in any environment, but the historical inequities and changing institutional landscape confront South Africa with special challenges. The national government has already undertaken reforms that are moving the system in the right direction and beginning to meet key national goals enshrined in the Constitution. In spite of the positive developments, several factors complicate and inhibit development of a more effective intergovernmental fiscal system. The benefits of a more clearly articulated vision of local autonomy, better information on which to make decisions and design reforms, greater clarity on the details of local government structures and functions, improved coordination of the various actors involved, and a more fully articulated but flexible implementation strategy would be substantial. Together, these elements would further the development of a politically acceptable, institutionally appropriate, and fiscally sound system of local government with the capacity to contribute to South Africa’s considerable development challenges.

IV. SELECTED CASES IN EAST AFRICA

We now turn to a brief review of fiscal decentralization in selected countries in East Africa, Ethiopia, Kenya and Uganda, but not at the same level of detail as in the South Africa case. Many similar issues with local own-source revenues, intergovernmental transfers, and lending mechanisms exist in some or all of these countries, although the context differs.

A. Overview Comparison of the Three Cases

The three countries under consideration are quite different in a number of ways that complicate adequate comparisons.\textsuperscript{42} The public expenditure-to-GDP ratios for Ethiopia, Kenya, and Uganda are, respectively, 24.1 percent (1995), 28.7 percent (1995), and 18.1 percent (1996). Their respective deficits in the same years were –5.5 percent, -11.4 percent, and -6.6 percent. Thus, the overall size of the public sector is moderate in each country. All of the cases run deficits, with Kenya having the largest.\textsuperscript{43}

The relative importance and independence of decentralized governments varies considerably across the three countries. Ethiopian decentralized governments accounted for 43.5 percent of expenditures (1996), while Kenyan local governments accounted for only 4.2 percent (1995). Kenyan local governments, however, raised 5.6 percent of total public revenues and received only token grants, such that they are essentially fiscally independent from the center. Ethiopian local governments, on the other hand, raised only 17.8 percent of total public revenues, such that they were

\textsuperscript{42}Most of the data reported here were taken from the IMF Government Finance Statistics Yearbook, country budget documents, and World Bank reports for the three countries being compared.

\textsuperscript{43}The relative position of the three countries changes when looking at the data for different years.
dependent on transfers for nearly 60 percent of their resources. In Uganda, local
governments accounted for 21 percent of total public expenditures (1995), but they
raised only about 8 percent of total public revenues.\footnote{In the Uganda case, these data include only recurrent expenditures, as the development budget has not yet been decentralized.}

Functional responsibilities are quite different in these three cases. In the
Ethiopia case, decentralized levels of government, for example, have heavy
responsibility for social services (health and education), nearly 80 percent for both. In
contrast, only a few colonial-era municipalities are involved in health and education in
Kenya—social service expenditures are almost entirely funded and provided by the
central government and NGOs. In Uganda, local governments legally have significant
responsibilities for health and education, but many of them have not been able to deliver
much to date.

The three countries also have dissimilar local revenue structures. Ethiopian
decentralized governments rely on shared percentages of central taxes (personal
income, business, excise, sales) and have only a few modest independent taxes and non-
tax revenues, especially enterprise profits and various kinds of charges and fees.
Kenyan local governments have relied heavily since independence on a local property
tax, and since the late 1980s on the local authority service charge, a combination payroll
and business tax. Various kinds of charges, fees and licenses also raise nontrivial
amounts of revenue. In Uganda, the most important source of local revenue (and the
dominant source—around 70 percent outside of Kampala) is the graduated personal tax
(GPT), an unusual and complex hybrid of a PAYE income tax, a presumptive income
tax, a wealth tax and a poll tax.\footnote{The GPT suffers from a number of serious weaknesses, including possibly severe efficiency and equity effects and major complexities in its administration. Thus, even though it is a productive tax, it may not be seen as a desirable one.} Local governments have access to the property tax,
but in practice few use it, and it is significant only in the large cities. As in Ethiopia and
Kenya, there are various types of fees, licenses, and other minor local revenues.

Finally, the three countries have significantly varied approaches to
intergovernmental transfer systems, both in terms of relative importance and structure.
In Ethiopia, there is a single block transfer program based on a fairly complex formula.
In Kenya, there have for many years been no transfers except for teachers’ salary grants
to the few municipalities that have some responsibility for primary education and a very
small grant to needy councils allocated at the discretion of the Minister for Local
Government.\footnote{A new but modest intergovernmental transfer system is being introduced by the Kenyan government in fiscal year 2000.} Uganda’s transfer system is designed to provide three types of grants,
block, equalization and matching, but the system is not yet fully implemented.
A few contextual issues with respect to these countries affect interpretation of the data. First, state governments are the main actors in Ethiopia, whereas local governments are the principal units in Kenya and Uganda. Second, Kenyan local governments have capacity problems, but they are generally stronger than their counterparts in Ethiopia and Uganda. Third, Kenyan local governments, even though they account for a smaller percentage of public activity than sub-national entities in Ethiopia and Uganda, function with fewer restrictions and are less dependent on the center for financial and technical assistance. Fourth, the degrees of experience with local democracy vary widely, with Kenya having the most and Ethiopia the least.

The point of making these detailed selective comparisons is to demonstrate the significant differences in intergovernmental fiscal structure and the broader environment in which sub-national governments function, even across a few neighboring countries in one region of Africa. Even with good data, no single framework could take full account of the highly complex issues involved in assessing an appropriate fiscal role for sub-national governments. Great variations in the internal context of developing countries along many dimensions can significantly influence the "optimal" assignment of public service responsibilities and revenue generating powers among levels of government, as well as the types of reforms required to deal with existing system deficiencies. Traditional economic concerns must, therefore, be balanced with careful consideration of the unique economic, cultural, institutional and political environment in a particular case and an understanding of how this affects the desirability of and possibilities for meeting the normative prescriptions of public finance theory.

With this broad comparison as background, we now turn to a brief discussion of fiscal decentralization in each of the three countries. Both achievements and outstanding problems are noted.

B. Ethiopia

Ethiopia has a long history of heavy central control. In modern times, the country has been under Italian rule, the Emperor Haile Selassie, and then the centrally planned economy under the Mengistu government. Since the overthrow of Mengistu, Ethiopia has developed a decentralization program that is among the most significant and ambitious in the developing world, certainly one of the most impressive in Africa. The country was driven to decentralization because of the ethnic identifications of the regions and the succession of Eritrea. Giving the regional governments more power was widely seen as a way to hold the ethnically fragmented country together.47

A number of positive features of the Ethiopian case are particularly worth noting. First, in contrast to the donor-driven situation in many countries, the decentralization in

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Ethiopia has clearly been an internally determined priority. Donor agencies have been invited to assist in various ways only after the federal government defined the basic parameters of the decentralized system.

Second, in contrast to many African countries, Ethiopia has developed a fairly robust and extensive framework to support decentralization. The 1995 Ethiopian Constitution explicitly provides for a federal system, with different service provision and revenue responsibilities for the federal and regional governments. This builds on Proclamation 41 of 1993, which provides more information on a number of issues related to regional government functions, detailing on a bureau-by-bureau basis fairly specific responsibilities. Revenue bases and provisions for their administration are defined in greater detail in Proclamation 33 of 1992.

Third, Ethiopia has pursued decentralization from a genuine desire to give more powers and resources to decentralized levels rather than to effect central budgetary relief, as is common in Africa. Consistent with this view, Ethiopia has developed a very significant intergovernmental transfer program that accounts for a substantial proportion of central revenues. Clear rules govern the intergovernmental transfer program, making it easier for all parties concerned to understand the basis for resource allocation.

Finally, the Federal Government has clearly recognized the importance of capacity building at the sub-national level, particularly in the form of training, to ensure that decentralization will be successful. Some efforts have already been undertaken in this regard, and plans are underway to further develop training programs.

While these positive features of the decentralization framework legitimately distinguish Ethiopia from many of her African neighbors, there are a number of outstanding concerns. First, although the enabling environment for decentralization is in place, many supporting systems and procedures—planning and budgeting, financial management, service delivery mechanisms (including involvement of the private sector/civil society), etc.—are not fully developed. Without these systems and procedures in place and operating, decentralized governments cannot be expected to behave in a fiscally responsible way and meet the service delivery responsibilities that are so critical for local economic development and poverty alleviation.

Second, even with an enabling environment and well-developed procedures, there are serious capacity constraints at decentralized levels in Ethiopia. At least some functions are officially the responsibility of regional governments that have limited capacity to perform them effectively. Moreover, the pressing need for appropriate technical assistance to decentralized governments as they assume new duties far exceeds the capacity of the relevant central agencies to deliver it. The training programs noted above a step in the right direction, but only a small one.

Third, there is not much specificity in the constitution and relevant legislation about the functions to be decentralized to lower tiers of government. In fact, little is said about the levels of government below the regions (the zones and woredas). Improved
responsiveness to citizens, one of the most important benefits attributed to decentralization and critical to allocative efficiency, can best be developed at these lower levels. Particularly worrying is the fact that the ambitious fiscal decentralization program does not explicitly deal with municipalities, a form of local government that was established in major urban areas and small towns in the 1940s. Since then, the only reform related to municipalities has been in the form of some Mengistu-era legislation intended to expand the municipal role in political consolidation. Thus, the municipalities, which have an important service role to play, operate without clear legal status in the context of the broader decentralized public sector structure being developed. This results in arbitrary and inconsistent treatment by higher levels of government, which have few clear standards to govern their dealings with municipalities.

Fourth, there is not a clearly articulated process for implementing and coordinating decentralization. Given the severe capacity constraints and lack of local governance in Ethiopia, there is a need for a strategic and gradual process of decentralization consistent with existing capacity at all levels. Local officials must learn how to perform effectively, and people must learn over time how to be good citizens and how to interact with their local governments. Thus, it is necessary to create a pragmatically phased and well-coordinated process to decentralize public functions in a way that helps to build capacity and accountability.

Fifth, more emphasis has been given to the development of intergovernmental transfer programs than to improving decentralized own sources of revenue. Local revenue yields have generally increased under the decentralization program, but much less than expected, and grants still account for the bulk of local revenues and substantial portions of central government revenue. The capacity issue is also relevant here. There are indications that some regions continue to receive substantial grants even though they have failed in previous years to use large portions of these funds or to make substantial progress in raising revenues from local sources.

Collectively, these problems raise serious concerns about the ability of the Ethiopian decentralization program to meet its objectives. Now that the major distraction from the border war with Eritrea has settled down and the government is focusing again on reform policies, there is increasing recognition of the serious challenges on the path forward. How they will proceed remains to be seen.

C. Kenya

Kenya has a rich history of local governance, both from the traditions of its ethnic groups and from the formal local government system set up by the British during the colonial era. During the colonial era, local governments were fairly autonomous and had

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significant sources of revenue. Local authorities were substantially weakened after independence (1963), but some have continued to provide basic services (water, local roads, solid waste collection, pre-primary schools, etc.). They have also maintained significant sources of revenue, particularly property rates, and to be governed by largely elected local councils. Kenya was and still is among the most fiscally independent local government systems in Africa. But the local governments increasingly developed a bad reputation over the years. Central officials complained about local incompetence and corruption, but seemed unwilling or unable to do anything about it. Local officials blamed their problems on central control and petty meddling in their internal affairs, and they argued that there was little they could do to turn things around until they were given more freedom and more revenues.

The reasons for the increasing deterioration of local authorities are largely historical. The environment of political consolidation that developed after Kenya’s independence in 1963 and that was reinforced by a 1982 coup attempt, led to attempts to recentralize that undermined the link between the more autonomous pre-independence local authorities and their constituents. The erosion of that link intensified over time with continued central neglect and poor local performance, reinforcing a popular perception of local government incompetence and a central view of local authorities as problematic entities to be controlled rather than key developmental entities to be supported.

Several conditions have provided potential opportunities for reform in the 1990s. First, the effectiveness of local service delivery systems has been declining dramatically to a point where it is broadly unacceptable. Second, rapidly changing central fiscal conditions in Kenya have more sharply focused attention on the fiscal burden imposed on the central budget by local governments, which fail to repay international donor loans on-lent to them by the Local Government Loans Authority (LGLA). Third, the political environment has been shifting in a number of ways. There has been considerable negative publicity regarding the poor performance of local authorities, and national scandals have weakened the legitimacy of the center in calling local authorities corrupt. In addition, genuine political opposition parties emerged in Kenya during the 1990s, and their success in winning some local elections and a voice in Parliament has confronted the ruling party with new pressures, which were reinforced by a freeze in IMF budgetary support in 1998.

Although emerging efforts are still in a relatively early stage, recent events and documents give a sense of the broad parameters of the proposed local government reform program. First, the government has expressed its intention to clarify some ambiguities in local service responsibilities and to define sector-specific programs for decentralizing and/or improving service delivery performance as appropriate.

Second, there appears to be a new willingness to consider changes to the Local Government Act in order to reduce unnecessary central government control over local authority activities. There is a movement to transform the main role of the Ministry of Local Authorities (MLA) from control and regulation to technical assistance and

performance enhancement. Local authorities will continue to require some supervision until their capacity to meet their responsibilities more independently is proven. There does, however, seem to be an emerging agreement that councils meeting certain standards in service delivery and revenue generation should be rewarded for good performance by being granted more independence, greater access to resources, etc. Those councils with poorer performance should be targeted for higher levels of monitoring and technical assistance.  

Third, serious intergovernmental fiscal reforms are underway. The Ministry of Finance (MOF) has taken steps to ensure that payments owed by central agencies to local governments are made in a timely manner. The MOF is also harmonizing problematic central and local sources of revenue, particularly business licensing, and it has begun to help local governments with resources for priority services. The Finance Act of 1997 allocated a portion of the Road Maintenance Levy (RML) Fund (financed by a national fuel tax) specifically for financing local authority road maintenance. Finally, an objectively defined system of intergovernmental transfers is being re-established. The Local Authority Transfer Fund (LATF) Act stipulates that the LATF will be initially capitalized with five percent of all tax collected under the Income Tax Act. Although the allocations for FY 1999-2000 are only two percent, the fund has been activated, a special account has been established in Treasury from which to manage it, and regulations have been be issued on selection of a broad-based LATF Advisory Committee and fund disbursement

Fourth, the government has instituted a number of measures to enhance local authority revenue generation. The initial effort is on property rates, the uniquely local source with the greatest unmet potential. The reform strategy being piloted is designed to enhance the equity and revenue yield of the current property rates system. The introduction of improved property rates administrative systems, the Rates Administration Management System (RAMS), which initially involves the updating of fiscal cadastres and appropriately simple computer-assisted mass appraisal systems, commenced in two Local Authorities during FY99, with expectations for further immediate replication.

Fifth, clear steps are being taken by the government to deal with the local infrastructure investment crisis. A serious mutual debt situation among local governments, central government agencies and parastatals is being better documented, and options for

49 In order for such differentiation among local authorities to occur, a system for evaluating local capacity and performance will have to be developed, and some preliminary investigation into this has already begun in the MLA. Information collected for this system would also allow MLA to develop realistic standards and guidelines for: 1) creating and upgrading local authorities; 2) assigning service responsibilities and measuring service delivery performance; and 3) assigning sources of revenue and setting revenue collection targets.

50 The 1997/98 Budget Speech by the Minister of Finance announced a large increase in the allocation for contributions in lieu of property taxes (CILOR) to local governments.

51 Reforms to the Trade Licensing Act that would harmonize central and local business taxes were initially announced in the 1997/98 Budget Speech.

resolving it in a fair and pragmatic way are being considered. It has also been made clear that local authorities will be required to repay loans from LGLA or the agency that replaces it in the future, thus establishing a greater sense of fiscal responsibility. In addition, there are plans to significantly restructure the LGLA to ensure more efficient use of funds and to introduce fiscal discipline into the system in a formal and binding way.

Sixth, three broad reforms to enhance local authority management have been undertaken. First, the MLA has instituted clearer guidelines for local authority department and committee organization. Second, standardized and simplified accounting and record-keeping systems are under development and are being tested in a number of local governments. Third, better procedures and incentives for recurrent and capital budgeting, cash-flow management, revenue and expenditure control, internal auditing, and local employment management are being designed and tested to improve the utilization of local resources.

Finally, these various components of intergovernmental fiscal reform are being integrated as they are implemented. The property rates reform work is being carried out in conjunction with some of the broader reforms in local financial management. The Local Authority Transfer Fund (LATF) is replacing the contentious, administratively difficult, and politically unpopular local authority service charge (LASC), thereby improving the overall structure of the intergovernmental fiscal system. The transfer formula is also structured to provide incentives for improved local revenue generation and the adoption of managerial and operation reforms. All of these reforms are imbedded in a program that is also intended to improve accountability at the local level and to build the capacity of local governments.

The integrated approach is embodied in the Kenya Local Government Reform Program (KLGRP), which has evolved over the past several years with World Bank support on the basis of experience with the Small Towns Development Project (STDP), an MLA-based capacity-building project for small local governments jointly funded by the Kenyan and German governments (GTZ). The STDP has involved experimentation with sequencing reforms. KLGRP is being built gradually and systematically in a series of manageable, mutually reinforcing steps coordinated by an inter-ministerial body.\(^53\)

The KLGRP involves three major phases, each of which has several components. The first phase, which is essentially completed, solidified agreement on the most fundamental reforms required and took preliminary steps towards implementing them.\(^54\) The second phase is advancing the process of implementing the fundamental reforms

\(^{53}\) The summary of KLGRP achievements presented here is largely taken from internal documents and memos prepared by KLGRP staff in the Ministry of Local Authorities.

\(^{54}\) The key tasks in this phase included the operationally specific definition of several critical reforms largely under the jurisdiction of the Ministry of Local Government, including basic local authority organization and financial management, a comprehensive assessment of intergovernmental fiscal relations, and a set of preliminary needs, capacity and endowment studies that tentatively identify the most important infrastructure needs of the local authorities participating in the KLGRP.
defined and approved in first phase and laying the groundwork for the appraisal of the third phase of the program. This final phase will involve development and implementation of a physical infrastructure program in participating local authorities through a tiered process that requires progressively more comprehensive institutional and financial reforms at both the central and local government levels. The type of approach embodied in the KLGRP strategy is also being considered to phase in various types of more advanced fiscal and institutional reforms in the future, e.g., introducing more sophisticated and efficient systems for financing local public investments and building local credit worthiness. There is a long way to go, but Kenya has begun to move its intergovernmental fiscal system in the right direction.

D. Uganda

Uganda, like Kenya, operated a British-style local government system during the colonial era. Post-independence reforms included several that were similar to the Kenya experience discussed above. The Idi Amin era saw the effective destruction of the local government system. When Yoweri Museveni became President in 1986, he presided over a resurrection of the government sector that eventually involved local governments. In recent years, Uganda has managed to make some solid steps forward.

Several aspects of reform are worth noting. First, the government has developed fairly robust and extensive constitutional and legal provisions to support decentralization and the strengthening of decentralized levels of government. The Local Governments Statute of 1993, the 1995 Ugandan Constitution, and the Local Governments Act of 1997 provide considerable detail about the powers and responsibilities of local governments.

Second, Uganda has developed a special-purpose and somewhat more “neutral” than typical institutional mechanism, the Decentralization Secretariat, to oversee decentralization and local government reform. Although the Secretariat reports to the Permanent Secretary for Local Government, it is staffed by non-civil servants and is substantially detached from the normal government bureaucracy. In addition, the Local Government Finance Commission, which has considerable influence over local revenue policy, is a broad-based independent body (set up by the Constitution and further defined in subsequent legislation) that reports directly to the President.

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55 This phase, which is currently underway, includes the implementation of the basic local authority organization and financial management reforms defined in the first phase for all of the local authorities participating in KLGRP. In addition, this phase requires the implementation of several key intergovernmental and inter-ministerial reforms at the central level.

56 Funding for basic infrastructure will be provided after minimal reform requirements defined in the first two phases are met. As a precondition to additional infrastructure funding, an increasingly comprehensive set of reforms must be satisfactorily undertaken.

Third, like the other countries discussed here, Uganda has recognized that effective local governments must have adequate resources to meet their responsibilities under decentralization. Rather than reducing local claims on the national budget, the government has developed very significant, rule-based intergovernmental transfer programs that account for a substantial proportion of total central government revenues.

How has Uganda managed to develop this relatively strong decentralization framework? Perhaps the key consideration is that political change opened up opportunities for genuine reform based on a perceived need to build national cohesion and to improve responsiveness to citizens through enhanced local governments. Thus, Uganda did not make the common mistake of moving forward without building a broad consensus on the value of decentralization and the form the intergovernmental system should take. As the driving force behind reform has been largely internal, international donor agencies were invited to assist only after the government determined the general direction of decentralization policies.

Despite the positive features of Uganda’s decentralization, problems remain, many of them similar to those experienced by Ethiopia. First, although there is a strong legal and constitutional basis for decentralized government rights and responsibilities, there has not been a clear process or pragmatic timetable for the transferring of functions. Realistically, not all functions can be transferred simultaneously to local governments that have not previously managed serious responsibilities, and many central sectoral ministries are, no matter what the constitution says, reluctant to relinquish responsibilities in a way they perceive to diminish their own power. The issue of how, under these circumstances, to implement the decentralized system laid out in the constitution, legislation and policy documents has been poorly addressed. Uganda claims to have decentralized gradually, but this meant nothing more than about one-third of the local governments receiving new powers in each year over a three-year period. This has resulted in unplanned asymmetric decentralization. In some sectors, decentralization occurs slowly because a reluctant ministry stalls progress. In other sectors, responsibility has been devolved too rapidly by ministries attempting to comply with the letter of the law, overwhelming the capacity of local governments, such as the case of education.

Second, the bodies formally charged with coordinating the decentralization process have not been performing well. The lack of a clearly defined process for decentralizing, as outlined above, contributes to slow progress and/or weak performance. In addition, the Decentralization Secretariat and the Local Government Finance Commission have inadequate authority to mandate cooperation from other key agencies. Finally, there has been a post-constitutional development of a somewhat more cautious attitude about decentralization as its institutional and fiscal implications are more fully understood by the center. Without clear political mandate, an appropriate strategy to move forward, and adequate authority to enforce cooperation, the complex task of managing decentralization cannot be effectively undertaken by the coordinating agencies.
Third, there is inadequate recognition given under either decentralization program to the severe local capacity constraints. At least some functions are being decentralized to many local governments that have little capacity to perform them responsibly. Moreover, in both cases the need for technical assistance to local governments as they assume new duties far exceeds the capacity of the relevant central agencies to deliver it. A more strategic and gradual process of decentralization consistent with existing capacity at all levels would have been more likely to lay the ground for more clear-cut success.

Fourth, more emphasis has been given in Uganda to the development of intergovernmental transfers than to improving local sources of revenue, and there are not adequate incentives in the transfer formulas to encourage local revenue generation. Local revenue yields have generally increased under the decentralization programs in Uganda, but much less than expected, and grants still account for the bulk of local revenues (typically greater than 80 percent outside of a few larger municipalities) and increasingly substantial portions of central government revenue, as noted above. In addition, there are some serious questions about the clarity of objectives, the degree of transparency, and the accuracy of the data in the transfer formulas being used.

Fifth, early decentralization has focused exclusively on recurrent budgets. This approach would be fine if it were part of a more clearly articulated strategy for reform, but it appears to be primarily a function of the fact that the capital budget is almost entirely funded by international donors whose funds the center has been unwilling to share. Now it appears that Uganda is, with donor encouragement, in the process of considering how to decentralize the capital budget without having sorted out the problems of over-ambitiously decentralizing the recurrent budget.

Sixth, although Uganda has clearly moved towards greater local participation and democratically elected councils, there is a lack of explicit linkage between development of local administration and the development of local democracy. Civil society has been historically weak, and there is little explicit recognition that people must learn over time how to be good citizens and how to interact with their local governments. One recent study of a few “successful” local governments in Uganda, for example, demonstrated that local government revenue yields and local service expenditures had indeed increased after decentralization. Further analysis, however, revealed that people were paying their local taxes primarily because they were being hassled by aggressive enforcement officers, and a non-random sample of local residents claimed to be generally dissatisfied with the types and levels of services being provided by their local councils. Thus, in this anecdotal example, decentralization was technically occurring, but without helping to develop the attendant political links between local governments and the local population underlying the public choice models used to justify key benefits from decentralization.

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58 This is based on work produced by Nicole Barnes of the Department of Urban Studies and Planning at MIT for the Management Governance and Development Division of the United Nations Development Program, New York.
Finally, government has been allowing the international donor community to experiment with decentralization in questionable ways. Experimentation is fine and can yield valuable lessons, but because different donors are developing different operating systems and procedures in different regions, they may undermine rather than support the development of a well-integrated multi-tier system of government.

Although Uganda has developed a strong enabling environment for decentralization, the perceived political imperative to decentralize has led to some of the other common problems of decentralization discussed earlier, including attempts to move forward more rapidly and less strategically than a complex process like decentralization merits. The government has realized this and taken steps to slow the process and to introduce a greater role for central guidelines and monitoring. A new program similar to but more comprehensive than the Kenya effort described above, the Local Government Development Program, is about to begin operating.

V. CONCLUSIONS AND RECOMMENDATIONS

The cases discussed in this paper raise provide a sense of how fiscal decentralization is proceeding in a number of countries in East and Southern Africa, both some of the accomplishments and some of the challenges. There is clearly no single best way to determine the appropriate extent of fiscal decentralization or how to realize it in practice—the context across countries is too different. At the same time, it is possible to outline some key principles and considerations that should generally be taken into account.

The Basic Elements

Before thinking about fiscal decentralization, consideration needs to be given to the appropriate role of the public sector in a particular case. Once there is a broad understanding of this issue, it makes sense to consider which level of government should take responsibility for key functions. Fiscal decentralization is appropriate from an economic perspective when there are variations in demand for public services across local jurisdictions, and the benefits of decentralized service provision are not offset by the need to account for scale economies or to correct for inter-jurisdictional externalities. Such factors are not easy to measure precisely and to balance empirically, but careful analysis can set basic boundaries for the appropriate functions of different levels of government. Most of the countries discussed here have done a reasonable job on this task. In addition, gains to local governments from fiscal decentralization must be balanced against “start-up” costs of decentralizing and possible negative macroeconomic effects. It is also important to recognize that fiscal decentralization gives primary responsibility to subnational governments, but they may contract private providers to deliver these functions, an option that only South Africa has made measurable progress with.

Assuming macroeconomic concerns are not serious or can be controlled through appropriate institutional mechanisms, three important “prerequisites” must be in place to maximize the potential long-term benefits of fiscal decentralization. First and often
ignored, there must be a viable local political mechanism to determine local preferences and to hold the local governments accountable to their constituents. Second, local governments must have the institutional, technical, and managerial capacity to deliver the services demanded by their constituents. Third, local governments must have access to the financial resources required to meet their responsibilities. These conditions are only weakly met in all of the African countries reviewed in this paper, although there has been some progress in all of them.

The bottom line is that even if analysts use the economic, spatial and demographic characteristics of a country to determine an “ideal” degree of fiscal decentralization and an “ideal” structure of local governments, such a system is not going to appear unless these basic prerequisites are built over time. A number of related concerns should be considered with respect to the design and implementation of fiscal decentralization.

**Process is as Important as Goals**

The first system design issue is that normative fiscal principles are not likely to be the starting point for many of the actors involved in fiscal decentralization. Different institutions will typically have different perspectives on how far to push decentralization and what form it should take, as is evident in all of the Africa cases discussed here. There will often be political and bureaucratic resistance to even the most carefully defined program of fiscal decentralization. As discussed earlier in a number of cases, competing central government agencies that would lose power and resources under a fiscal decentralization program may try to undermine progress. In some cases, sub-national governments may also resist decentralization if they are comfortable being served and financed by the center. When such conditions exist, there is a need to develop a political negotiation process for defining the fiscal decentralization goals and strategy. Getting a consensus from key institutional actors on how to define fiscal decentralization may be more critical, at least initially, than the specific form the intergovernmental system initially takes. If the process is fair, it should result in a system with at least some basic checks and balances among various organizations and individual employees within key institutions, so that none are too powerful in the process of defining what fiscal decentralization means or controlling its implementation.

**Identifying a Strategic Entry Point**

Even if a broad consensus can be forged on the type of intergovernmental fiscal system a country would ultimately like to have, there is significant work involved in developing fiscally effective and responsive sub-national governments. Decentralization must generally be seen as a lengthy process in which attitudes of key actors at all levels must be changed and capacity at all levels must be built, reality that is only weakly but increasingly recognized in the Africa cases considered in this paper. Thus, effective fiscal decentralization requires a strategic implementation approach designed to phase in reforms in a gradual, pragmatic way. Initial steps should be undertaken in sectors and functions for which rapid success is most likely. This requires prioritizing reforms, focusing on simple tasks that don't immediately threaten central actors or overwhelm sub-
national capacity. Even if initial reforms are defined modestly, however, they should be based on a broader conception of what the government ultimately wants to accomplish. For example, program designers should have a sense of how the reform of a particular local tax or the introduction of a specific new operating procedure helps to build the intergovernmental fiscal system the government intends to have 10 or 20 years from now.

A second component of the starting point is the possible need for asymmetric treatment of local governments. There are great differences among local governments in most countries, even among those of a particular category. It will generally be more effective, even if politically and administratively difficult, to differentiate among local authorities. Treating those with weak capacity as if they can handle responsibilities invites failure. Unduly controlling and providing technical assistance to capable local authorities wastes resources. Only Kenya among cases considered here has made a meaningful attempt to adopt reforms differentially. In all other cases, however, mixed experiences with decentralization to date are raising awareness of the value of such an approach.

Creating an Integrated Implementation Strategy

A fiscal decentralization implementation strategy must be built on the starting point discussed above. There are two key concerns in this regard. First, the individual elements of fiscal decentralization programs must be closely linked. Local sources of revenue should be matched as closely as possible to local expenditure responsibilities. Intergovernmental transfer systems should target local expenditure needs and local fiscal capacity differences. Local government lending mechanisms cannot be defined independently of local fiscal capacity and transfer programs. Fiscal mechanisms cannot be expected to work if there is not an adequate degree of local political development and accountability. The historical tendency in many countries to deal with these various elements as separate aspects of intergovernmental finance has resulted in imbalances between expenditure responsibilities and sources of revenues, transfer programs that undermine incentives to collect local own-source revenues, unnecessary grant financing of local governments that can afford to tap capital markets, and award of loans to local governments without adequate managerial and fiscal capacity to repay them.

Second, the various elements of fiscal decentralization reforms should also be linked to central government efforts to build capacity and performance progressively. These reforms can be implemented in a way that makes it clear to local governments exactly what they must do before they will be assigned additional responsibility or resources. Specific steps should be designed in a way that helps to build local political and institutional capacity, such that what I cautiously labeled “prerequisites” above should more accurately be considered key elements or building blocks of a strategic fiscal decentralization program. The central government normally has considerable leverage in helping to build capacity and governance. In this regard, the center can strategically use access to grants, loans and technical assistance to encourage the development of political mechanisms, the adoption of new procedures, and other key reforms. None of the countries considered in this paper have adequately linked the components of fiscal decentralization in the way suggested here. Problems with fragmented approaches,
however, are leading to a greater understanding in all of the countries of the benefits of a more integrated approach that builds incentives for improved sub-national fiscal behavior into the decentralization process.

**Overall Benefits of a Strategic Approach**

The type of gradual, strategic, integrated approach broadly outlined here will inevitably require a different and slower path to fiscal decentralization than would be expected from a more conventional technocratic approach. It is, however, better to embed political compromises in a fiscal decentralization process from the beginning than to risk having powerful forces sabotage it, perhaps effectively removing fiscal decentralization from the policy agenda for years to come. Such an approach also raises the prospects for initial success, creating a base on which to build additional reforms. Finally, by slowing the fiscal decentralization process and building capacity in a controlled way, this type of approach reduces the likelihood that the negative macroeconomic effects attributed to fiscal decentralization by its opponents will materialize. Although none of the East and Southern African countries reviewed here has a fully articulated implementation strategy, all of them have learned from their early experiences to move towards such an approach.

**Concluding Statement**

Fiscal decentralization is likely to be a slow and painful process because serious constraints on decentralization are not going to disappear suddenly. Available conceptual frameworks for analyzing fiscal decentralization are useful, but they are not designed to deal with some of the most important factors affecting the prospects for effective fiscal decentralization. Moreover, implementation is complex and requires careful attention. Despite these concerns, the cases discussed in this paper offer a number of potential lessons for countries in Africa that have been slower in decentralizing.

Perhaps the most critical problem fiscal decentralization analysts face is a dearth of good comparative information on the extent to which and the conditions under which the alleged benefits and disadvantages of fiscal decentralization can be realized. Anecdotal evidence and case studies can give us relevant insights, but additional policy experimentation and more systematic research are needed to help us understand more broadly the realities of and prospects for fiscal decentralization in Africa.

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