

Intergovernmental Grants and Borrowing Power

South Africa

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This paper examines the theory of intergovernmental grants and its relevance to South Africa. It further describes some of the practical difficulties encountered when attempting to implement the theory. Examples are drawn from Canadian and American experience.

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

This discussion of grants as they appear, in practice, will emphasize practical problems in implementing an ideal grant system. It will argue that some departures from the ideal are so common and so predictable that they indicate a universal tendency among democratically elected politicians to deviate systematically from the goals found in the textbooks. Given these theoretical considerations and a good deal of practical experience, the paper then focuses on the main issue before this conference. What, if anything, should be said about the intergovernmental grant structure in the new South African constitution?

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

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

A. The Grant Structure

The Theory

It is generally agreed that for a considerable period in the future, lower levels of government in South Africa, especially the newly-established provinces, will be heavily dependent on grants from the

central government to finance their expenditures on public goods and services. It will take a considerable period of time for them to design and implement their own tax sources.

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

Equalization grants - The goal of equalization grants is to put each province in a more equal position to provide the public goods and services for which the provincial level of government is responsible. This is often interpreted to imply that different provinces' fiscal capacity should be equalized. This implies, of course, that provinces will eventually be given some degree of fiscal freedom. Even if their own tax and fee revenues amount to a small portion of total revenues, the concept of fiscal capacity has some meaning.

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

Most authors, but not all, argue that the equalization grant should be independent of a province's choice of tax rates or tax structures. The issue of whether a central government wants to influence a province's choice of tax bases or tax rates can then be considered as a separate problem.

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

hypothetical tax yields per capita receive the per capita amount necessary to bring them up to the average. This grant is then reduced in every province by an equal per capita amount that reflects the budget duress recently being experienced by the central government.

For example, in fiscal 1989/90, the hypothetical average per capita revenue raised by applying the representative tax system in the five relevant provinces was \$4,503. The same tax system applied in Newfoundland, however, would have raised only \$2,808. Newfoundland, therefore, receives a per capita grant of \$1,695 ($\$4,503 - \$2,808$) minus an adjustment of \$128 that reflects overall budget constraints. Provinces in which the hypothetical tax system would yield an above-average per capita amount do not have to contribute anything to the central pool. That is to say, there are no negative grants. Such negative grants can, however, be found in the German system of equalization and in some other countries.

The Canadian system can be characterized as one that brings the poorest provinces up to the average and not as one that directly brings above-average provinces down. Obviously, richer provinces make an important indirect contribution in providing a disproportionately large share of the federal government revenues that finance the system. Nevertheless, the lack of negative grants implies that the degree of equalization is not as precise as it might be. But precision is not essential. Indeed, the degree of equalization desired is primarily a political matter. If less equalization is desired, it would be quite easy to design a Canadian-type system that raises the bottom provinces to, say, 30 or 40 percent of the average.

Technically, the issue as to whether there should be negative grants in South Africa should be considered to be an open issue, but as a practical matter, it would seem to be extremely difficult to design such a system in South Africa in the foreseeable future. As in all countries, and especially in the United States and Canada, richer states and provinces will resist such a system strongly. More important, no South African province has sufficient own revenues to make contributions into a central grant pool.

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

Because the provinces of South Africa are so new and because demographic and economic data have only been recently estimated at the provincial level, it would be difficult to implement an equalization system based on a representative tax system. Besides, the tax systems of provincial governments have not evolved to the point that it is possible to define a particular tax system as being

“representative”. To use a distinction made at this conference by Professor Antony Melck, it may be preferable to think in terms of a formula grant that might be called “revenue sharing”. Such a grant might provide for considerable equalization, but it might consider other variables as well. The formula would have to depend on variables such as population and per capita disposable income that have only recently been estimated at the provincial level.

As will be described later, it will be surprising if such a formula can be devised without considerable political bargaining. The end result is likely to be a formula that is not as accurate an indicator of well-being as economists might like, but it is still important, in my view, to arrive at an explicit, transparent formula. That saves repeating the bargaining process every year and it increases the confidence with which provinces can forecast their grant receipts for budget planning purposes. Put another way, a crude formula is better than no formula at all. Even the crudest possible formula -- one providing equal per capita grants -- provides considerable equalization because it amounts to a higher percentage of the per capita income of a poor province than it does of the income of a rich province.

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

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

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

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

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

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

Most countries are only willing to allocate a portion of their specific grants as entitlements. It is common to also have closed-end grants. These are grants that are subjected to a strict budget constraint. It is then necessary for the limited budget to be allocated to qualified projects by an application process operated by the bureaucracy. I like to call this type of grant a rationed subsidy. Although it is theoretically possible for bureaucrats to focus the limited funds on projects and activities that have the highest beneficial spillovers, it will be argued in the next section that this is a very unlikely outcome.

It is quite possible to build an equalization element into specific grants that finance activities that are deemed to be in the national interest. For example, to the extent that the central government supports the social welfare activities of lower-level governments, a disproportionate share of the funds will go to the lower-level governments containing the largest poor populations even if the central government's matching share of the cost is the same for all lower-level governments. It is, however, possible to go further in the pursuit of equalization. In the United States, the central government pays

50 percent of the cost of Medicaid, a health program for the poor, in the typical state. In poorer states, however, the central government's cost share can exceed 50 percent depending on the results of applying complex rules. When equalization goals are mixed with economic efficiency goals related to spillovers, it must be admitted that the grant becomes a mongrel and it is no longer possible accurately to relate the central government's matching share to the importance of the spillover.

Practical problems

Equalization grants - Although equalization grants play a prominent role in textbook discussions of grant systems, they are not easy to implement explicitly. For understandable reasons, they are often strongly resisted by richer states or provinces. Indeed, in the United States, it is common for a state like New York to estimate the total taxes that its residents pay to the central government and to compare that amount to grants received and the amount of central government procurement in the state. The implication is that New York has a moral right to the revenues that it produces for the central government. This same notion appears more explicitly in the shared tax systems common in Eastern Europe. The central government returns different portions of central government taxes collected within local jurisdictions.

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

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

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

It is also important to repeat another point made above. Even though a formula may reflect the political power of various parties to the bargaining process rather than the goals described in textbooks,

it is very important to arrive at a formula that lasts several years rather than repeating the bargaining process every year with unpredictable results.

As South Africa transits from the current system of transfers to a new system, it is important to avoid violent shocks to the budgets of particular provinces. One technique for cushioning the impact of the reform is to make the grant under the old regime a variable in the new grant formula. That variable can be given a steadily declining weight. This approach works best in an environment in which provinces have some discretion over own-source revenues, so that they can more easily adjust for any losses over time in their grants from the central government.

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

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

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

As the central governments of the United States and Canada have faced more and more severe budget constraints, some cost sharing grants have evolved to the point where there is absolutely no chance of affecting marginal decisions. In the United States, the total amount of highway assistance going to any one state is limited by a formula and by the requirement that states finance part of the cost of projects. But for a large number of states, the formula is the binding constraint and these states contribute a much greater share of costs than is required by the law. Marginal decisions are not affected at all. The "highway" grant becomes a lump-sum transfer that might as well be totally unrestricted. Exactly the same thing has happened to the Canada Assistance Plan, a grant that used to pay 50 percent of the cost of unemployment assistance and other social welfare costs. The growth of the central

government's budget for the program is now capped while actual costs facing the provinces have grown faster than the cap. Decisions are no longer affected at the margin, and as far as the provinces are concerned, the grant might as well be an unrestricted lump-sum payment.

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

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

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

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

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

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

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

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

However, philosophical considerations will probably dominate administrative considerations in South Africa. The choice of whether grants go directly from the center to localities or always through provinces will have a profound influence on the power of provincial governments vis-à-vis the power of the central government and it will have an even greater influence on the power of provinces to influence lower-level governments. As a general rule, a heavy dependence on grants makes the grantee obeisant to the grantor. The degree of obeisance will depend on the extent to which the use of the grant is restricted by rules and regulations. To the extent that the grantee has the freedom to make decisions regarding the use of the grant, some of his or her political influence is restored.

Clearly, the issue of how political power is distributed among different levels of government cannot be decided by technicians. It is a matter for politicians. The design of the grant structure will be an important determinant of how power is distributed among the various layers of government in South Africa.

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

lot of sense. It might then be preferable to convert them all into one large equalization grant that is based on an explicit formula.

B. The Borrowing Powers of Lower Level Governments

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

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

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

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

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

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

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

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

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

There are, however, two problems with relying on private market discipline to limit irresponsibility. First, lower-level governments often borrow by pledging revenue streams to service the debt. The lender is much more interested in the security of the pledged revenue stream than in the quality of the projects being financed or in the overall fiscal behavior of the jurisdiction. By pledging one revenue stream after another a jurisdiction may be able to borrow a great deal at low interest rates when, by any overall, objective criteria, the borrowing is not warranted.

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

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

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

C. Constitutional Considerations

Grants

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

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

The question is whether this commitment should be made more precise or whether it should be omitted from the final constitution altogether. The U.S. constitution is silent regarding the revenue powers of states and about financial transfers from the Federal government to the states. In contrast, the Canadian constitution from its beginning in the British North America Act of 1867 has contained some sort of commitment to provide financial assistance to the provinces. As noted above, the current version, written in 1982, describes a system of equalization grants closely resembling the description of ideal equalization grants found in public finance textbooks. It says that "Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." As with the language in the South African interim constitution, the quantitative implications of the Canadian commitment are very vague, but clearly there is a moral imperative to provide some sort of assistance to provincial governments.

Because the Canadian provision was added to the constitution so recently, I know of no cases that would more precisely define "reasonably comparable levels of public services" or "reasonably comparable levels of taxation". It would, however, seem unwise to attempt to be any more precise for constitutional purposes. The above description of actual experience in Canada and the United States showed that the

grant system has evolved significantly over time in response to bad and good experiences and to the budget constraints faced by the central government.

In the United States, the evolution of the system has caused the amount of resources devoted to grants to vary enormously over relatively short time periods. In 1960, less than 1.5 percent of the GDP was devoted to the grant system and it amounted to less than 14 percent of state and local own-source revenues. By the late 1970s, grants had reached 3.5 percent of the GDP and 26 percent of own-source revenues. There was then a major reaction and grants fell to 2.5 percent of the GDP and about 15 percent of own-source revenues by 1990. By 1994, grants were again absorbing 3.2 percent of the GDP, but primarily because of the growth of Medicaid spurred on by soaring health costs.

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

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

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

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

Borrowing Power

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

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

The most common characteristic of all these restrictions is that they are often evaded. Off-budget independent agencies are frequently created to carry on some functions of government free of restrictions on borrowing, capital investment is often loosely defined to include activities that do not much resemble true investments and on and on. My own conclusion is that it is futile to try to draft constitutional language that restricts borrowing effectively. I even wonder if the various U.S. constitutional provisions reduce borrowing at all. But this is a minority view among U.S. experts. Most think that borrowing is reduced, although perhaps not as much as a casual glance at the constitutional language would imply..

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

A law could be drafted to require that provinces get permission from the Department of Finance for their own debt issues and for local government issues within their borders once debt servicing for on- and off-budget debt rises above some arbitrary proportion of the province's or the locality's revenues, say 10 percent.

D. Conclusions

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

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

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

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