THE COURTS AND THE INTERGOVERNMENTAL FISCAL RELATIONS SYSTEM IN SOUTH AFRICA

by
Tania Ajam and Christina Murray

It is truly remarkable how rapidly and fundamentally a constitutional ethos has permeated the design and implementation of fiscal policy[1] in South Africa. Prior to the adoption of the interim and final Constitutions, the conduct of fiscal policy was unfettered by binding commitments to equity, transparency, accountability and operational efficiency. And, it was not constrained by the demands of a constitutionally entrenched system of multi-level government. The adoption of the Bill of Rights and the fiscal constitution delineated in Chapter 13 of the Constitution have meant that the objectives of the fiscal system are not the sole prerogative of the government of the day, but must also meet constitutional requirements[2]. Furthermore, the fiscal instruments chosen and the modalities of their use have to be constitutionally compliant[3]. The fiscal constitution also provides a framework for fiscal and budgetary processes and identifies the role-players who must be involved in these processes[4].

Now, aggregate public resource allocation processes (such as the annual division of nationally collected revenue among the three spheres of government[5]) and macro-prioritisation acknowledge the Constitution and the Bill of Rights. In particular, the National Treasury and, to a lesser extent, provincial treasuries, have fulfilled the constitutional requirement of transparent government through excellent reporting and by providing increasingly sophisticated information on budgeting process, provincial and municipal revenue and expenditure patterns, as well as service delivery outputs. Nevertheless, in many areas, the impact of the Constitution is uneven. First, although multi-level government and the fiscal constitution have had a far reaching effect on national budgeting, the evidence suggests that the demand of the Bill of Rights that socio-economic rights are not only acknowledged but prioritised in budgeting has not had the same impact. Secondly, although an obligation to implement socio-economic

[1] A cursory glance at the 1995/96 *Budget Review* reveals a lack of understanding of implications of the adoption of the interim and final constitutions for the fiscal system. However, by 1998/99 the broad outlines of the current system of intergovernmental relations had begun to coalesce and the entire tenor of the discourse on intergovernmental fiscal policy in *Budget Review* 1998 reflected the emerging constitution-based institutional framework.

[2] So for instance, a tax policy would not be constitutionally permissible if it discriminated on the basis of gender, marital status or race.

[3] For instance, the Constitution says that provincial governments may not levy corporate income tax. This narrows the range of fiscal instruments available, in principle, to that sphere of government. Also s215 and s216 of the Constitution describes what information budgets should at minimum contain, and prescribes "uniform treasury norms and standards".

[4] Eg the role of Parliament in exercising oversight over the budget, the role of National Treasury, the Financial and Fiscal Commission and the Auditor-General.

[5] In terms of section 214 of the Constitution which governs the allocation of nationally collected revenues among the national government, the nine provincial governments and the 284 municipalities.

rights might be recognised at the strategic level, it does not always seem to be taken into account adequately at operational level.[6]

The failure of government to develop and assess its policies in the context of the Bill of Rights can be attributed to many things, including the newness of the constitutional system, the huge challenges facing administrations established only ten years ago, the complexity of the processes and the silence of academic economists and public finance practitioners on the impact of the Bill of Rights on budgeting per se, and intergovernmental relations by extension. This paper is a modest attempt to open a debate among public finance academics and practitioners in South Africa on the impact of the fiscal constitution in general, and socio-economic rights in particular, on the intergovernmental fiscal system. But, it does so from just one of many possible perspectives. It looks at the implications of the power of the courts to make decisions which concern the allocation of public resources.

The paper commences by examining how courts, in enforcing socio-economic rights and the provisions of the fiscal constitution, could potentially impact on public resource allocation processes and outcomes in the context of multi-sphere government. This introduction is primarily conceptual, drawing from the fields of law, political science and economics. The second part of the paper examines how the Constitutional Court has responded to these issues to date. The third section provides a few concrete examples of how court decisions could impact on intergovernmental fiscal system. The final section attempts to draw tentative conclusions.

1. Fiscal constitutions and the courts

To understand the economic role of the constitution itself, it is important to first explore why a fiscal constitution was deemed by the framers of the South African constitution to be necessary in the first place. Most other countries have not considered it necessary to

[6] The South African Human Rights Commission's reports note numerous instances where certain government departments or specific programmes fall short of constitutional muster in their design, financing and implementation. For instance, the 2004 SAHRC report concludes that "many people, and children in particular, had their right to food violated during the reporting period as they lost access to affordable food due to high prices and/or unreasonable plans devised and supervised by government." (During the reporting period 101 152 children were admitted to hospital with severe malnutrition and it was not possible for the SAHRC to state how many children died of malnutrition. However, the Commission notes that "it is alarming that case fatality rates for severe malnutrition in two under-resourced hospitals in the Eastern Cape ranged from 21% to 38%." SAHRC, 2004: xv). The Minister of Housing has acknowledged that the adoption of the Emergency Housing Policy was conceptualised as a result of the *Grootboom* case (which pointed out that housing policy fell short of constitutional requirements) and recent floods. The same applies to social security. ("Though the State has an obligation to respect, protect, promote and fulfil the right of access to social security,92 the reality of the matter is that the State has not fully complied with its obligations as set out in the Constitution and binding international instruments. Most vulnerable and marginalised groups are excluded from social security legislation mainly because they do not form part of the formal workforce of the country" (SAHRC, 2004).)

craft a specific fiscal constitution, and fiscal policy is generally governed mainly by ordinary budget laws and regulation[7]. The broader design choices involving a largely[8] Westminster model of parliamentary/cabinet government[9] overlaid on a system of constitutionally entrenched multi-level government contributed to the level of detail in the constitution. The decision that revenue raising powers should be centralised for both tax collection efficiency and redistribution/equalisation reasons, while permitting decentralised expenditure functions necessitated a high degree of clarity in the constitution[10]. The fiscal constitution itself thus provides the context for analysing the interaction between courts and the intergovernmental fiscal system.

Bednar et al (1999) and De Figuerdo and Weingast (2001:2) identify two fundamental institutional design dilemmas which fiscally decentralised constitutions must resolve simultaneously: (1) "What prevents the national government from destroying federalism[11] by over-awing its constituent units?"[12] and (2) "What prevents the constituent units from undermining federalism by free-riding and other forms of failure to cooperate?"[13].

There should be a credible commitment by all parties to refrain generally from infringing on the rights of their federal counterparts (the "commitment dilemma"). In the interests of sustainability, the rules underpinning a federation[14] must therefore be self-enforcing

[7] Federal countries (such as Germany and the United States) tend to be the exceptions, but there fiscal constitutions are typically not as detailed as ours.
[8] The Westminster hybrid adopted in South Africa has a few additional checks and balances, including the Bill of Rights, constitutional provisions enabling an active role for Parliament and the Legislatures and independent institutions designed to safeguard democracy (chapter 9 of the Constitution).
[9] Which tends to emphasise effective government with concentrated authority.
[10] This, incidentally, is contrary to the dictates of conventional fiscal federalism theory which advocates first expenditure assignment and then revenue assignment, to ensure that "finance follows function".
[11] By federalism, De Figuerdo and Weingast (2001) mean "a hierarchical government structure in which each level of government has some level of autonomy.". In contrast with political science and constitutional law, the generic meaning of the term "federalism" in economics is decentralisation, and the fiscal federalism literature deals with the fiscal implications of a decentralised system of multi-level government. The political science definition of federalism generally involves territorial divisions of authority, typically entrenched in the constitution which neither a sub-unit nor the centre can alter unilaterally. In comparision, decentralised authority in unitary states can be revoked by central legislation at will. The fiscal federalism literature is concerned primarily with the level at which decisions are actually taken rather than whether a formal constitution exists.
[12] National government could be tempted to pass the burden of national redistributive policies on to the states. They could also commandeer the states to carry out, at their expense, federal regulatory programmes. This would result in unfunded mandates (Bednar and Eskridge, 1995)
[13] State shirking could occur when they selectively apply national policies, refusing to implement policies which are not perceived to be in their interests. States could also impose externalities (i.e. spillover effects) on other states. State protectionism entails policies which shield local interest at the expense of the common market (Bednar & Ekridge, 1995).
[14] Or indeed any decentralised fiscal system characterised by constitutionally entrenched assignment of revenue raising and expenditure powers to the various tiers of government, such as in South Africa.

for all stakeholders at all levels of government (i.e. all political officials should have an incentive to abide by the rules[15]). If the choice of institutional authority for all levels of government is not self-enforcing, the federation would ultimately fail. Resolving this quandary, requires a trade-off: institutional configurations designed to mitigate the former could exacerbate the latter and vice versa[16]. For example, institutional fragmentation of national power[17] can constrain national encroachment on subnational government powers and functions. It simultaneously, however, undermines national government's ability to regulated subnational government cheating on the decentralised constitutional compact.

The "commitment dilemma" alluded to above thus also has intertemporal dimensions. Changes in the holders of political power could hinder the implementation of pareto efficient[18] institutional investment. Policymakers today may fear that the policies and institutions created in the present will be at the disposal of an opponent's coalition in the future. If they want to ensure that current decisions provide benefit flows in the future they may want to insulate their effects by designing institutions which will survive in the future. This precommitment exercise could create deviations from an optimal institutional design from a purely "technical" perspective (Iaryczower et al, 2000: 16). The rigidity introduced by precommitment to avoid future opportunism could entail significant cost in terms of loss of flexibility and efficiency in the present.

From this perspective, a Bill of Rights can be regarded as a commitment designed to eliminate dynamic or time inconsistency[19]. Ferejohn (2002) points out that the widespread acceptance of constitutional adjudication in Italy and elsewhere in Europe was influenced by the expansion of the set of rights to be protected by the proposed constitutional court:

---

[15] As pointed out by Bednar et al (1999) decentralised political institutions must induce all stakeholders to believe that the others would adhere to the federation's terms, and to comply as well.

[16] Too weak a central government would give rise to free-riding and shirking by subnational governments which may compromise the common market, which could ultimately lead to the disintegration of the federation. On the other hand, excessive centralisation and aggrandisement by the centre which limits interstate competition, could compel the states to abandon their responsibilities or exit the federation.

[17] Mechanisms could include a formal system of separation of powers, bicameral approval of legislation, presentation of proposed legislation to the chief executive for veto. Each of these devices require the cooperation in policymaking by different institutions which are accountable to different constituencies. An electoral system that limits the growth and influence of political parties would have a similar impact (Bednar et al, 1999).

[18] In the sense that the welfare of at least one roleplayer is increased, while the others are not harmed.

[19] A time inconsistent policy is one which appears to be optimal when it is formulated and announced, but will nevertheless not be implemented. Something inherent in the situation changes the incentives facing the policy maker over time such that the policy planned for some future date appears ex ante optimal, but is actually suboptimal once the time to implement it arrives. Ex ante a national government may refuse to bail out a municipality or province. But once the province overspends, the national government may have an incentive to bail out the subnational government ex post.

> "The need to ensure that ordinary lawmaking would be regulated by fundamental values was especially felt in Italy and Germany. The ordinary lawmaking processes in those countries had completely failed to respect human rights during the fascist and nazi periods. Not only was the legislature suspect as a defender of fundamental human rights, so too were the ordinary courts, which had done little to control or limit the impact of authoritarian legislation. The institution of new constitutional courts, which would have the power to overturn legislation but be independent from the judiciary itself, were part of this double circumstance of distrust – of the legislature and the court system".

This find resonance in the South African situation, where the Bill of Rights, and the tranformative tenor of the constitution as a whole, can be regarded as a commitment devices. As Albie Sachs (1990:2) notes in his motivation for justiciable socio-economic rights:

> "The danger exists in our country as in any other, that a new elite will emerge which will use its official position to accumulate wealth, power and status for itself. The poor will remain poor and the oppressed. The only difference will be that the poor and the powerless will no longer be disenfranchised, that they will only be poor and powerless and that instead of racial oppression we will have non-racial oppression."

As noted before, while ensuring commitment, the Bill of Rights could also, conceivably, limit flexibility (for example in respect to programme design and budgets) and thus introduce inefficiencies. The extent to which deviations from efficiency are minimised would depend on how the courts choose to interpret both the formal rules as well as the informal norms in crafting their socio-economic rights jurisprudence.

One of the most significant changes introduced by the interim Constitution in 1994 was to subject all government in South Africa to the Constitution. No longer was Parliament to be sovereign. Instead a constitution with special amendment procedures is supreme. All action of Parliament and the executive is subject to the Constitution. The Constitution also establishes a referee: the court system. Ultimately the Constitutional Court is final arbiter in disputes concerning the constitutionality – and thus the validity – of action.

Two aspects of the Constitution are particularly relevant to this paper. First, the Constitution sets out the rules of the fiscal game. It sketches the broad outlines of the complex intergovernmental fiscal system that three distinct but inter-related spheres of government demand and it anticipates legislation[20] and intergovernmental fiscal forums[21] will add substance to the skeleton. Secondly, it contains an extensive Bill of Rights which includes social and economic rights[22]. The intergovernmental fiscal system must ensure cooperative service delivery in support of the progressive realisation of these socio-economic rights.

---

[20] The legislative framework would include, inter alia, the Intergovernmental Fiscal Relations Act of 1997, the annual Division of Revenue Acts, the Borrowing Powers of Provincial Government Act of 1996, the Provincial Taxation Regulation Process Act of 2001, the Financial and Fiscal Commission Act of 1997, the Public Finance Management Act of 1999 and the Municipal Finance Management Act of 2003.

[21] These include the Budget Council, the Budget Forum, extended Cabinet, Min-MECs etc

[22] Such as rights to housing, health, education, a safe environment, food and water etc

Disputes in either of these areas may come before the courts. Because intergovernmental fiscal structures and processes are outlined in the Constitution[23], and because the rights enshrined in the Bill of Rights are justiciable, both fall within the jurisdiction of the court system and, finally, the Constitutional Court. The judicial decisions in these two areas potentially have implications for the structure and functioning of the system of intergovernmental fiscal relations. For instance, as arbiter of intergovernmental disputes, a court could be asked to consider whether an intervention by the national government under section 100 were arbitrary.[24] Or, it may be asked to decide whether a particular function is properly allocated to local government or should be carried out by the provincial sphere. Each of these cases would have budgetary consequences. Likewise, a court's enforcement of rights, and particularly socio-economic rights could have implications for the intergovernmental budgeting process[25] and the degree of centralisation/decentralisation in the fiscal system[26]. The *Grootboom*[27] case on the right to access to adequate housing implicated all three spheres of government. The more recent *Khosa*[28] case which concerned access to social grants had an impact on the division of revenue between the national and provincial governments[29].

When courts are called upon to decide such cases and interpret the rules of the fiscal game[30], they will help to shape them. Although a court order formally binds only the parties before the court, its impact is always broader. This is because court decisions are provide authoritative interpretations of the Constitution that bind other courts in future decisions. Cases thus often have a far reaching impact. For instance, a decision on the right to housing in the Western Cape, like the *Grootboom* decision, provides an interpretation of the right that is relevant to the entire housing sector and beyond. This means that the potential of the courts, and particularly the Constitutional Court in

[23] For example s214 on revenue sharing, s230 on subnational borrowing, s220 establishing the Financial and Fiscal Commission, s228 on provincial taxes, s229 on municipal fiscal powers and functions etc

[24] In countries, like India, similar intervention clauses have been politically motivated and arbitrarily invoked by the federal government, especially when the subnational government in question is held by an opposition party.

[25] This is especially so given that functions like health, education, and housing are joint competences of national and provincial/local spheres.

[26] In the South African context it could be argued that social development grants are both statutorily determined, and the non-payment of these grants (such as old age pensions) to eligible beneficiaries have already been subject to judicial scrutiny. These payments, coupled with unexpectedly high take-up rates, have lead to a crowding out of other expenditures within provincial budgets. These provincial overspending pressures, coupled with widely varying capacities across provinces to actually ensure delivery of the grants, have lead to this function being taken away from provinces and located within a proposed national social security agency.

[27] Government of the Republic of South Africa and Others v Grootboom and Others, 2000 (11) BCLR 1169 (CC)

[28] Khosa and Others v Minister of Social Development and Others, Unreported judgment, 4 March 2004, CCT 13/03

[29] As well as, presumably, the quantity of funds allocated to social security in the future, and hence possibly also on aggregate government spending.

[30] Either directly, as in a dispute pertaining to intergovernmental fiscal processes or allocations, or indirectly as a consequence of a decision on, for example, socio-economic rights.

initiating system change, with considerable distributive and allocative efficiency consequences is large.

Ultimately, courts and particularly constitutional courts can influence the evolution of intergovernmental systems and their structures directly (for instance by influencing the degree of centralisation or decentralisation). In addition, judgments that have implications for the allocation of resources can influence intergovernmental fiscal relations. Here two important questions arise:

1. What is the appropriate role for courts in cases with budgetary implications?
2. What approaches to these issues are South African courts developing and what impact will their decisions have on the fiscal system?

The role of courts in decisions that call for allocation of resources has been controversial for a long time and it is generally believed by politicians, bureaucrats and judges alike that the courts should have as limited involvement in policy making as possible. Theunis Roux writes sums it up well:

> "Some degree of judicial intervention in politics is an inevitable consequence of the adoption of a supreme-law Bill of Rights. The political branches' power to allocate resources, however, is conventionally thought to be beyond 'the limits of adjudication'. Judges, the standard argument runs, are neither mandated nor institutionally equipped to undertake the complex economic and interest-balancing inquiries that inform the allocation of public resources. It is therefore unwise to give them the power to review decisions taken by the political branches in this area, and foolish for judges to assume this power when they are not compelled to do so."[31]

Some of the reasons why involvement by the judiciary into the policy-making terrain has been regarded with disquiet include: the lack of expertise and capacity of judges in making "polycentric" decisions, the need for an independent judiciary, related concerns about infringements of the separation of powers, and the lack of accountability of judges for their decisions to the electorate.

"Polycentric" decisions (the term coined by Lon Fuller)[32] are those that "affect an unknown but potentially vast number of interested parties and that have many complex and unpredictable social and economic repercussions, which inevitably vary for every subtle difference in the decision" (Roux, 2004).

Public resource allocation is therefore a "polycentric" area, par excellence. The budget can influence macroeconomic variable such as the interest rate, gross fixed capital accumulation, savings, investment, the balance of payments, inflation and unemployment in ways which are difficult to predict precisely, entail second order effects which are difficult to quantify and affect not only South Africa, but potentially the entire region. In addition, the micro-economic configuration of budgetary decisions influences behaviours of individual consumers, firms and investors.

---

31 'Legitimating Transformation: Political Resource Allocation in the South African Constitutional Court' The phrase 'the limits of adjudication' is Lon L. Fuller's (see 'The Forms and Limits of Adjudication', Harvard Law Review, Vol.92, No.2 (1978), pp.353-409, at pp.394-404).

32 Fuller, L (1978) The Forms and Limits of Adjudication, Harvard law Review, 92(2) 353-409

The second argument is that courts do not have the institutional capacity to "undertake the complex and interest balancing inquiries that inform the allocation of public resource" (Roux, 2004:1). The intergovernmental budgeting process typically takes nearly two years to complete, requiring several thousands of hours of technically specialised labour. In addition it is incredibly information intensive. The argument is thus that courts do not have the technical expertise nor the information to make informed judgements on budgetary issues. In addition court decisions are decided on a case-by-case basis, whereas the intergovernmental budget process has the merit of being comprehensive.

But probably the most fundamental observation is that, in terms of the theory of public economics, it is common cause that it is not rationally possible to weigh up the marginal impact on aggregate social welfare of a rand spent on one government activity as opposed to another. Such an evaluation of marginal social returns do not depend on reason alone, but also on value judgements. So the value judgement of the courts would then supersede the value judgements of the legislature (which is supposed to be reflective of their electorates). These trade-offs may also be intertemporal and intergenerational in questions, for example, of taxation, borrowing and infrastructure development, and the court may be ill equipped to deal with them. Nevertheless, although the courts may not be able to deal with such issues competently, it cannot be pre-supposed that the other branches of government would be more effective (Pieterse, 2004).

There is also a concern that infringement of the separation of powers would undermine the constitutional regime of checks and balances, and dilute accountability. This is crucial, since unlike the limitations on the executive and the legislature, the limitations of the judiciary are self-imposed, arising from judicially developed and enforced interpretations of justiciability, precedent and the policies of deference to the other branches of government the courts have elected to follow (Ferejohn, 2002). Clearly these concerns are magnified in a new democracy where the legitimacy of the courts may not yet be fully established and there is no historical precedent on the basis of which to predict court behaviours, since the courts, themselves, to all intents and purposes, are largely "making it up as they go along".

Arguments relating to judicial accountability point out that judges are not elected and are not directly or indirectly accountable for their decisions. Judicial independence necessarily implies diminished public accountability. There is thus a sense that judicial review could compromise democracy, for instance when the courts strike down policies by democratically elected branches of government.

South African constitution-makers were alert to these issues. This is most obvious in chapter 3 of the Constitution. Here the Constitution attempts to minimise conflict through cooperative government[33], with litigation seen as a last resort:

[33] 41(1) All spheres of government and all organs of state within each sphere must—
(a) preserve the peace, national unity and the indivisibility of the Republic;
(b) secure the well-being of the people of the Republic;

> "41 (3) An organ of state involved in an intergovernmental dispute must make every reasonable effort to settle the dispute by means of mechanisms and procedures provided for that purpose, and must exhaust all other remedies before it approaches a court to resolve the dispute.
> (4) If a court is not satisfied that the requirements of subsection (3) have been met, it may refer a dispute back to the organs of state involved."

These provisions capture a widely held view that that balance of power between levels of government in a system of dispersed powers should be established by political means and not imposed by the courts.

But, during the constitutional negotiations it was the inclusion of socio-economic rights in the Bill of Rights provoked most concern about the appropriate role of the courts. Many politicians and observers alike argued that to include socio-economic rights in the constitution would infringe separation of powers and demand that the courts become involved in decisions concerning how the budget should be allocated, which are properly left to government. These objections were presented to the Constitutional Court by the Free Market Foundation during the certification proceedings. The Court responded simply:

> "It is true that the inclusion of socio-economic rights may result in Courts making orders which have direct implications for budgetary matters. However, even when a court enforces civil and political rights such as equality, freedom of speech and the right to a fair trial, the order it makes will often have such implications. A court may require the provision of legal aid, or the extension of State benefits to a class of people who formerly were not beneficiaries of such benefits. In our view, it cannot be said that by including socio-economic rights within a bill of rights, a task is conferred upon the Courts so different from that ordinarily conferred upon them by a bill of rights that it results in a breach of the separation of powers…. At the very minimum, socio-economic rights can be negatively protected from improper invasion."[34]

(c) provide effective, transparent, accountable and coherent government for the Republic as a whole;
(d) be loyal to the Constitution, the Republic and its people;
(e) respect the constitutional status, institutions, powers and functions of government in the other spheres;
(f) not assume any power or function except those conferred on them in terms of the Constitution;
(g) exercise their powers and perform their functions in a manner that does not encroach on the geographical, functional or institutional integrity of government in another sphere; and
(h) co-operate with one another in mutual trust and good faith by—
(i) fostering friendly relations;
(ii) assisting and supporting one another;
(iii) informing one another of, and consulting one another on, matters of common interest;
(iv) co-ordinating their actions and legislation with one another;
(v) adhering to agreed procedures; and
(vi) avoiding legal proceedings against one another.

[34] *Ex parte Chairperson of the Constitutional Assembly: in re Certification of the Constitution of the Republic of South Africa 1996* ("First Certification Judgement") paras 77 and 78.

The Constitutional Court makes two points that are relevant to this paper. First, it reminds us that it is not only those rights labelled 'social' or 'economic' that may have budgetary implications. Indeed, a number of the cases that we discuss below are not conventionally classified as socio-economic rights cases. Secondly, it points out that rights enforcement can be narrow. Negative enforcement might mean that the right to access to adequate housing means only that courts will restrict evictions. In other words, the Constitutional Court reminded us that courts would not necessarily interpret social and economic rights broadly.

2. What the South African Constitutional Court has done

The judicial suggestion of very weak enforcement of socio-economic rights in the Certification judgment must have relieved anxious bureaucrats and policy makers but it disappointed activists. In fact, the Constitutional Court has been bolder in the area of decisions that affect budget allocation than this statement suggests but it has nevertheless generally (but not always) avoided replacing a political judgement with its own. On the other hand, the Constitutional Court has treated very seriously the injunction in section 41 of the Constitution not to hear cases if the parties have not made real attempts to resolve the problems out of court[35].

Two groups of rights cases illustrate well the approach courts have taken thus far. First are those concerning claim under constitutional provisions protecting social and economic rights. The cases are well known: *Grootboom* concerned access to housing in the Western Cape, the *TAC*[36] case concerned access to health care and, more particularly, anti-retrovirals for pregnant mothers and, most recently, *Khosa* which concerned access to social grants.

The question that faced the Constitutional Court in each of these cases was how strictly it should interpret the right in question. It was faced with three possible approaches. It could subject government action which was claimed to infringe one of these rights to a very low level of scrutiny. Under this test it would simply ask whether the government action was rational. If it found that there was some rational link between the action and the outcome it would be satisfied that the government action was constitutional. A housing policy such as that contested in the *Grootboom* case would surely meet this test. In that case the contested policy focused on providing people with permanent residential structures that also provided access to social services and work opportunities. It did not have a plan for people in desperate circumstances such as Irene Grootboom. The government purpose here was surely legitimate because it responded to the need for housing by developing a long term project. The connection between the law and its

[35] For example Uthukela District Municipality, Zululand District Municipality and Amajuba District Municipality v President of the Republic of South Africa and others, Case CCT 7/02, also National Gambling Board of South Africa v Premier of KwaZulu-Natal and others, CCT 32/01
[36] Minister of Health and Others v Treatment Action Campaign and Others 2002 (10) BCLR 1033 (CC)

purpose was also close. In the words of Yacoob J, the policy was 'systematic' and 'not haphazard'. Thus, the rationality test is passed.

The second approach is tougher. Under it, courts scrutinise policy and law for reasonableness. The requirement that the challenged law or policy must be reasonable requires a court to be convinced that it will work. In the words of Yacoob J in the Grootboom case: 'The programme must be capable of facilitating the realisation of the right'. It also requires the law or policy to be assessed in its full context. Courts will investigate the social, economic and historical context of the right and the challenged law or policy. They will also examine the capacity of the relevant institutions for implementing the right. In *Grootboom*, the Constitutional Court decided that the challenged housing policy was not reasonable because it excluded an exceptionally vulnerable group, giving them no reasonable prospect of housing in the short term. The policy was not flexible enough or comprehensive enough to meet the test of reasonableness. When a court applies this test, its engagement with law and policy is significantly greater than when it applies the rationality test. But, this approach does not go as far as the strictest approach because it does not expect a court to enquire into whether the policy adopted by the state is the best one possible: it does not demand a review of whether the job could be done better.

The third approach takes the next step. Under it a court must consider whether the job could have been done better. In the context of the infringement of a right, this demands an enquiry into whether measures less invasive of rights could have been adopted. South African courts use this approach when dealing with questions about the legitimacy of the limitation of a right under section 36 of the Constitution. For instance, assume a law that infringes the right to freedom of expression by prohibiting demonstrations near hospitals. The state might claim that the infringement of the right is reasonable and should be condoned. Section 36 of the Constitution covers this situation and recognises that rights may be limited in certain circumstances. In deciding whether or not such a limitation of a right is constitutional, one of the questions a court must ask is 'are there less restrictive means to achieve the purpose?' To answer this question the court might investigate whether the area in which marches are prohibited is too great or whether a prohibition on megaphones might not serve the same purpose without infringing the right as greatly. In this process courts go further than assessing the reasonableness of the law or policy. It engages courts actively in considering alternatives and, in effect, allows a court to substitute its view of what should be done for that of the executive or legislature.

The Constitutional Court has set the second test, the reasonableness test, for cases involving social and economic rights. Overall this means it has been cautious. The reasonableness test is not so weak to provoke the charge that the rights are worth nothing but it respects the role of the political branches in determining policy.

The cautiousness of the Constitutional Court is equally evident in the orders that it hands down once it finds a right to have been infringed. This is very clear in *Grootboom*. There the Court simply said:

> "(a) Section 26(2) of the Constitution requires the State to devise and implement within its available resources a comprehensive and co-coordinated program progressively to realize the right of access to adequate housing.
> (b) The program must include reasonable measures such as, but not necessarily limited to, those contemplated in the Accelerated Managed Land Settlement Program, to provide relief for people who have no access to land, no roof over their heads, and who are living in intolerable conditions or crisis situations."

There is no detail here. Responsibility for devising a plan is left in the hands of the state, as it should be.

But, as we indicate earlier, it is not only in cases involving social and economic rights that courts are implicated in budgetary matters. Consider *Premier, Mpumalanga v Executive Committee, Association of State-aided Schools, Eastern Transvaal*[37]. This case was decided by the Constitutional Court in 1999. The case concerned a challenge to a decision by the MEC for Education in Mpumalanga that bursaries for needy students in state-aided schools would be terminated immediately. This decision had not been announced in the MEC's annual budget speech but was conveyed to the schools later. The Constitutional Court found that the MEC's action was unconstitutional. It was retrospective in effect and breached the right to fair administrative action.

Again, the Court's decision is cautious. It is at pains to point out that it is aware that it should interfere as little as possible with the business of government. It said:

> "In determining what constitutes procedural fairness in a given case, a court should be slow to impose obligations upon government which will inhibit its ability to make and implement policy effectively (a principle well recognised in our common law and that of other countries.) As a young democracy facing immense challenges of transformation, we cannot deny the importance of the need to ensure the ability of the Executive to act efficiently and promptly".

Nevertheless, reasonable notice of a decision like that contested in the case was something that citizens could expect.

Despite the caution of the Court and despite its concern that its orders should leave scope for the government to craft appropriate remedies, decisions like *Grootboom*, *TAC*, *Khosa* and *Premier, Mpumalanga* have obvious and immediate budgetary implications.

Many have a direct impact on the intergovernmental fiscal system.

3. Polycentric decisions: courts and the intergovernmental fiscal system

In this section we look how court decisions could have "polycentric" impacts on the intergovernmental system. The aim of this section is merely to illustrate the potential

[37] 1999 (2) SA 83 (CC)

strategic interactions and their possible interaction by means of various scenarios[38]. One issue that emerges very clearly from each of these examples is that our system of shared powers makes the likely impact of court decisions on the fiscal system greater. There are many areas in which the allocation of responsibilities is unclear.

Social grants

One (not so hypothetical) example could be the payment of social grants. Here court decisions do not create, but may amplify incentive structures built into the fiscal constitution. The payment for social grants (such as the old age pension, and the child maintenance grant) are currently the responsibility of provincial governments. Entitlements to these grants are set at national level, but provinces are required to budget for them. Let us assume that these grants were not, however, budgeted for adequately by the provincial government. Reasons for this could be range from unforeseen circumstances (increased inter-provincial migration influencing take-up rates for these grants), to political preferences for other politically desirable political objectives, to sheer incompetence. Whatever the underlying cause, potential beneficiaries who are eligible for social security launch a class action suit against the offending provincial department[39] alleging that their socio-economic right to social assistance has been infringed. The court finds in the litigants favour and order an appropriate remedy.

It is relatively easy for the court to ascertain the scope of the entitlement: the eligibility, durability, value etc because these are expressed in monetary terms (in other words, budgeting for the right is almost sufficient to ensure its delivery; issues of capacity for delivery (such as grant administration) are crucial, but arguably, relatively easier to rectify than educational service delivery capacity) and quality of service is relatively easy to ascertain[40]. In addition, old age pensions are already government policy, rather than creating a completely new right (for instance, extending eligibility to immigrants), and thus the budgetary consequences are likely to be limited.

The provincial government has to make good the court order, but they cannot. Provincial governments are reliant on the equitable share of nationally collected revenue, and have insignificant own revenue sources. They appeal to national government for financial assistance. Even though the national government may have vowed, ex ante, never to bail out the provinces ex ante, they have every incentive to

[38] As noted by Iaryczower et al (2000) "Ideally, one would like to present a formal argument, however, as Bednar (1999) notes, the standard equilibrium analysis modelling form is constrained in its ability to inform us about dynamic development. Hence we resort to a discursive analysis, following a heuristic that has become common in dynamic questions of some complexity". Roughly translated, this means that the problem at hand is too complex for us to solve quantitatively, so we will resort to a structured story!

[39] This did in fact happen in the Eastern Cape in mid 2004 .

[40] If a person got less that the legal entitlement, it is clear that the right has been fulfilled. But if a child goes to school hungry, perpetually fearful of the gangs which invade the school premises and the sexual advances of fellow students and teachers, inadequate toilet facilities, substandard classroom facilities, under qualified and under-motivated teachers, and minimal learner support materials, then it is less clear whether the right has been fulfilled or not.

provide additional funding. This is especially so, since this situation will probably obtain in *all* the provinces, rather than in any single one – ignoring the situation would be politically unpalatable. The affected province overspends and gets bailed out by national government. This creates a perverse incentive, since it may signal that provinces do not have to remain within their budget constraint, but can elicit further funds from national government. They may be tempted to divert resources *away* from social security to other areas, knowing that they will be able to extract further finances later.

Policy-makers and budgeters now realise that what once was an implicit contingent liability, has – through the courts elaboration of damages, back pay etc – become an explicit liability. More resources are diverted to social security payment, which "crowd out" other forms of social expenditure, such as education or health. As budgets in these sectors decline, either quality of delivery is compromised (eg larger queues in clinics) or other forms of discretionary spending are curtailed (learner support materials in schools, infrastructural investments in the forms of classrooms).

As a result of the systematic overspending at provincial level, national government may have an incentive to shift the responsibility of budgeting from provincial to national level[41]. National government has more flexibility in increasing the aggregate budget constraint through increased taxation (although this is also limited by the narrow tax base and potential brain drain) or borrowing (where, in principle, international credit markets should exercise discipline).

Grant structures
The urban renewal programme is currently funded through the local government equitable share. Suppose a metro were to receive this funding and spend it not on urban renewal projects, but on some other priority, such as a new convention centre. When challenged by the national government, the city claims that the equitable share is unconditional and that it can spend the money as it sees fit. The court would then have to comment on the conditionality or otherwise of the equitable share. If the court upholds the national government's claim that the funds should indeed be spent on urban renewal, then it is de facto attaching some degree of conditionality to the equitable share grant. This changes an established norm that the equitable share is regarded as unconditional. On the other hand, should the court uphold the city's claim that it can expend the funds received as it sees fit, then it is likely that future funding would be made via conditional grants. Either way, there would be an impact on the intergovernmental fiscal structure.

Bankrupt municipality due to exogenous, structural economic shocks
Assume that there is a poor municipality which is (marginally) financially viable initially, but within adequate financial management capacity and competence[42]. This municipality is however dependent on a single industry (such as a mine or a single large factory) for

[41] Taylor Commission Report (i.e. the Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa) *Transforming the Present Protecting the Future*. Recommended the establishment of a social security agency http://www.welfare.gov.za/Documents/2002/2002.htm

[42] In other words, improving financial management per se will not improve this situation since all accounts receivable are already being recovered, expenditures kept to the minimum etc

employment for most of the economically active labour force in the municipality. This industry goes into rapid decline. The factory or mine closes, laying off workers. With the increase unemployment, the municipality's bad debt increases, and cashflows are negatively impacted. The municipality can no longer render its constitutionally mandated services, thus a financial crises burgeons into a service delivery crisis.

The revenue raising capacity of the municipality has been rapidly and structurally altered. But it would take two to three years before the data from the central statistical service register this change, and the revenue sharing formula allocation is adjusted given the new information.

The municipality initiates a court case against both national and provincial government for urgent interim financial relief to fulfil its constitutional mandate in terms of progressive realisation of socio-economic rights of its citizens. It argues that this dramatic deterioration of the tax base through exogenous circumstances should be immediately taken into account (In terms of section 214(2)(c) and (d)[43]). In addition, provincial governments also have the duty in terms of 155(6) to support local government in the province and to develop local government capacity to perform their functions. Furthermore, in terms of section 139, a provincial government must intervene

[43] 214. Equitable shares and allocations of revenue.—(1) An Act of Parliament must provide for—

(a) the equitable division of revenue raised nationally among the national, provincial and local spheres of government;

(b) the determination of each province's equitable share of the provincial share of that revenue; and

(c) any other allocations to provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations may be made.

(2) The Act referred to in subsection (1) may be enacted only after the provincial governments, organised local government and the Financial and Fiscal Commission have been consulted, and any recommendations of the Commission have been considered, and must take into account—

(a) the national interest;

(b) any provision that must be made in respect of the national debt and other national obligations;

(c) the needs and interests of the national government, determined by objective criteria;

(d) the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them;

(e) the fiscal capacity and efficiency of the provinces and municipalities;

(f) developmental and other needs of provinces, local government and municipalities;

(g) economic disparities within and among the provinces;

(h) obligations of the provinces and municipalities in terms of national legislation;

(i) the desirability of stable and predictable allocations of revenue shares; and

(j) the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria.

(Date of commencement: 1 January, 1998.)

in a financial crisis[44]. However, none of the measures listed in section 139 is likely to help this municipality: the financial crisis is not caused by bad financial management (i.e. low fiscal effort), but by severely curtailed fiscal capacity. The municipality contends that if the provincial government has not budgeted for this, national government should provide the funds in terms of s139(7)[45].

In this instance, the Court may either choose to be specific about which sphere of government should provide financial relief and the quantum, or it could simply require that financial relief be provided, leaving provincial and national government to determine the specifics. Given that provincial governments have limited revenue sources, the short term financial burden would almost certainly devolve onto national government. In subsequent rounds of the fiscal game, other municipalities – encouraged by this precedent – could demand similar relief. The share of nationally collected revenue accruing to local government could thus increase. Provincial governments may argue that their constitutional support and capacity building function to municipalities requires an increase in their equitable share allocations. Assuming that the efficiency gains in the South African Revenue Services start demonstrating diminishing returns, this could ultimately have an impact on tax policy and/or borrowing.

Free basic services[46]

There has been substantial debate about whether the 6 kl of free water and the 30 Kilowatts of free electricity (per household) give effect to the Bill of Rights in the Constitution. The question is whether this level of basic services is sufficient to fulfil the "right to human dignity". Many NGO's have criticised the government's free basic services policy, saying that in rural areas, where the size of the household is large, 6 kl of free water and 30 Kilowatts of free electricity is not sufficient. In fact, many of the

---

[44] (5) If a municipality, as a result of a crisis in its financial affairs, is in serious or persistent material breach of its obligations to provide basic services or to meet its financial commitments, or admits that it is unable to meet its obligations or financial commitments, the relevant provincial executive must—

(a) impose a recovery plan aimed at securing the municipality's ability to meet its obligations to provide basic services or its financial commitments, which—

(i) is to be prepared in accordance with national legislation; and

(ii) binds the municipality in the exercise of its legislative and executive authority, but only to the extent necessary to solve the crisis in its financial affairs; and

(b) dissolve the Municipal Council, if the municipality cannot or does not approve legislative measures, including a budget or any revenue-raising measures, necessary to give effect to the recovery plan, and—

(i) appoint an administrator until a newly elected Municipal Council has been declared elected; and

(ii) approve a temporary budget or revenue-raising measures or any other measures giving effect to the recovery plan to provide for the continued functioning of the municipality; or

(c) if the Municipal Council is not dissolved in terms of paragraph (b), assume responsibility for the implementation of the recovery plan to the extent that the municipality cannot or does not otherwise implement the recovery plan.

[45] (7) If a provincial executive cannot or does not or does not adequately exercise the powers or perform the functions referred to in subsection (4) or (5), the national executive must intervene in terms of subsection (4) or (5) in the stead of the relevant provincial executive.

[46] We are indebted to Amanda Jitsing for this example.

'wealthier municipalities' have implicitly acknowledged this by providing a higher level of FBS, for instance Knysna provides 8 Kilolitres of free water and 59 Kilowatts of free electricity.

There is already some research from the World Bank and IFPRI showing the minimum level of water required for a human being to live in a healthy manner. This would be based on biological need. In a case of an NGO versus national government, there may well be a good case for setting the level of water about 6 kilolitres, i.e. redefining the minimum standard. Courts in the past have shied away from pronouncing on minimum standards for core services, but if the constitutional court finds in favour of the NGO, then, national government could have to revise its FBS policy, and allocate more money to FBS. If national government is accountable for ensuring that each and every household receives FBS, it will also have to find ways of making sure that municipalities spend the extra allocation on FBS (possibly increased conditionality).

Every year, the intergovernmental budget process resolves anew competing priorities such as water, electricity, health, education etc. However, the courts decision would, in effect, "top-slice" allocations to water and electricity needed to finance the minimum standard enforced by the courts. These funds are thus "ring fenced", and immune from political input. But the case sets the precedent for a minimum right to food (based on the fact that a biological minimum for sustaining human life exists), and so on. The extreme case is where minima are set for each of the socio-economic rights, and collectively these minimum standards are not affordable. The national government could attempt to comply through increasing taxation burdens on a very narrow tax base (possible resulting in decreased corporate and household investment and savings, brain drain effects etc) or increased borrowing (resulting in increasingly onerous interest burdens, and fears of a debt trap). Increased court-confirmed minimum standards could erode the autonomy of all three spheres of government, but particularly the powers of subnational governments.

Municipal Roads[47]

Municipal roads are a concurrent function between local and provincial governments (under part B of Schedule 5). Municipalities often do not budget for adequate road maintenance, relying on provincial governments to do so. Often this is because operational expenditures crowd out more discretionary maintenance expenditures. The provincial government has an incentive to pay for municipal road maintenance, because to do otherwise would compromise the integrity of the entire road network in the province. The provincial government requests that the court force the Council to budget for maintenance, arguing that the municipality's action is "unreasonable" and "prejudicial to …. the province as a whole" (section 139(1) (b) of the Constitution). Given that the municipal budget is regarded as a legislative act (such as in the Fedsure judgement), the question arises whether the court could, and should, intervene to alter prioritisation.

Alternatively the province could assert its right to "regulate" municipal road maintenance. This raises the question whether the provincial government's regulation should specify the minimum standard of maintenance, or whether the right extends to

[47] We are indebted to Amanda Jitsing for this example.

the regulation of the budget of municipalities. If the former approach is adopted and the municipality still is in breach, what would constitute an appropriate judicial remedy? If the latter approach obtains and the municipality claims that it is willing to budget for maintenance, but unable due to its limited revenue base and unfunded mandates from the national government, how could the courts proceed?

The examples above are illustrative of the of the impact that court decisions could have on the public resource allocation both in respect of both the progressive realisation of socio-economic rights, as well as in respect of intergovernmental fiscal structures and budgeting processes.

Each of these two interfaces between the Constitutional Court and the intergovernmental fiscal system is conceptually distinct[48]. However, their cumulative impact is likely to be most important in the South African context. For instance, a decision that the Constitution requires greater spending in social services, health and education would have an impact on the division of revenue amongst the three spheres. In Germany for instance, the Constitution charges the Constitutional Court both with ensuring that the constitutional commitment to maintaining equal living standards was honoured and with resolving intergovernmental fiscal disputes. In an environment of substantial disparities between former East German and West- German *Länder* the German Court handed down a series of decisions which included fairly precise directions to the regions and the federal government as to how fiscal equalisation should be carried out. Although it is not strictly analogous with the South African case, the case highlights some of the relevant interdependencies, and incentive effects. These are outlined in Appendix 1.

The German courts seem to have been extremely active in their intergovernmental fiscal system. For example, they have censured the federal governments use of grants to the states[49], resulting in a reduction in the number and size of these grants (Spahn and Franz, 2000). The German Constitutional Court ordered that a broad definition of "financial ability" be used when assessing state and municipality's revenue capacity (in order to prevent non-disclosure of all income by states in order to increase their grant allocations)[50]. The courts have interpreted solidarity between jurisdictions in support of uniform living standards as the need to bail out state's in financial difficulties. They have also criticised the use of weighting of population figures within the equalisation formula to cater for "specific burdens" (i.e. cost disabilities, for instance in the city states).

4. The courts and policymakers: quo vadimus?

[48] There could be socio-economic rights in a fiscally centralised unitary state which would have budgetary consequences, but obviously no intergovernmental fiscal problems. On the other hand, it is possible to have a fiscally decentralised system without socio-economic rights (e.g. US).
[49] BverG, BvF 2/98 of November 11, 1999, http://www.bverg.de/
[50] Concessional levies are collected by German municipalities as compensation for granting infrastructure companies rights of way (e.g. telecommunications and electricity providers). The German constitutional court ordered that these should be taken into account for the purposes of fiscal equalisation.

In contrast to the German case, while not avoiding these issues, the South African courts have adopted a much more deferential and self-limiting approach to their interface with the budgetary system in respect of intergovernmental fiscal relations and the enforcement of socio-economic rights. From the court decisions so far, the following broad principles seem to be emerging (Roux, 2004, Swart 2004):

Fiscal discipline[51]**:**
The question of fiscal discipline centres around the courts' interpretation of "available resources". The amount of resources available to the state is in part a policy decision (since it has taxation and spending powers). It is, however, constrained in principle by factors such as the size of the tax base, international mobility of skilled labour and capital, the discipline of capital markets etc. The court has refrained from defining a minimum essential level of each of the rights (on the grounds of legitimacy of doing so, as well as its ability i.e. lack of information). If it did so for every right individually, there would be no guarantee that aggregate fiscal discipline would not be violated. The question of aggregate fiscal discipline is vexing because public sector departments often have unspent funds yet advocate increased budget allocations. The binding constraint on service delivery thus is not always financial, but often managerial competence and institutional capacity.

Allocative efficiency:[52]
The UN Committee on economic social and cultural rights has interpreted articles 2.1 and 11.1 of the International Covenant on Economic, Social and Cultural rights to mean that governments have to direct all their public resources first to satisfy the "minimum core content" of the right to adequate housing. At the time of Grootboom, South Africa was not yet signatory to (and thus was not yet bound by) this convention. The court rejected this definition as being an absolute criterion, signalling its hesitation to order the state to reconsider its spending patterns, or to impose a temporal sequence for prioritisation of socio economic rights. The court seems to have accepted that in providing constitutional remedies budget impacts are inevitable. However possible budgetary impacts should be a consequence of the courts' duty to enforce progressive realisation of socio-economic rights, rather than an end in itself, which would be an unjustifiable breach of the separation of powers. The court has also avoided quantifying the precise amounts needed to be redeployed to remedy the deviation from non-compliance with the constitution. Departments will, however, at least have to demonstrate that sufficient attention is being given to the most vulnerable and needy sectors of the community.

Operational efficiency[53]
In the *Grootboom* case, the court stated that – in applying its reasonableness criterion – it will not consider other measures which could have been adopted. The court is thus refraining from comparing the relative operational efficiency of different service delivery

[51] I.e. the impact on the aggregate spending and taxation of government
[52] the impact on macro-prioritisation (across various sectors such as health, education and trade and industry), as well as micro-prioritisation (such as primary versus secondary education, basic health care versus heart surgery)
[53] impact on the productivity with which resource inputs are converted into service delivery outputs

modalities. However, unspent budgets over an extended period of time due to, for example, lack of capacity would probably fall foul of the court's reasonableness test, which covers both the conceptualisation and execution of policies.

There may be tensions built into the constitution design which create perverse incentives to undermine fiscal discipline or allocative and operational efficiency (eg the need for equity and redistribution encouraging centralisation vis-a-vis decentralisation for efficiency reasons). The constitution itself binds the constitutional court, as well as the jurisprudence it has fashioned though past decisions. Nevertheless some scope exists for it to exacerbate or ameliorate these problems. The South African Constitutional Court has, so far, been adept at exploiting this space to manage its relationship with the executive and the legislature while creating a role for itself as "legitimator of the social transformation project" (Roux, 2004)

Importantly, in cases involving rights, the Constitutional Court has avoided engaging in a discussion of who should do what. In other words it has kept away from issues relating to expenditure assignment across spheres of government.

Currently, ANC political hegemony is likely to mean that the courts will remain in the background as intergovernmental disputes can be resolved through intergovernmental forums. Under different circumstances, in which the power of the centre is reduced, this may not be the case[54]. Should aggregate nationally collected revenues decline or grow too slowly, competing claims by the various spheres of government could result in increased intergovernmental conflict, highlighting the courts as instruments of dispute resolution. The South African government has, to date, responded well to external shocks[55] and once-off increases in tax collections have cushioned the intergovernmental fiscal system from aggregate fiscal risk. It remains to be seen how robust the intergovernmental fiscal system is under conditions of fiscal stress.

Finally, as noted by Pieterse (2004), despite being more representative than ever before, the legislature is currently the least powerful branch of government. In no area is this more apparent than the area of budgets[56] and intergovernmental fiscal relations. Given the dominance of the executive over the legislature, it is not surprising that the poor and vulnerable might increasingly look to the courts as champions for their rights and for holding the executive accountable. Unless there is political will to empower South African legislatures to play a more active role in the budget prioritisation and oversight over budget implementation, it is likely that this imbalance could create increasingly thrust courts onto the centre stage of the public resource allocation process.

[54] The Indian experience seems to indicate that only once the regions were dominated by different political parties from the centre, was there an incentive to formalise many intergovernmental fiscal structures.
[55] For example the Asian crisis
[56] With notable exceptions, legislatures have not fulfilled their constitutional obligation to exercise effective oversight over budget implementation. Furthermore, though the constitution has made provision for legislatures to amend money bills (budgets), but Parliament to date has not passed the enabling legislation that would allow it to do so. Neither have the provincial legislatures.

Concluding remarks

The aim of this paper is to start a dialogue on these inherently convoluted issues, rather than provide authoritative conclusions. As the paper attempts to demonstrate, the issues are extremely complex. To even begin to do them justice, a multi-disciplinary analysis with legal, political science and public finance dimensions is essential. How the courts actually respond to these questions over time, and how other political stakeholders anticipate judicial behaviour, will create incentives that may alter the behaviour of both elected and appointed officials. The decisions that they make and their actions (conditional on the incentives they face) will ultimately affect the substantive outcomes of the intergovernmental fiscal system: fiscal discipline, equity, allocative efficiency, and operational efficiency of service delivery.

Similarly, though, courts will inevitably be influenced both by the programmes and approaches developed in the political branches of government, the legislature and executive, and by the thinking that has gone into them. If the actions of government are based on a thoughtful attempt to fulfil the promise of the constitution and particularly the Bill of Rights, courts are unlikely to second guess them. For these reasons, it is crucial that both academic economists and public finance theorists join a debate that, to date, has been dominated by the legal fraternity[57].

Institutions are not only created through conscious design in formal constitutions and legislation. Rather they also evolve though the myriad decisions and actions of independent roleplayers who co-create the formal and informal institutional norms underpinning institutional culture. This is as true for the development of constitutional jurisprudence as policy. It is therefore even more important that politicians as well as all public managers with control or oversight responsibilities over public resources[58] should engage with these issues, so that they exercise their authority fully conscious of the constitutional implications, the fiscal institutions they are creating and maintaining, and their implications for the societal vision embedded in the Bill of Rights.

[57] The Financial and Fiscal Commission is one of the few exceptions, since the implications of the progressive realisation of social and economic rights has been on of the Commission's preoccupations, since its inception ten year's ago.

[58] Accounting Officers at national, provincial and local level, their Chief Financial Officers and other senior management, as well as senior management in national and provincial treasuries as outlined in the Public Finance Management Act of 1999 and the Municipal Finance Management Act of 2003

Appendix 1:
A case study of German intergovernmental fiscal relations after unification in the 1990s

In this section the impact of the German constitutional court rulings on intergovernmental fiscal relations, and ultimately macroeconomic balance is examined. The case of Germany intergovernmental relations post-unification is an interesting case study since it shares many features with South Africa: its subnational governments have considerable autonomy on the expenditure side, but limited revenue capacity. In addition, it also has constitutional clauses aimed at equalising standards of living around the country (which are similar to socio-economic rights in the South African constitution). In Germany, as in South Africa, subnational governments are seen as implementing agents for national level policies. Both countries have some constitutional restrictions on subnational borrowing, although the German states have considerably more autonomy in this regard.

German intergovernmental fiscal relations prior to unification

Given the long history and the complexity of the German system of intergovernmental fiscal relations (IGFR), it is not possible to provide a comprehensive overview[59] of its origins, development and political, fiscal and administrative dimensions. The salient features of the system motivating this paper will, however, be briefly summarised below.

Germany, except for the Nazi era, has been a federation since 1871[60], but over that period the nature of the system and concomitant financial arrangements have changed fundamentally. The broad outlines of the current IGFR system can be traced to establishment of the Federal Republic of Germany in 1949, consisting of 11 West German states/regions/provinces (called *Länder*) and the federal government (the *Bund*). The *Länder* differ significantly in terms of size, population and economic and fiscal capacity. The constitutional reforms of 1969 have provided the more specific elements of the current IGFR system. Van Houten (1999: 19) notes:

> In the 1949 constitution, the *Bund* and *Länder* had mostly exclusive financial competencies. As a result, they were pitted against each other in budgetary negotiations. Since the federal level often managed to ally with the poorer regions, which were in serious need of federal financial support, the result was an increasing centralization of competencies and power. This development was formalized and reinforced by the 1969 constitutional reform. This reform established the so-called 'joint tasks', which were to be planned and decided upon jointly by the *Bund* and *Länder*, and the system of tax sharing for the major taxes. Also, the *Finanzausgleich* was reformed in favor of the poorer regions. The result was a reduction of the differences and tensions between the poorer and richer regions, but also the strengthening of *Politikverflechtung*[61] and unitarization.

[59] For more comprehensive overviews, refer to Spahn and Foettinger (1997), Trounin et al (2001), Scheider et al (2001), Spahn (2001) from which this section is drawn.
[60] The experiences included the German empire (1871-1918), the Weimar Republic (1919-34), the Third Reich (1934-35) and the postwar allied occupation.
[61] This term refers to the integration of policies and politics between the different levels of government.

> The regions were primarily concerned with pursuing their own interests, and securing their financial situation. For the poorer Länder, this meant securing support from the federal level. The richer Länder were concerned about maintaining some of their autonomous powers, but were not willing to increase their financial transfers to the poorer Länder. As a result, it was inevitable that the federal level would get a more prominent role in intergovernmental financial relations, reducing overall regional autonomy. Thus, the richer Länder traded some of their autonomy for narrow self-interest.

From 1949 to 1989 there have been 35 amendments to Germany's constitution (the *Basic Law*). Hega (2003) notes that while 20 of them influenced federal arrangements, in no cases were the *Länder* given expanded powers. Similar to the US case, an increased role of the federal government in the distribution function has been accompanied by an increase in conditional grants in aid to the weaker *Länder* over time.

The German federal model has often been characterised as "cooperative federalism", "unitary federalism" or "administrative federalism". This refers to the closely interlocked legislative and administrative powers of the two levels of government, their financial interdependence, extensive joint decision-making (including on intergovernmental fiscal issues) and legislative centralisation coupled with administrative decentralisation in respect of taxing and spending. The federal government has a broad range of exclusive[62], concurrent (with federal law prevailing)[63] and framework legislative[64] powers. There is also constitutional provision for "joint tasks" which *Bund* and *Länder* carry out together[65].

Although residual powers lie with the *Länder*, their legislative authority is limited, but they play a critical role in implementing federal policies[66]. *Länder* are also directly involved in decisionmaking at federal level through the *Bundesrat*. The *Bundesrat* is the second chamber of Parliament which comprises the First Ministers and the senior Ministers of the *Länder* serving as the ex officio delegates of their *Land* governments. It has an absolute veto on all federal legislation affecting the *Länder*. Since in practice

[62] Article 73 of the Basic Law grants exclusive powers to the *Bund* in areas such as foreign affairs, defence, citizenship, immigration, rail and air transport, criminal policing and foreign trade.
[63] These include civil and criminal law, the regulation of nuclear energy, labour relations, environmental protection and road transport (Article 37).
[64] Framework legislation is aimed at providing a degree of uniformity across all the *Länder*. Within the broad guidelines of the framework legislation, *Länder* can enact their own detailed and tailor-made laws. Areas include higher education, nature conservation and regional planning.
[65] Areas include university construction, regional policy, agricultural structural policy, coastal preservation, education planning and policy research.
[66] Aricle 83 of the Basic Law confers on the *Länder* both the right and the duty to "execute federal statutes as a matter of their own concern in so far as this Basic Law does not otherwise provide or permit" (i.e. under general administrative rules requiring *Bundesrat* consent and subject to federal supervision relating to legal standards only). Where the *Länder* act as agents, constitutional provision is made for more stringent supervision, subjecting them to "the instructions of the appropriate highest federal authorities" relating to the "appropriateness of execution" (Articles 84 and 85).

about 60% of all legislation falls in this category, the *Länder* can exert substantial policy influence on federal decision-making

A Federal Constitutional Court was also established by the Basic Law, not as a court of general appeals such as the Supreme Courts of the USA and Canada, but specifically to deal with questions of federal constitutional law. Its functions include: the judicial review of legislation, the adjudication of disputes between *Länder* and *Bund* political institutions, the protection of individual civil rights as constitutionally guaranteed and the protection of the constitutional and democratic order against groups and individuals seeking to usurp it. Half of the members of the Constitutional Court are appointed by the *Bundesrat* on behalf of the *Länder*, and the rest by the *Bundestag* [67].

One of the most important objectives of the Federal Republic of Germany since its inception was the realisation of "uniformity of living conditions" which was enshrined in the 1949 Constitution. In the aftermath of World War Two, all the West German states were equally poor, and solidarity in the form of balanced regional development and uniform living standards was attractive as the basis for policy making and nation-building. The pursuit of uniformity became a powerful norm underpinning the political culture and permeating all relations between levels of government, and even broader society (i.e. the corporatist approach to wage bargaining etc).

Article 72 of the Basic Law reads:

> "1. On matters within the concurrent legislative power, the *Länder* shall have the right to legislate so long as, and to the extent that, the Federation has not exercised its legislative power by enacting a law.
> 2. The Federation shall have the right to legislate on these matters if, and to the extent that, the establishment of equal living conditions throughout the federal territory or the maintenance of legal and economic unity renders federal legislation necessary in the national interest."

The uniformity of living conditions is further elaborated in Article 106(3) which specifies that shares accruing to the various levels of government in the VAT shall be determined based on the following principles:

> "1. The Federation and the Länder shall have an equal claim to funds from current revenue to cover their necessary expenditures. The extent of such expenditures shall be determined with due regard to multi-year financial planning.
> 2. The financial requirements of the Federation and the [Länder] shall be coordinated in such a way as to establish a fair balance, to avoid excessive burdens on taxpayers, and ensure uniformity of living standards throughout the federal territory."

In 1994, the Constitutional Reform Act substituted the term "uniform living conditions" with "equivalence of living conditions" (*gleichwertige Lebensverhaeltnisse*). Trounin et al (2001) however note that this modified constitutional wording does not appear to be "reflective of a serious diminution of the norm of uniformity."

[67] The Federal Council which is the first Chamber of Parliament, directly elected via a mixed electoral system.

The "fiscal constitution" governing the tax assignment, expenditure assignment, revenue sharing, borrowing and intergovernmental grants is spelt out in great detail in the Basic Law. A basic theoretical principle is that the federation and the *Länder* 'shall be autonomous and independent of each other in their budget management', but that they shall on the other hand 'have due regard ... to the requirements of overall economic equilibrium' (Article 109/1-2 of the Basic Law).

As in the South African case, the tax instruments assigned exclusively to individual sphere is negligible. All the most fiscally significant taxes are shared between the various levels of government. In general tax policy is centralised in the *Bund* whereas tax administration is done by the *Länder*. This centralisation of tax policy coupled with decentralised expenture responsibility for implementation of federal legislation means that the German *Länder* are heavily dependent on tax and revenue sharing from the common pool of tax resources[68]. The financial arrangements which evolved were conditioned by the constitutional imperative of equivalent living standards, and thus contain elements of highly redistributive fiscal equalisation between *Bund*, *Länder* and local governments (vertical equalisation), and among right and poor *Länder* (horizontal division). The rules for revenue sharing are approved by the *Bundesrat* which has an absolute veto, and therefore is always preceded by protracted and often contentious negotiations and bargaining between *Bund* and the *Länder*. The *Bundesrat* therefore becomes an important vehicle for the *Länder* to influence *Bund* tax policy.

The tax and revenue sharing processes proceed as follows. First there is a vertical division of tax revenues from shared taxes[69] where the percentage shares of each tax are constitutionally fixed and thus relatively uncontroversial. This is followed by the horizontal division of revenues among Lander. This intergovernmental transfer system can be further sub-divided into 3 phases.

1. Division of the VAT proceeds among the *Länder*;
2. Fiscal equalisation from rich to poor *Länder* (*Finanzausgleich* proper);
3. Finally there are also asymmetrical discretionary vertical grants from the *Bund* to the *Länder* which also have redistributive effects[70].

Personal income tax, company income tax and VAT cumulatively comprise about three quarters of total tax revenue, and the proceeds of all are shared. Article 106(3) of the Basic Law mandates that the proceeds be shared among the *Bund*, *Länder* and local government (*Gemeinden*). The *Bund* and the *Länder* collectively each receive 42.5% of the proceeds, with the remaining 15% assigned to local government. Corporate income

[68] In 1995, only 9% of total state revenues came from own tax sources over which the *Länder* have exclusive jurisdiction (primarily the motor vehicle tax, the net wealth tax and business taxes). 63% of revenues comes from the various shared taxes. A further 15% is derived from intergovernmental transfers (such as supplementary grants and transfers associated with joint federal-state infrastructure programmes (Spahn & Fottinger, 1997). The main federal exclusive taxes are excise taxes (on mineral oil, tobacco and alcohol except beer), customs duties, as well as the right to levy a surcharge on income taxes.

[69] This tax sharing has its origins in the Weimar republic. It is interesting to note that the 1993 Interim Constitution of South Africa had emulated this approach, but that it was superseded by a general revenue sharing arrangement in the final Constitution of 1996.

[70] These payments are made in terms of Article 91(a) and 104(a) of the Basic Law.

tax is constitutionally mandated to be shared equally between the *Bund* and the *Länder*. These percentage shares are laid out in the Constitution and can only be changed by constitutional amendment. They are thus quite stable, on the one hand, which creates certainty in the budgeting environment, but also rigid in terms of response to rapid and fundamental economic shocks. The only element of flexibility inherent in the vertical division lies with the apportionment of VAT where the shares are not determined constitutionally, but by federal legislation. The ratio is reviewed every two years and adjusted in response to changing fiscal needs, and formalised in legislation which must be approved by the *Bundesrat*.[71]

Income tax is distributed to among the *Länder* according to the derivation principle[72], corporate income tax is divided according to a formula based on plant location to take into account firms with multiple regional activities, and a proportion of VAT is divided to the individual *Länder* on a per capita basis[73]. The sum of the shares of each revenue source accruing to each *Land* constitutes primary pre-equalisation tax capacity and would thus display significant differentials.

In the first stage of horizontal fiscal equalisation, up to a quarter of VAT proceeds is distributed to the *Länder* with the lowest primary equalisation tax shares[74]. The aim is to bring their fiscal capacity up to 92% of the state's average tax revenue per capita. The remaining three quarters is distributed according to the population of the states (which is quite redistributive).

Article 106 (3) of the *Basic Law* assumes that it is possible to define necessary expenditures at *Bund* and *Land* level, and to achieve a "fair compensation" (*billiger Ausgliech*) between the two levels of government. At this stage of horizontal equalisation across the states (*finanzausgleich*), the financial endowment of each state (*finanzkraft*) is calculated and compared to financial needs (*finanzbedarf*). Revenues are redistributed from states whose endowments exceed their needs, to those for which the opposite holds true. The sum of payments always equals the sum of receipts. The benchmark for revenue needs is based on the average per capita income tax for the country as a whole and not on expenditures required. At this stage, the weaker states are elevated to 95% of their financial needs thus defined.

In the third stage, the *Bund* confers additional discretionary supplementary grants on the states. These were negligible prior to unification, focussing mainly on financing "joint tasks" and "special needs"[75], but have assumed much more importance post unification.

---

[71] In 2001, the allocation ratio of VAT was 56:44% to the *Bund* and the *Länder* respectively (Trounin et al, 2001).
[72] I.e it follows the regional patterns of tax yields according to the residence principle.
[73] Refer to Article 106(3) quoted above for the principles which should underpin the division of VAT revenues.
[74] In terms of Article 107(1) of the Basic Law
[75] The higher costs of administration in smaller states. These supplementary grants (*Bundesergänzungszuweisungen*). Pitlick et al (2001) note that a Constitutional Court decision had set the basis for further "special needs grants" in 1986 – Bundesverfassungsgericht (1986) Urteil vom 24.6.1986, *Entscheidungen des Bundesverfassungsgericht* 86, 330-436

As far as borrowing conditions are concerned, *Länder* decisions are not subject to review by the *Bund*, but they are bound by the provisions of their own constitutions which allow them only to borrow for "investment" purposes. However, "investment" is a nebulous concept, defined administratively rather than by economic criteria. In addition, since 1969, the constitutions of the *Länder* have permitted them to violate this "golden rule" in cases of "disturbances of general economic equilibrium". *Länder* like Bremen and Saarland, as described below, have simply ignored these borrowing restrictions with impunity.

German intergovernmental fiscal relations post unification

It is important to note that there had been concerns about the fiscal equalisation arrangements even prior to the unification of Germany. Two *Länder*, Baden-Wűrttemberg and Hesse, bore the burden of fiscal equalisation while all the other states were beneficiaries or were exempt from major contributions to the scheme.

Since 1987, the federal government had granted to Bremen and Saarland supplementary transfers in order to allow then to cope with high public debt (Rodden, 2001).

In 1988, the state governments of Bremen and Saarland requested that the German Constitutional Court support their demands for increased financial support from the *Bund* to service their high levels of debt. The long term economic downturn in these states had been triggered by the secular decline in the shipbuilding industry in Bremen and the coal mining and steel industries in Saarland in the wake of the oil price shock of 1973-74. Unemployment rates had increased in Saarland from about 6 per cent in 1980 to almost 14% in 1985. The unemployment rate in Bremen had also climbed from about 6% in 1980 to almost 16% in 1986. This erosion of their economic bases had fiscal consequences for both the revenue and expenditure side of the budget. Tax revenues declined while expenditures increased, both due to increased welfare payments and to investment subsidies by these two state governments to the ailing industries upon which they had relied to generate revenues (Von Hagen et al, 2001).[76]

The argument marshalled by these two state governments was that their debts had resulted from negative economic circumstances which were beyond their control. They contended that the debt service obligations rendered it impossible for them to fulfil their constitutional duties. Cutting public expenditures would result in severe deterioration of public services which would violate the constitutional mandate to provide equivalent living conditions across the states. These two states also contended that they could not comply with the constitutional requirement which limits budget deficits to public investment. Finally, they argued that the bulk of their expenditures (such as welfare payments) were statutorily determined by federal law and hence beyond their discretion (Von Hagen et al, 2001).

The Constitutional Court to five years to arrive at the decision that the *Bund* must make additional transfers to Bremen and Saarland amounting to around DM 30 billion over the

[76] Note that at the same time, states like Baden-Wurttemberg and Hesse were successfully adapting to hi-tech and high growth industrial development (Jeffery, 2000)

period 1994-2000 in order to reduce public debt while avoiding expenditure cuts (Rodden, 2001).

> In its 1992 ruling, it upheld the claims of both states, arguing that the Federal Constitution, and especially the design of fiscal federalism in Articles 104 to 107, aims at establishing homogeneity of fiscal conditions and equalization of living standards throughout Germany. In the court's view, these objectives could only be achieved by mutual support between the states and the federal government and among the states. Thus, the Court stressed the constitutional principle of solidarity and concluded that a state— or, as it might be, the federal government— experiencing extreme budgetary hardship was entitled to financial support from the other members of the federation. The Court, like the two state governments before, concluded that there was indeed extreme budgetary hardship in the two states on the basis of three observations: the poor economic performance of the two states, the high levels of per capita debt of the two states, which far exceeded the German average, and the unusually high ratio of debt service to total expenditures in the two states. (Von Hagen et al, 2001)

Between 1987 and 1993, Saarland received DM 75 million and Bremen DM 50 million annually. In 1993, German federal government concluded a contract with the two state governments, promising annual grants to Bremen of about DM 1.6 billion and to Saarland an annual DM 1.8 billion over a period of five years to reduce the financial burden caused by the high debts. This would constitute 22.5 percent and 18 percent, respectively, of their annual expenditures. Although they need not be repaid there were, however, conditions attached to these payments:

- The states had to restrict annual expenditure growth below three percent, a limit that was reduced to two percent in 1997;
- The grant had to be used for the reduction of the public debt and the resulting savings in interest payments had to be used either for further debt-reductions or for additional infrastructure investment.
- The two states were obliged to present regular reports on the progress of their fiscal consolidations to the federal and the other state governments. Thus, both state governments were forced to explain and justify their fiscal policies.

This contract also indicated that the financial situation of both states would be evaluated in 1997 as a basis for deciding whether financial assistance beyond 1998 would be required. A decision could not be reached in 1997 or 1998, and finally in the spring of 1999, a new contract extending the grants to the two states was concluded. The grants would decline annually from DM 1.2 billion for Bremen in 1999, to DM 500 million for 2004. Similarly, DM 1.8 billion would be granted to Saarland for 1999, declining to DM 700 million in 2004. Further transfers after 2004 were excluded. In total, Saarland would have received DM 16.7 billion from the federal government by the end of 2004, and Bremen DM 13 billion. This corresponds to slightly more than twice the 1998 volume of total state government spending for Saarland, and 165 percent of 1998 spending for Bremen.

In addition to these explicit payments, Saarland and Bremen also received implicit transfers from the federal and the other state governments by being granted exemption from the financial responsibilities of German unification. The East German states received transfers from West Germany through the German Unity Fund during 1991-94 (discussed in detail below) which was mainly debt financed. At its dissolution in 1994,

the federal government and the West German states reached an agreement distributing the Fund's debt between them. In view of their high debt levels, however, Bremen and Saarland were excused from accepting part of this debt. As a result, Bremen and Saarland were left with financial liabilities from the German Unity Fund amounting to DM 350 and DM 310 per capita, respectively, about half of the DM 730 per capita accepted by the other West German states.(Von Hagen, 2001:22)

The Constitutional Court's ruling has attracted criticism and has been seen as exacerbating the perverse incentive structure inherent in the structure of the German constitution, but becoming problematic only under conditions of fiscal stress.

> "The bail-outs of Bremen and Saarland point to a fundamental flaw in the design of Germany's federal system. This is the contradiction between the states' autonomy in spending and borrowing decisions, and their limited freedom in determining current revenues. This contradiction is sharpened by the constitutional mandate to provide a uniform standard of government services in all states. A narrow reading of this mandate can only lead to the conclusion, reached by the Constitutional Court, that the German states and the Federation are bound together by mutual solidarity….. The two cases then show how solidarity can turn into mutual liability for severe policy errors. Ultimately the Court ruling forced federal government to pay for the two governments' flawed economic policies, which were trying to prevent necessary economic restructuring by outdated programs of industrial policy and government spending" (Von Hagen et al, 2000).

Rodden (2001) notes that the incentive for bailout seem to be associated with the third stage of equalisation in which the *Bund* distributes discretionary supplementary transfers. He argues that the increasing the flow of these grants:

> "- coupled with the constitutional obligation to maintain equivalent living conditions – provide politicians with rational beliefs that current deficits can be shifted onto the residents of other jurisdictions in the future trhough increased transfers. Even if unsure whether these bail-outs will be provided and the form they will take, politicians in most transfer dependent states have few reasons to feat the wrath of voters and creditors if their debt servicing burden increases" (Rodden, 2001:27).

Creditors and voters recognise that subnational debt burdens will not translate into defaults, closure of schools and hospitals, scaling down of the public service etc. Poor subnational governments where the bulk of the expenditure is funded by non-residents, faced with long term declines in revenue, may attempt to defer fiscal adjustment which requires politically unpalatable expenditure cuts in the expectation of increased transfers in the future.

The effect on borrowers can be gauged by the typical response of Fitch IBCA, a credit ratings agency which extended the same AAA rating to all German *Länder* irrespective of their economic circumstances. In its press release of 25 March 1999, Fitch IBCA gave three justifications for its decision:

> First, it argued that the states and the federal government are interlinked by strongly interdependent decision-making processes and interactions between powers at the federal and the state levels. Second, the agency referred to the 1992 Constitutional Court

> ruling, pointing out that the German constitution read in this way requires the federal government to bail out state governments. Third, the agency noticed that the fiscal equalization system in Germany was designed to prevent states from falling into financial difficulties arising from revenue shortfalls. On this basis, there seems to be no room left for risk premia differentiated among the states. The implication is that Germany can no longer rely on market discipline to enforce fiscal prudence on the state governments (Von Hagen, 2001:22)

However, Rodden (2001) notes that the bailouts were accompanied by significant loss of control over expenditures and as a result, political embarrassment. This sanction may be sufficient to deter other states from following a Bremen strategy.

In sum, while the perverse economic and fiscal effects of the pre-unification IGFR system were well known, there was no political will to effect fundamental changes in the distribution of financial competences (Van Houten 1999) or revision of the living standards provisions.

A document, the 'Cornerstones' of the *Länder* for Federalism in a Unified Germany was published by the heads of government of the west German *Länder* on 5 July 1990 and was endorsed by their counterparts in the newly established East German *Länder* in December of that year. It placed a lot of emphasis on the restoration of competences to the *Länder*, as well as proposing increased tax powers for the *Länder*. The contradictions in this document highlight the divergent interests between the rich Western *Länder*, poor Western *Länder*, and the Eastern *Länder* relative to the *Bund*:

> The 'Cornerstones' were the product of a package of compromises negotiated between the western *Länder* governments which only thinly papered over the fault-lines which had begun to emerge in the 'old' Federal Republic in the 1980s. The emphasis placed on diversity and subsidiarity reflected the preferences of the richer west German *Länder*, which would like to mobilise their superior resource base as autonomously as possible and reduce their obligations to weaker *Länder* . The contradictory emphasis on equalisation and the reduction of disparities reflected the preference of the poorer west German *Länder*, whose major concern was to compensate for a weak resource base, at least to some extent at the expense of the richer *Länder* (and if not, presumably with the aid of the federation, with all that would imply for their autonomy). (Jefferies, 2000:771)

On 3 October 1990, the five eastern Länder which had been administered centrally by a socialist government joined the Federal Republic of Germany, adopting its complete legal system, and East Berlin was merged with West Berlin. Even though there had always been disparities between the wealthy and relatively poorer Western Länder, fiscal capacity was much lower in the East due to lower productivity, higher employment, shorter working hours etc. In 1989, per capita GDP was about 2.5 times higher in the Western States than in the ex-communist East (Schneider et al 2001). This would place the existing intergovernmental fiscal system under severe strain.

After the unification, Western *Länder* initially resisted pressure to include the Eastern *Länder* in the equalisation scheme, insisting that the new states first should experience a substantial economic recovery as a precondition for inclusion. In order to buy time for renegotiating the architecture of the IGFR system to achieve a fair distribution of the additional burdens being assumed, the Treaty on Unification stipulated that a new set of

rules was to be put in place no earlier than 1995. Had the existing scheme been extended to the Eastern states without adjustment, all the former beneficiaries of equalisation payments (i.e the "poor" West German states) would have turned into contributors to the scheme.

From 1990-1994, the existing arrangements continued to be applied only the Western *Länder*, and equalisation to the Eastern *Länder* flowed in an ad-hoc manner through a temporary extrabudgetary fund, the German Unity Fund. From 1990-1994, DM 143 billion was channelled through this fund to the Eastern *Länder* as unconditional grants. This Fund was financed from the following sources: the *Bund* contributed roughly DM 50 billion, DM 16 billion came from the Western *Länder* (excluding Bremen and Saarland as noted above), and the remainder was financed through borrowing from capital markets. The *Bund*, *Länder* and local government serviced these loans in equal proportions. Other forms of income support flowing to the Eastern *Länder* included conditional grants by federal government, investment credits of the European Recovery Program (ERP), direct transfers from the west German unemployment insurance scheme and pension funds and direct payments by Western *Länder*.

Spahn and Fottinger (1997:236) note that the VAT shares between the *Bund* and *Länder* were changed from 63/37 to 56/44. They contend that this increases the scope for implicit equalisation at the first level, and reduced West-East transfers at the second phase of equalisation.

One year after unification, the two federal legislative bodies decided to form a Constitutional Commission to formulate proposals for constitutional reform, requiring a two thirds majority in both houses. This was afforded an ideal opportunity to restructure the entire intergovernmental system, possibly creating greater tax and expenditure decentralisation and redefining the system of fiscal equalisation. The Commission could not however agree on a reform and the task of revising the IGFR system was delegated to the *Länder* ministers of Finance. Scheider et al (2001) contend that this delegation strengthened the inertia in the system, given the "customary tendency of the administration to preserve the status quo", and the main interest of each of the *Länder* in their fiscal affairs rather than the county are a whole. The result was a tinkering with the old system, but strengthening various elements of political discretion[77] through supplementary grants rather than formula driven allocations.

> The main conflict line concerning the vertical relation between the federal and the Länder administrations was the distribution of VAT shares. In this respect, the entirety of the states formed a strong coalition against the Bund. The federal ministry of finance had to concede immediately to a higher VAT share of the Länder amounting to about DM 16

[77] Scheider et al (2001:8) point out that the least conflicting way to manage the problem of integrating the new Länder without harming a majority of the old states was "to rely more heavily on bargaining procedures, protecting the basic elements of the established system. In this respect, a fraction of Western states that could expect to be net winners in the future bargaining game due to their extraordinary bargaining powers, together with the 5 new states plus Berlin jointly held a majority of 40 votes in the Bundesrat. Hence, this group of states constituted a 'natural' coalition supportive of an enlargement of discretionary elements in the system of interstate fiscal relations".

> Billions. This was approximately the sum, the old Länder expected to lose by an incorporation of the new states on the first stage of the LFA (Lenk, 1999, p. 170). As a consequence, the largest part of the financial burden of the incorporation of the new Länder into the LFA had been shifted to the Bund (Peffekoven, 1994, p. 306). Yet, the federal government regained its fiscal position to a certain extent by introducing a 'solidarity surcharge' on the income tax, which receipts solely accrued to the Bund. (Scheider et al 2001)

While there was a recognition that change to the system was inevitable, there was very little political appetite for fundamental changes[78]. Interestingly, the debate focussed almost exclusively on the horizontal division, rather than a more penetrating appraisal of the role of government, minimum standards and the vertical division.

In 1993, a "Solidarity pact", agreed to by all the *Länder,* was passed by the national parliament, which restructured the distribution of tax revenues between *Bund*, *Länder*, and local government, and laid the foundations of the inclusion of the new states.

The East German *Länder* were fully integrated into the horizontal equalisation scheme in 1995. The current three stage fiscal equalisation scheme completely reverses the order of initial fiscal capacity. The East German *Länder*, through the federal supplementary grants) actually reach a fiscal capacity above the national average. Since costs in Eastern *Länder* tend to be below their Western counterparts, their effective purchasing power is greater.

In 1995, the *Länder*'s share of VAT was raised from 45% to 52%. As compensation, the *Bund* received a temporary income tax surcharge (*Solidaritätsabgabe*) set to stop in 1998, initially set at 7.5% and later reduced to 6.5%.

Since 1995, greater emphasis has been placed on supplementary grants which 12 of the 16 states now receive. Only North Rhine Westphalia, Bavaria, Baden-Württemberg, and Hamburg do not get these supplementary payments. This increased use of supplementary grants rather than formula-based allocation creates more political discretion into the equalisation process which is influenced more by the bargaining powers of the respective *Länder*.

Under the revised system including the eastern *Länder*, of the six recipient states prior to unification, four--Bremen, Lower Saxony, Rhineland-Palatinate, and the Saarland--continued to receive equalisation payments. Schleswig-Holstein and Hamburg have

[78] Van Houten (1999:20) noted that while public finance and constitutionl experts had mooted greater regional autonomy "politicians, however, did not show much interest in these proposals (Renzsch, 1996). As Häde (1996: 312) stated, with respect to such proposals, "nobody seems to be willing to take the corresponding decisions." Admittedly, the complexity of a comprehensive reform and the urgency to incorporate the new Länder made fundamental reforms very difficult (Renzsch, 1996). However, regional politicians appeared not to be interested in reforms that would imply larger fiscal responsibilities, and focused instead on making sure that their budgets would not decrease. Thus, this was a situation in which "[t]he Länder insist, on the one hand, on a strengthening of federalism; on the other hand, they are not willing to accept the consequences of a weakening of the influence of the central state" (Hummel and Niehaus, 1994: 133)"

switched from recipient to donor *Länder*. The net payers were North Rhine Westphalia, Baden-Württemberg, Bavaria and Hesse, in that order

Figure 1: Fiscal equalisation between the German states (Länderfinanzausgleich) 1994 – 1999 in millions of DM

	1994	1995	1997	1999
Baden-Württemberg	-410	- 2,804	-2,423.0	-3,426
Bavaria	-669	- 2,533	-3,079.4	-3,188
Berlin			4425.2	5,316
Brandenburg	-37	865	975.8	1,147
Bremen	558	562	350.6	665
Hamburg	60	- 118	-263.7	665
Hesse	-1,827	- 2,154	-3,129.7	4,744
Lower Saxony	958	451	672.0	1,037
Mecklenburg- West Pomerania	38	771	834.6	921
North Rhine-Westphalia	158	- 3,442	-3032.6	2,578
Rhineland-Palatinate	657	229	304.6	379
Saarland	434	180	202.9	294
Saxony	- 148	1,763	1,895.8	2,149
Saxony-Anhalt	54	1,123	1162.0	1,300
Schleswig-Holstein	72	- 142	-5.1	174
Thuringia	94	1,017	1110.1	1,218

Source: Hega (2003)

Hega (2003) also notes the fundamental redistribution of tax capacity occurring through the tax and revenue sharing system. Assume the average fiscal capacity of all sixteen German states to be 100 in 1996. Arranging the states from highest to lowest tax capacity pre-equalisation in terms of this index would yield: Hamburg (with a fiscal capacity index of 136), Hesse (132), Bremen, North Rhine Westphalia, Baden-Württemberg (116), Bayern (112). Of the old states, Schleswig-Holstein, Lower Saxony, Rhineland-Palatinate and the Saarland are below average. All the new East German states (including Berlin) are well below average, with Thuringia and Mecklenburg- West Pomerania coming in last. However, this original picture of tax revenue power of the 16 German states is almost completely reversed after the application of the various fiscal equalization measures. Hamburg declines from first to seventh place, North Rhine Westphalia from rang four to twelfth, Bavaria from 6th place to 14th, and Hesse declines from second rank to last.

The equalisation system with tax sharing creates disincentives for rich states to strengthen their tax base, whereas poor states have little incentive to follow sustainable fiscal policies suited to their tax capacities. Their inefficiencies may even, in fact, be rewarded – as the instances of Bremen and Saarland demonstrate. At the same time, because equalisation centres on revenues rather than costs, some of the poorer *Länder* still feel that their allocations are inadequate to cover costs of implementing federal policy. Not surprisingly, this situation has generated considerable political tensions:

> In 1997, the premiers of Bavaria and Baden-Württemberg, Edmund Stoiber and Erwin Teufel, continued to call for the reform of the fiscal equalization scheme. They argued that Bavaria and Baden-Württemberg, the two states with the highest net payments to

> the *Länderfinanzausgleich*, had to cover the costs caused by the "fiscal irresponsibility" of (the mainly social democratically-dominated) small city states and new Eastern states. Teufel threatened to challenge the constitutionality of the fiscal equalization scheme before the Federal Constitutional Court in Karlsruhe. Stoiber went as far as demanding the regionalization of the main federal social insurance fund, the *Sozialversicherung*, arguing that Bavarians were financing the lavish welfare spending of socialdemocratic state governments in other regions; regionalization would thus mean lower payments for Bavarians and higher payments by Schleswig-Holsteiners, properly allocating the costs and benefits of successful versus failed economic policies.

Political divisions between transfer-paying and transfer-receiving Länder have grown more acrimonious, as wealthier *Länder* become more vocal in demanding changes to the IGFR system. In 1998 Bavaria and Baden-Wűrttemberg complained to constitutional court about the effects of the third stage of the horizontal equalisation (i.e. the allocation of supplementary allocations) as the wealthier Western states are usually not in a good bargaining position.

The Court's ruling on the *Finanzausgleich* in 1999[79], although restricted by the framework of the Basic Law itself, has give some support for a fundamental systemic redesign of IGFR and has generated intense debate in Germany:

> The arguments underline "the preservation of the historic individuality" of the states and "a degree of competition among the individual states as secured by the federal principle" (section 213) as well as the "innovation-fostering function of political competition among the states, and vis-à-vis the federation" (section 214). This takes up elements of a more fundamental criticism by competitive federalism theorists.
> The verdict requests the legislator not only to revise the existing law on equalization, but insist on a "law on general standards" *(Maßstäbegesetz*) which is to specify the constitutional principles as to their content that would reign the equalization process (section 277). This law would attain almost constitutional rank, and is supposed to be drafted in the spirit of Rawls' "veil of ignorance" (section 282)—albeit intricate to realize in practice.
> In this vein of thought, the Court has even expressed its unwillingness to tolerate legislation that, in practice, conveys equalization to the sole responsibility of the Bundesrat (section 284). A simple parliamentary majority would not justify equalization at the expense of a minority of states—even though their governments may have actively and positively been involved. It conveys a responsible, balancing, and neutrally appraising role to the federal government, a duty confined by elementary, general, and overarching legal principles.
> (Spahn, 2001: 5)

[79] BverfG, 2 BvF 2/98 of November 11, 1999, Nos 1-347; http://www.bverg.de

Since then another agreement has been reached, but the fundamental issues of unification have still not been addressed.

> In June of 2001, the Bund and Länder agreed to a new equalization law, to take effect in 2005. The basic structure of the old three-stage system remains unchanged, but the wealthy states agreed to the new system because it allows them to keep a larger share of the taxes they collect.23 But the agreement will not reduce the receipts of the relatively poor Länder. This apparent "win-win" scenario was possible because the central government agreed to make up the difference by committing billions of additional DM to the system. In other words, the central government will be replacing some of the horizontal redistribution between the Länder with direct, vertical redistribution from theBund to the Länder, and transfer-dependence among the poorest Länder will only grow. Though many details of the new system remain unresolved—including the possibility of new nation-wide debt restrictions imposed on the Länder—this does not bode well for fiscal performance among the recipient states if current trends continue. (Rodden, 2001:28)

Lack of political will in respect of determining affordable national standards and lack of commitment to fiscal discipline, buttressed by constitutional court interpretations within a constitutional framework which created perverse incentives can lead to macroeconomic balance, even in a country like Germany whose federal government is renown for its fiscal rectitude.

BIBLOGRAPHY

Bednar, J and Eskridge, W (1995) Steadying the court's unsteady path": a theory of judicial enforcement of federalism, California Law Review, 68, 1447-1491)

Bednar, J., Eskridge, W and Ferejohn, J (1996) A Political Theory of Federalism", in Ferejohn, J., Rakove, J and Riley, J (eds) Constitutions and Constitutionalism.

Baybeck, B and Lowry, W. (2000) "Federalism outcomes and ideological preferences: The US Supreme Court and Preemption cases", Publius, 30(3), 73-97

Boudreaux, D. and A.C. Pritchard (1993); Rewriting the Constitution: An Economic Analysis of the Constitutional Amendment Process, Fordham Law Review, 62:111-62.

Broscheid, A (2002) "Appeals Court discretion in separation-of-power games", unpublished paper, http://www.uncp.edu/home/brosch/research.htm

Buchanan, J. and G. Tullock (1962); The Calculus of Consent - Logical Foundations of Constitutional Democracy, Ann Arbor:University of Michigan Press.

Buchanan, J and Wagner, R (1977), Democracy in Deficit: The Political Legacy of Lord Keynes, Academic Press, New York et al. 1977.

Buchanan, J and Wagner, R. (1978), The Political Biases of Keynesian Economics, in Buchanan J and Wagner, R (eds.), Fiscal Responsibility in Constitutional Democracy,Martinus Nijhoff, Leiden/Boston 1978, pp. 79 – 100.

Buchanan, J.M. (2003) Same Players, Different Game: How better rules make better Politics, Freiburg Discussion Papers on Constitutional Economics 03/9, Walter Eucken Institut, Freiburg, Germany

Davis, D (2004) Socio-economic rights in South Africa: the Record after 10 years, unpublished paper

De Figuerdo, R and Weingast, B (2001a) Self-enforcing federalism, http://www.wcfia.harvard.edu/conference/piep/piep11172001/weingast.pdf

De Figuerdo, R and Weingast, B (2001b) Constructing Self-enforcing federalism in the Early United States and Modern Russia, http://www.haas.berkeley.edu/faculty/pdf//defiguerdo.pdf

Ferejohn, J. (2002) "Judicialising politics, politicising law", Law and Contemporary Problems, 65, 41-70

Ferejohn, J. (1998) Dynamics of judicial independence: Independent Judges, Dependent Judiciary, Judicial Independence and Accountability Symposium, University of Southern California, Nov 1998

Hega, G.M. (2003) Between *Reformstau* and *Modernisierung*: The Reform of German Federalism since Unification", Paper presented at the Conference on "Europeanization and integration", EU Centre of the University of Oklahoma, Norman, OK, October 24-25, 2003

Iarycyzower, M, Saiegh, S and Tommasi, M (2000) Coming together: The industrial organization of Federalism, Paper prepares for the 2000 meeting of the Latin Ameican Studies Association, Hyatt Regency, Miami, 16-18 march 2000

Inman, R.P. and Rubinveld, (1997) Rethinking federalism, Journal of Economic Perspectives, 11 (4), 43-64

Jeffery, C (2000) Failing the Challenge of the Unification? The *Länder* and German Federalism in the 1990s, http://www.psa.ac.uk/cps/1994/jeff1.pdf

Kirchgassmer, G (2001) "The effects of fiscal institutions on Public Finance, A Survey of the Empirical Evidence", Discussion Paper no 2001-15, Department of Economics, University of St Gallen.

Landes, W. and R. Posner (1975); The Independent Judiciary in an Interest-Group Perspective, The Journal of Law and Economics, 18(3):875-911.

Montinola,G, Qian Y, And Weingast, B (1995) Federalism, Chinese style: The political basis for economic success in China, World Pol vol 48, 50

Qian, Yingyi, and Barry Weingast (1997) "Federalism as a Commitment to Preserving Market Incentives." Journal of Economic Perspectives 11 (4): 83-92.

Parikh, S and Weingast, B (1997) A comparative theory of Federalism: India – A Respsonse, Virgina Law Review, 83 1593-1615

Pieterse, M (2004) Coming to terms with judicial enforcement of social rights, South African Journal on Human Rights Conference, 5-7 July 2004

Ramseyer, M. (1994); The Puzzling (In)dependence of Courts: A Comparative Approach, Journal of Legal Studies, 23(2): 721-47.

Riker, W.H. (1964) Federalism: origins, Operations and Significance, Little, Brown, Boston

Rodden, J (2001) And the Last shall be First: Federalism and Fiscal Outcomes in Germany, Unpublished paper prepared for a presentation at Harvard University.

Roux, T (2004) Legitimating Transformation: Political Resource Allocation in the South African Constitutional Court

Sachs, A (1992) Advancing Human Rights in South Africa, Oxford University Press, Cape Town

SAHRC (2003) Fourth Economic and Social Rights Report, South African Human Rights Commission, April 2000 – March 2002, Pretoria

SAHRC (2004a) "The Right of Access to Adequate Housing", Fifth Economic and Social Rights Report Series, South African Human Rights Commission, 2002/03, Pretoria

SAHRC (2004b) "The Right of to Food", Fifth Economic and Social Rights Report Series, South African Human Rights Commission, 2002/03, Pretoria

SAHRC (2004c) "The Right to Education", Fifth Economic and Social Rights Report Series, South African Human Rights Commission, 2002/03, Pretoria

SAHRC (2004d) "The Right to Health Care", Fifth Economic and Social Rights Report Series, South African Human Rights Commission, 2002/03, Pretoria

Schneider, F., Pitlik, H., and Strotmann, H. (2001) On the politicisation of Intergovernmental Fiscal Relations in Germany after Unification", Department of Economics, Johannes Kepler University, Working Paper 105, March 2001

Spahn, P.B and Fottinger, W. (1997) "Germany". In Ter-Minassian, T. (ed) Fiscal Federalism in Theory and Practice, IMF, Washington DC

Spahn, P.B and Franz, O. (2000) Consensus Democracy and Interjurisdictional Fiscal Solidarity in Germany, 4 November 2000

Spahn, P.B. (2001) Maintaining fiscal equilibrium in a federation: Germany

Trounin, I., Zolotareva. A, Sinelnikov, S., Dneprovskaya, S, Tchetverikov, S, Watts, R, Hobson, P, Vigneault, M. and Boadway, R. (2001) Fiscal Federalism in Russia: Problems, Theory, Experiences, Institute for the Economy in Transition, Moscow, http://www.iet.ru/special/cepra/federalizm/

Voight, S (1999) Explaining constitutional change: A positive economics approach, Elgar, Cheltenham

Von Hagen, J (1991), A Note on the Empirical Effectiveness of Formal Fiscal Restraints, Journal of Public Economics 44 (1991), pp. 99 – 110.

Von Hagen, J (1992), Fiscal Arrangements in a Monetary Union: Evidence from the U.S., in: D. Fair and De Boissieu, CH (eds.), Fiscal Policy, Taxes, and the Financial System in an Increasingly Integrated Europe, Kluwer, Deventer 1992.

Von Hagen, J (1992a), Budgetary Procedures and Fiscal Performance in the European Communities. Economic Papers, Commission of the European Communities, Economic Papers No. 96, October 1992.

Von Hagen, J., Bordignon, M., Dahlberg, M., Grewal, B., Petterson, P. and Seitz, H (2000) Subnational Government Bailouts in OECD Countries: Four case studies, Research Network Paper #R-399, Inter-American Development Bank, Washington

Weingast, Barry (1995) "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development." Journal of Law, Economics, and Organization 11 (1): 1-31.